

**SHADOW OPEN MARKET COMMITTEE  
(SOMC)**

**Policy Statement and Position Papers**

**March 8-9, 1992**

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## SHADOW OPEN MARKET COMMITTEE

The Shadow Open Market Committee met on Sunday, March 8, 1992 from 2:00 PM to 6:00 PM in Washington, D.C.

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## SOMC POLICY STATEMENT SUMMARY

Washington, March 9—The Shadow Open Market Committee today called on the Administration and Congress to "take actions that will maximize the durability and sustainability of the expansion with declining inflation."

In a policy statement, the Shadow Committee, a group of academic and business economists who regularly comment on economic issues, recommended the following actions:

*First*, the Federal Reserve should reduce the growth of the monetary base to a range of 5 to 6 percent. Even if this move leads to a temporary rise in short-term interest rates, it would establish a foundation for sustainable growth and lower rates in the future.

*Second*, the Administration and Congress should limit the growth of mandatory federal spending (excluding net interest) to the sum of the rate of inflation and the growth rate of the population. Such action would reduce federal spending by \$390 billion over the next five years. President Bush should withdraw his proposed changes in fiscal policy on March 20 if, as we hope, Congress fails to enact them into law by that date.

*Third*, Senator Paul Sarbanes and Representative Lee Hamilton should withdraw their proposal to remove the presidents of the Federal Reserve banks from the Federal Open Market Committee. This proposal is a shameful assault on the independence of the central bank.

*Fourth*, Congress should move with deliberate speed to deal with structural problems in the banking system.

*Fifth*, the U.S. should reject proposals to provide large sums to stabilize the currency of the former Soviet Union. Such aid, if provided, would be ineffective and would waste scarce resources in donor nations.

The Shadow Open Market Committee meets in March and September. It was founded in 1973 by Professor Allan H. Meltzer of Carnegie Mellon University and the late Professor Karl Brunner of the University of Rochester.

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In its statement, the SOMC warned that "Rapid money growth has raised fears of future inflation which, in turn, has played a role in the recent rise of long-term rates. The longer rapid money growth continues, the more rates will eventually rise and the shorter will be the current economic expansion."

The Committee said that faster rates of growth require changes in tax law. "Productivity will increase if tax changes (1) favor growth instead of redistribution, (2) favor long-term instead of short-term improvements and (3) eliminate the bias that currently favors consumption over investment and saving . . . It is irresponsible to propose credits for home purchases, reduced withholding taxes, or increased family allowances as solutions to the long-term problems of middle-class voters and taxpayers."

**SHADOW OPEN MARKET COMMITTEE**  
**Policy Statement**  
**March 9, 1992**

Contrary to popular perceptions, the economy has expanded since spring 1991, albeit at a mild 1.3 percent pace. The rate of recovery accelerated in January and February. We expect the pace of the rebound to pick up through the year. The primary objective of economy policy makers now should be to take actions that will maximize the durability and sustainability of this expansion with declining inflation. To accomplish this goal, we recommend the following actions:

*First*, the Federal Reserve should reduce the growth of the monetary base to a range of 5 to 6 percent. Even if this move leads to a temporary rise in short-term interest rates, it would establish a foundation for sustainable growth.

*Second*, the Administration and Congress should limit the growth of mandatory federal spending excluding net interest to the sum of the rate of inflation and the growth rate of the population. Such action would reduce federal spending by \$390 billion over the next five years. President Bush should withdraw his proposed changes in fiscal policy on March 20, if, as we hope, Congress fails to enact them into law by that date.

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## The Outlook for the Economy

Although the 1.6 percent decline in real GDP in 1990-91 was mild, the economy has languished since spring 1989. This reflects the lengthy period of slow money growth from 1987 through mid-1991. In addition to the cyclical slowdown, significant structural shifts have altered the mix of economic output and generated large declines in industries that attract public attention. While exports have continued to grow robustly, some domestic industries have contracted. Firms have cut costs and restructured their operations. Restructuring, while painful in the short run, should yield sizeable, permanent gains in productivity.

The cyclical recovery since last spring has been muted by declining defense spending. Federal defense expenditures went from a 14 percent annual rate of increase in the two quarters ending in March 1991 to an 8.5 percent annual rate of decline in the last three quarters. The pace of decline in defense spending increased as the year progressed, reaching a 13.6 percent annual rate in fourth quarter 1991.

The decline in defense spending helps to explain in part the sluggish recovery and some of the differences between the states. Several of the states with the largest increases in unemployment—Massachusetts, California, New Hampshire, Connecticut, and Missouri, for example—are states that relied most heavily on defense procurement (see Figure).

## Monetary Policy

We have often criticized Federal Reserve policy makers for knowing only two speeds for money growth—too slow and too fast. In the late 1980s, central bank officials appeared to have learned from past mistakes. Since mid-1991, they have forgotten these lessons.

Monetary expansion is now too rapid. Growth of bank reserves, monetary base and money—currency plus checkable deposits—was between 8 and 9 percent in 1991. These growth rates increased markedly in the first two months of 1992.

Rapid money growth has raised fears of future inflation which, in turn, has played a role in the recent rise of long-term rates. The longer rapid money growth continues, the more rates will eventually rise and the shorter will be the current economic expansion.

Recent Federal Reserve statements to Congress send two messages. The first says that there is now sufficient monetary stimulus for the recovery to proceed at a more rapid pace. The second says that faster money growth will be provided so that the Federal Reserve cannot be blamed for the electoral defeat of the President or current members of Congress.

Many observers urge the Fed to seek faster money growth by forcing short-term rates to lower levels. We reject this advice. One popular reason for advocating easier money is that the growth of broad measures of money—M2 particularly—was near the lower bound of the Federal Reserve's target in 1991. While M2 has accelerated recently, the growth of this aggregate remains moderate. We believe that the reported growth rate of M2 understates current monetary stimulus.

The slow growth reflects declines in only one component of M2—small time deposits. These deposits are term deposits. The holder pays a penalty for early withdrawal. As the deposits made in earlier years become available for withdrawal without penalty, holders are reluctant to renew them at current rates of interest.

This behavior is entirely consistent with other observed behavior such as the rush to refinance home mortgages and the funding of corporate debt. Each of these actions suggests that the public believes that short-term interest rates will not fall further. When interest rates rise, the spread between short- and long-term rates should close, and the shift out of small time deposits should reverse.

Efforts to boost M2 growth to a 6 percent annual rate (as some have suggested) would produce two unfortunate results that would threaten the durability of the expansion. *First*, inflation will rise, not immediately but more likely in 1993. The nation paid a high price to lower inflation—particularly the slow average economic growth of the past three years. We must not waste these efforts.

*Second*, current policy is a return to stop and go. At some point, money growth will have to slow to reduce inflation. Slowing money growth often produces a wrenching adjustment, particularly when high money growth has been maintained too long.

The shift to slower money growth causes slower growth of output or a new recession. We urge the Federal Reserve to begin now to slow the growth of the monetary base from the current 8 percent annual rate to a 5 to 6 percent range, even at the cost of a temporary rise in short-term interest rates.

We believe that 5 to 6 percent base growth will provide sufficient monetary stimulus for a durable expansion. Stable monetary policy can contribute to stable growth and stable prices. Money growth that is consistent with low inflation will increase economic efficiency.



Also, under current law, depreciation and capital gains are not indexed for inflation. Inflation, therefore, taxes capital. This has slowed the expansion of capital intensive industries. Price stability ends this tax on capital, thereby strengthening the industrial sector.

## **Fiscal Policy**

The Administrations' tax and transfer program and its rebuttal from Congressional Democrats call for short-term stimulus and income redistribution. These proposals will not meet their immediate objectives and divert attention from meaningful reform. Congress should reject these proposals. President Bush should withdraw his proposed changes in fiscal policy on March 20, if, as we recommend, Congress fails to enact them into law.

Faster rates of economic growth, higher productivity and improved standards of living require changes in tax law. Since the early 1970s real wages, real compensation and real income have grown slowly, reflecting the sluggish growth of labor productivity.

Short-term tax changes that increase spending cannot solve the problem of lagging productivity growth. It is irresponsible to propose credits for home purchases, reduced withholding taxes, or increased family allowances as solutions to the long-term problems of middle class voters and taxpayers.

Middle class and other incomes can be increased permanently only by increasing productivity. Taxing upper-income groups to benefit middle-income groups will neither restore prosperity nor promote long-term growth. Tax changes that encourage productivity will raise standards of living and improve our ability to produce high value-added products.

Productivity will increase if tax changes (1) favor growth instead of redistribution, (2) favor long-term instead of short-term improvements and (3) eliminate the bias that currently favors consumption over investment and saving. If a tax policy meeting these criteria cannot be adopted in an election year, the best course would be to defer action.

Last fall, the Treasury released a study on integration of personal and corporate taxes that highlighted the double (sometimes triple) taxation of income from capital. This study focused attention on the bias in the current tax system against investment, productivity and growth.

The study pointed out that the U.S. lags behind its trading partners in the treatment of taxes on capital. The President should endorse a proposal to deal with the problems described in the Treasury analysis.

In his annual message, the Director of the Office and Management and Budget (OMB) called attention to the growth of spending for so-called mandatory programs. Such outlays amount to \$767 billion, excluding net interest. They make up more than half of total spending and are likely to increase by more than 7 percent a year for the next five years and beyond.

OMB noted that if these programs were constrained to grow at the rate of growth of population plus the rate of inflation, the saving over five years would be \$390 billion. This would lower the budget deficit and, most importantly, encourage a shift of resources toward investment.

We urge the Administration and the Congress to limit the growth of mandated benefits to encourage growth and productivity by shifting resources from consumption to investment. Cutting defense spending is not a substitute for reforming non-means-tested entitlement programs.

### **Reform of the Financial System**

Congress has failed to act on the Treasury's 1991 proposals to improve the stability and efficiency of our financial system. The weaknesses in the financial system persist. Timely reforms are required to prevent another debacle similar in magnitude to the S&L crisis. Present law allows the Administration to make needed changes while Congress debates more basic actions.

The regulatory agencies should repudiate their "too big to fail" policy. The Fed should (1) amend its Regulation A to eliminate its extended credit facility, (2) reduce required reserve ratios on net transactions deposits to the legislated minimum of 8 percent, and (3) request legislation to authorize reserve requirements as low as zero.

Such administrative changes would eliminate the subsidization of large bank profits resulting from the exemption of *de facto* insured deposit liabilities from Federal deposit insurance premiums. These changes would reduce the discriminatory taxation of depository institutions relative to other types of intermediaries.

### **The Sarbanes-Hamilton Proposal**

Senator Paul Sarbanes and Representative Lee Hamilton have proposed removing Reserve Bank presidents from the Federal Open Market Committee (FOMC). This proposal is shameful; it is a direct assault on the independence of the monetary authority.

The proposal seeks to remove the influence of those members of the committee who have been among the most outspoken proponents of price stability and higher growth. Since depreciation is not indexed for inflation, as noted earlier, higher inflation is a tax on capital that reduces the capital stock and lowers productivity growth.

The Sarbanes-Hamilton proposal may never become law, but it is damaging nevertheless. It increases doubts about the commitment of the federal government to long-term price stability, and it pressures the Federal Reserve to pursue inflationary policies. We urge the sponsors to withdraw their proposal.

### **International Trade**

Public perceptions are incorrect: The U.S. is the largest exporter in the world. Real exports have grown at a compound rate of more than 10 percent over the past six years. In real terms, the U.S. trade deficits has declined from over \$155 billion in 1986 to just \$20 billion in 1991. Continuation of this trend will result in a trade surplus in the near future. The U.S. has clearly achieved a dramatic improvement in its international competitiveness.

Recent calls for increased protectionist policies in response to America's bilateral trade deficit with Japan are dangerous and misguided. Currency market intervention to prevent a decline in the yen makes no sense. Current disputes with Canada over the domestic content of automobiles and lumber subsidies threaten to scuttle the free trade agreement at great cost to the U.S. economy. The Administration should, instead, continue to pressure governments in Europe and Japan to complete the Uruguay Round of Trade negotiations.

### **Aiding Russia and Other Former Soviet Republics**

The Administration may soon propose financial aid to Russia and other former Soviet republics. Proponents of aid raise fears of a return to totalitarianism or military adventurism to make their case. Some urge a five-year commitment of \$30 billion per year of which the U.S. would contribute as much as \$5 to \$6 billion annually.

We in the West cannot determine the fate of the Soviet peoples. Grants of \$30 billion would provide about \$100 for each former Soviet citizen. The survival of democracy and freedom will not be ensured by this, or any other, sum. The fate of Soviet citizens must depend on their decisions and actions, not ours.

Calls for a new Marshall Plan suggest that we should give the former Soviets the type of support we gave to western Europe in the early postwar years. This, too, would be a mistake. The Marshall Plan provided capital to market economies in which competition was the norm. All of these economies had legal, financial and accounting systems, property rights and enforceable contracts.

None of these institutions is present in the former Soviet republics. Economic development cannot be expected until these economies introduce private property and the institutions that permit markets to function effectively and honor and enforce contracts. Freeing prices is not enough. Nor can the former Soviets' problems be solved by grants or loans to stabilize the ruble.

A popular argument presents these loans as costless because we give the Russians paper dollars that the Russian state bank would hold as backing for the ruble. If the plan works, the ruble will be convertible at a stable value, and the dollars will not be spent. If the plan fails, as many have in Latin America and Africa, the grants will be dissipated. A safe thing for Russians to do is hold dollars instead of rubles. The dollars we lend or give would quickly disappear from the central bank.

This would be certain to happen if Russia fails to close its enormous budget deficit. The deficit is currently financed by printing rubles as fast as the presses can run. Inflation is rampant, and lifetime savings are destroyed.

Dollars we give are a claim against U.S. wealth. If the International Monetary Fund (IMF) advances the dollars, the only difference to U.S. taxpayers is that they will share the cost with other countries. The U.S. has the largest share. The advance would be paid from the money American taxpayers have given to the IMF. The IMF would soon ask for more money. As always in the past, our government would make our taxpayers contribute.

There are better ways to help the Russian economy. *First*, we should remove all tariff and non-tariff barriers to trade and urge the Europeans to do the same. If Eastern Europe can sell goods, including food, to Western Europe and the U.S., they will earn hard currency to pay for Russian oil, coal and minerals. The Russians will earn foreign exchange which they can use to stabilize and develop their economy.

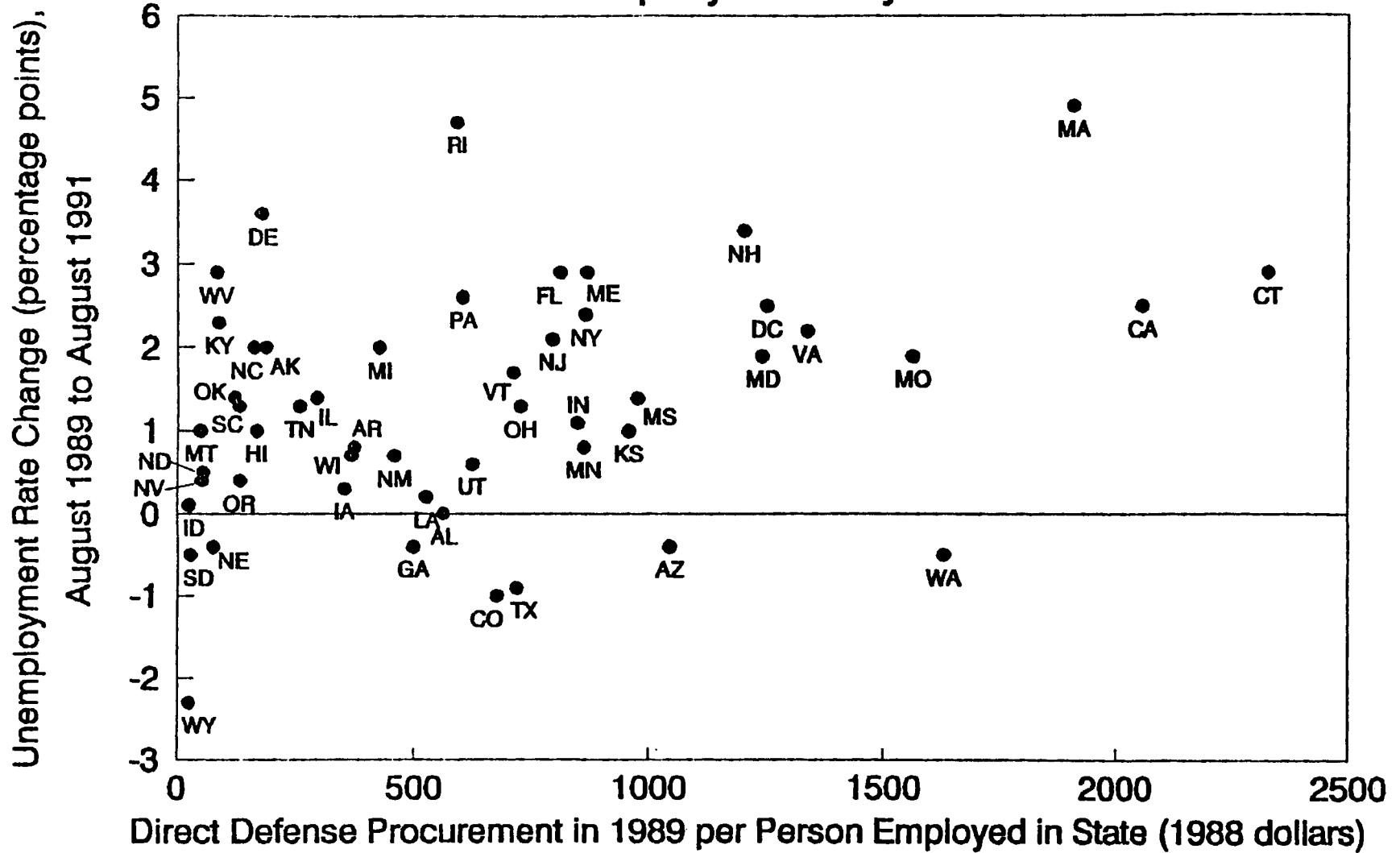
*Second*, Russia is rich in mineral resources. It lacks management skills and technology to exploit many of these resources. These will not come from government-to-government loans or the IMF. The most effective way to develop the Russian economy is to let foreign investors buy participations in assets. The new owners will bring technology and management skills. But not much will happen until the Russians establish the institutions and economic structure which permit markets to function efficiently.

Russia has decontrolled many prices. This was an important step; it took courage to make it. But it is not enough. With the present budget deficit and no clear rules for ownership and contract, the economy will at best limp ahead. Foreign aid will be wasted.

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The mark of successful reform will be a flow of private capital to Russia and its neighbors. Private capital from loans or asset sales can be used to stabilize the ruble and, if the budget is balanced, bring down inflation and put the economy on a positive, sustainable growth path. Protecting U.S. taxpayers' interests will do more to help the Russians than the well-intentioned schemes now on their way.

# Direct Defense Procurement Purchases and Unemployment by State



Source: Department of Defense and Bureau of Labor Statistics

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## **STRUCTURAL SHIFTS AMID A CYCLICAL FLUCTUATION: A TRICKY ENVIRONMENT FOR COUNTERCYCLICAL MACROECONOMIC POLICIES**

**Mickey D. LEVY**  
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The cyclical aspects of recent economic performance are well-known and disappointing: after falling 1.6 percent from third quarter 1990 through first quarter 1991, real GDP has risen very gradually for three quarters and, aided by the recent monetary easing, the economy is mounting a stronger recovery from recession. However, this cyclical fluctuation masks deeper, structural shifts in demand and supply that began before the recession took hold and will continue to distinguish themselves well beyond the recovery. These non-cyclical adjustments, which underlie the uniqueness of this cycle, are generating a significantly different pattern of output. Economic policy makers, however, seem unable to discern these shifts and non-cyclical adjustments from previous cyclical fluctuations, and so they continue to pursue traditional countercyclical macroeconomic policies. Such policies would produce phantom, short-term gains for consumers and businesses at the expense of sustainable long-term increases in living standards, and only postpone needed economic reforms.

- Recessionary conditions merged in Spring 1989, more than a year before real GDP began to decline, and those conditions have persisted for nearly three years. This elongated period of subdued economic activity is attributable both to the cyclical slowdown in aggregate demand generated by the Fed's gradualist monetary policy—despite the significant decline in short-term interest rates since Spring 1989, money supply growth was stingy from 1987 through most of 1991—and to ongoing structural shifts in the economy. These structural shifts, which involve shifts in certain production processes and changes in sectoral demand in response to changing relative prices and government incentives, have been as important as the cyclical slump in shaping economic performance.
- The resulting significant shifts in the shares of GDP have generated highly variable economic performance across industries and regions. Exports have continued to rise as a share of GDP, while the shares of investment in residential housing and business structures, consumption of durable and non-durable goods, and federal defense purchases have receded. Associated with this uneven pattern,



the Midwest has outperformed the national economy and its banks have generally remained sound, in sharp contrast with the declining economies and widespread banking problems on the eastern seaboard.

- With the recent aggressive monetary easing, real GDP is projected to accelerate gradually to 2-3 percent in the second half of 1992 and slightly over 3 percent in 1993, while inflation is projected to recede gradually in the next year. However, uneven performance will persist as healthier aggregate economic growth unfolds. Accordingly, certain industries will continue to consolidate, and certain regions will continue to struggle with recovery.
- In light of the nature of these non-cyclical adjustments, traditional countercyclical macroeconomic policy prescriptions that attempt to manage aggregate demand may be ineffective, inappropriate, and counterproductive. Excessive stimulus may raise short-term activity, but it does not lift productivity or long-run growth, and only weakens the durability of the expansion.

### Cyclical Slump and Shifting Mix

Although the 1.6 percent decline in real GDP was far less than the average 2.5 percent decline in the previous eight recessions, aggregate declines in selected variables have been in line with recent recessions episodes. A number of *recessionary-type conditions* have gripped the economy and financial markets for nearly three years: markedly weaker product demand in domestic industries; squeezed profit margins and declining corporate profits; business efforts to reduce operating costs, including payroll layoffs and inventory control; declining real estate activity and prices; deterioration in credit quality, rising bankruptcies and sharp increases in bank loan loss reserves; and declining short-term interest rates.

Meanwhile, amid this elongated slump in the aggregate economy, performance has continued to be very uneven by industry and by region. Since first quarter 1989, real exports have risen 25 percent, compared to 1.2 percent in real GDP. While the slumping auto industry has received the most attention, exports of capital goods, excluding autos, have risen 37 percent and exports of consumers goods are up 27 percent. As a consequence, the changing mix of GDP that began in mid-1985 has continued. Exports, which had fallen to 7.1 percent of GDP, have rebounded to 11.6 percent. Real consumption of durable and non-durable goods has fallen since early 1989, and has declined as a share of GDP. New construction—both residential and business structures—has fallen sharply in real terms and as a share of output, while federal defense purchases have also receded by both measures. At the same time, businesses have reduced inventories relative to sales and national output.

In light of this unevenness, it is no wonder that the real estate and retail trade industries have incurred the bulk of the bankruptcies in the non-financial sector. Nor is it surprising that the anecdotal evidence supporting the allegation of a credit crunch is largely concentrated in these underperforming industries; clearly the supply of credit is being reallocated from declining to rising industries, and the unevenness of performance is accentuating the reallocation. The banking industry, whose portfolios were overweighted in assets of underperforming industries (particularly real estate) and has been suffering from slumping loan demand, has experienced huge losses and must deal with its excess capacity through restructuring and consolidation.

The unevenness by industrial sector has had a direct bearing on performance in different geographic regions. The eastern seaboard, particularly the New York and New England areas, has experienced economic hardship and significant readjustment because of its heavy reliance on the weakest industries—financial services, retail trade and real estate. This is also the region that has been the most severely affected by the stingy bank lending environment. The cutbacks in bank lending has occurred primarily as a *consequence* of declining loan demand and deteriorating economic performance and credit quality, rather than a cause of these conditions. The Midwest, with its heavy reliance on export-related manufacturers, has significantly outperformed the national averages; depository institutions have remained stronger, and bank credit generally has been more readily available. Within that region, areas relying on domestic automobile production have suffered, while certain other manufacturing centers have actually registered employment gains and very few businesses bankruptcies. The Northwest has continued to outperform, with its strong manufacturing and agricultural bases. California has been suffering from declining real estate activity and prices. Contraction of the federal defense industry is having its largest negative impacts on the economies in states that receive the highest per capita defense contracts including California, Massachusetts, Connecticut, Florida, Virginia and Texas.

### **Non-cyclical Economic Adjustments**

This shifting mix of GDP has occurred both independently and as part of the cyclical slump. It has involved both a change in the mix of aggregate demand—that is, a change in the types of goods and services demanded—and a shift in aggregate supply—that is, a change in certain production processes. These changes have occurred in response to changes in relative prices and/or government policies that have encouraged or discouraged certain types of economic activity, as well as rapidly changing technologies and demographics:

- The five-year surge in *exports* (10.5 percent average annualized growth) reflects the lower U.S. dollar; the restructuring of production processes by U.S. manufacturers, including cuts in operating costs that have significantly increased productivity and lowered unit labor costs relative to foreign competitors; and the increased international demand for certain U.S. exports, particularly capital goods, industrial materials and manufactured consumer goods.
- Investment in *residential real estate* reached a peak in 1986 and began slumping well before the cyclical downturn. The declines in real estate activity and prices reflect gradually slower new family formation and the earlier reduction in the tax advantages of home ownership and investment in multifamily dwellings, as well as the sluggish economy.
- *Business investment in structures*, which peaked in 1985 has fallen sharply, as have real estate prices, partly in response to the significant oversupply generated by the earlier tax advantages to build, and more recently by the subdued demand for office space as financial and business service industries restructure and consolidate.
- *Consumption of durable and non-durable* goods has been sluggish—and has declined as a share of GDP—as the earlier tax advantages of debt-financed consumption (the deductibility of sales taxes and personal interest expenses) have been eliminated, and high levels of indebtedness as well as declining real estate values and demographic trends have dampened propensities to consume.
- Businesses have reduced their *desired level of inventories* partly as an effort to reduce operating costs and partly due to rapidly evolving inventory control technology. As a result, certain production processes have been altered.
- *Federal defense purchases* have declined in real terms since 1988. As a result of the end of the cold war this trend is expected to accelerate. Although state and local government purchases have risen, total government purchases have been flat in real terms and receding as a share of total output.

While it is difficult to quantify the distinction between cyclical characteristics in the economy and non-cyclical adjustments, much of what has been occurring has been non-cyclical. Typically, excesses that emerge during expansions, fueled by stimulative macroeconomic policies (particularly accommodative monetary policy), are eliminated during recessions by shifts toward restrictive policies that squeeze aggregate demand. In contrast, many recent adjustments in the economy have been in response to non-cyclical factors that change incentives and relative financial advantages of certain types of activity, including tax policy, demographics, and exchange rates and international economic trends.

Businesses have been actively restructuring their production processes throughout the 1980s, and efforts have intensified since 1988. Attempts to cut operating costs have involved a permanent reduction in the desired level of inventories, reduced payrolls in response to the high costs of labor relative to capital, plant closings, and more investment in productivity-enhancing computer

equipment. While the cyclical downturn certainly has contributed to the weakness in the industries involved, the declines in product demand and profit squeeze that forced many of the recently announced restructurings unfolded well before the recession—in fact, it is unfortunate that many of the announced restructurings were delayed until the recession (witness General Motors). Throughout the 1980s, these restructurings generated significant productivity gains in manufacturing (2.6 percent annualized rise from 1980-1990 and 2.9 percent during 1983-1990), lifting the competitiveness of U.S. exporters. More recently, the restructuring has spread to wholesale and retail trade (both department stores and autos), real estate, banking, finance, business services and other service industries like airlines.

Also, in the foreseeable future, the reductions in defense spending will transfer some of the nations' most productive resources to private uses. This reallocative process will alter the mix of demand for goods and services and have a significant impact on production processes and productivity in the private sector. In the near term, however, it will have a dampening impact.

These non-cyclical adjustments have generated the impression that the cyclical downturn was much more severe than the actual statistics indicate. Many of these trends will supersede the cyclical downturn and will significantly influence performance as the economy rebounds. Moreover, while most attention focuses on the pain and short-run implications of these non-cyclical adjustments, they form the bases for long-run productivity gains.

### **Foundations for Economic Growth**

Contrary to popular impressions, the aggregate economy has stabilized and has been expanding ever-so-gradually since second quarter 1991. Given the widespread restructuring, what has lifted the economy? Exports have risen dramatically at a 14 percent annualized rate. Businesses have increased investment spending on producer durable goods, more than offsetting declining investment in structures. The bulk of this investment has been in information processing and related equipment, while investment in transportation equipment has declined. The level of inventories has stabilized following sharp decline during the cyclical downturn; the shift from inventory liquidation in the first half of 1991 to stability in the second half contributed positively to real GDP growth. Investment in residential housing has begun to grow. Personal consumption expenditures, which recovered immediately following their sharp decline in early 1991, but slumped again in fourth quarter 1991, have shown renewed signs of life.

The economy has been effectively chopping across an elongated trough. Real GDP is projected to grow at a very modest 1-2 percent annualized rate in the first half of 1992, accelerate to the 2-3 percent range in the second half and 3 percent plus in 1993. However, the recent unevenness of performance will persist, as strong growth in exports and producer durable goods equipment, and a modest pickup in housing are expected to lead the recovery. In contrast to recent recoveries, demand for consumer goods, including automobiles, will remain sluggish. Also lagging behind will be business investment in structures, banking and business services, and national defense-related industries. In other words, continued restructuring and selective downsizing is expected. The lack of full participation of every industry in the recovery will continue to support negative impressions about the economy.

*The Federal Reserve has more than sufficiently eased monetary policy to accommodate an acceleration in nominal GDP and real growth; lack of liquidity is not a factor that is inhibiting sustained economic expansion.* Bank reserve growth has been rapid and is accelerating: 10 percent year-over-year; 16 percent annualized in the last six months and 21 percent in the last three months. Rates of growth in the monetary base and M1 have risen sharply in response to the Fed easing: 12 percent and 9 percent, respectively, in the last six months. Growth rates in the broader monetary aggregates have lagged behind. Six month annualized growth in M2 and M3 has been 3 percent and 1 percent, respectively. This divergence reflects the shift of non-M1 components of M2 (particularly small time deposits) into M1 transaction deposits, plus bank purchases of U.S. Treasury debt, while private loan demand continues to decline. These portfolio adjustments change the composition of financial assets, but they do *not* alter the fact that the Fed has pumped up both currency and bank reserves, and is maintaining a policy of monetary accommodation. In the last three months, M2 growth has accelerated significantly to an approximate 4 percent annualized pace, and the gap between growth rates of M1 and M2 has narrowed.

The increased liquidity provided by monetary accommodation is a necessary but not a sufficient condition for increased short-run spending. Recently, the confluence of non-cyclical adjustments and structural shifts in many sectors have inhibited the growth of spending. Consequently, the Fed's infusion of bank reserves has had the effect of pumping up prices of certain financial assets. Yet, as these non-cyclical adjustments continue, certain factors create the basis for a stronger economic rebounds. The lower interest rates ease household and business debt burdens, raise real discretionary income and corporate cash flows, and lower the cost of debt-

financed spending; they help stabilize the market values of real estate and improve the quality of bank assets; and will gradually lift aggregate demand. With business inventories low, any pickup in product demand will elicit expanding production.

Exports are projected to grow approximately 6-9 percent per year in 1992-1993, despite economic weakness overseas, providing a major source of product demand. The need to rebuild infrastructure in Germany and throughout Europe, even as consumption and domestic demand in certain European nations subsides, raises the demand for U.S. capital goods, industrial materials, and electronic equipment. In the Asia Pacific nations, a major market for U.S. exports, economic growth continues to outpace the industrialized world, and selected Latin American countries continue their strong turnaround (Mexico leads the pack, with Chile, Brazil and Argentina not far behind), stimulating rapid growth in trade with the U.S.

Business investment in producer durable equipment will continue to rise as firms strive to increase productivity. Investment in equipment is forecast to rise rapidly, but total growth in business fixed investments will be suppressed by continued weakness in business investment in structures. Meanwhile, the rebound in employment, which typically lags the cycle, may be slower than usual, as businesses that are expanding continue to focus on controlling operating costs, while businesses that face further consolidation will shed excess human capital.

Given these foundations, a gradual recovery is unfolding, despite only modest participation by domestic consumers. Real consumption is projected to grow slower than real GDP, reflecting subdued growth in employment and real disposable income, and continued efforts by households to restructure their balance sheets.

U.S. trade deficit will fall further, as exports grow strongly while imports are muted by the slow rebound in consumption. The real trade deficit has shrunk from a peak of \$164 billion in third quarter 1986 to \$18 billion in fourth quarter 1991. Absent misguided efforts to stimulate short-term domestic consumption, the ongoing shift in the mix of output is projected to generate a trade surplus by 1993.

The sustainability of the expansion depends crucially on the avoidance of macroeconomic policy mistakes and government efforts to disrupt either the adjustment of relative prices (i.e. real wages, interest rates, exchange rates) or free functioning of the goods sector. Persistent excessive monetary easing that generates undesired rapid growth in nominal GDP and inflation pressures would require a monetary tightening that would jar economic expansion. The recent rapid growth

in bank reserves and the narrow monetary aggregates would be dangerous if sustained; although inflation is projected to recede gradually in 1992, the continued rapid monthly growth would eventually be inflationary and economically disruptive.

The Federal Reserve must recognize that the cyclical weakness in aggregate demand has been relatively mild, requiring only mildly stimulative countercyclical policy. Aggressive monetary easing that attempts to overcome what in reality have been structural and non-cyclical adjustments would be a mistake, generating a temporary boost to the economy that weakens the durability of the expansion. At issue is whether the Fed will take the politically unpopular step to lift the funds rate and slow money growth even when inflation seems under control. This may prove difficult during the election season.

In addition to low inflation, the ongoing adjustments of relative prices, without government interruptions, are also a necessary ingredient to sustained economic expansion. Foreign exchange intervention and attempts to manage the U.S. dollar are disruptive, may directly or indirectly lead to policies that inhibit international trade, or may be inconsistent with domestic policy objectives. Similarly, attempts to offset other private sector price adjustments (real wages), or to otherwise mitigate the impact of non-cyclical adjustments on certain sectors, reduces economic performance. Also, attempts to provide fiscal stimulus may also threaten the durability of the expansion by temporarily shifting the timing and mix of aggregate demand growth and/or indirectly eliciting undesired monetary policy.

### **Financial Market Implications**

Short-term rates have bounced off their lows, the yield curve has begun to flatten, and the U.S. dollar has begun to appreciate in anticipation of a sustained rebound in U.S. economic activity. Prices of certain commodities such as lumber and copper have risen sharply, and the sizeable stock market rotation from growth stocks to cyclical stocks is similarly anticipating rebound in economic activity and profits.

The previous inflection point in interest and exchange rates occurred in Spring 1989, the last time economic performance shifted gears. Short-term interest rates and the U.S. dollar peaked and the yield curve achieved its most inverted point coincident with the last quarter of 4 percent plus real GDP growth. As economic performance deteriorated into recession, short-term interest rates fell more than one half (the federal funds rate declined from 9 7/8 percent to 4 percent), long-term

rates receded from 9.3 percent to 7.8 percent and the yield curve shifted to sharply positive, and the trade-weighted U.S. dollar fell 11 percent, despite mounting economic weakness in most industrialized nations.

The magnitude of the changes in interest rates around inflection points in economic performance tends to depend on how rapidly the economy shifts gears and the Federal Reserve response. Around most previous economic peaks and troughs, economic decelerations and accelerations have been fairly sharp, reflecting the abrupt changes in monetary and fiscal policies; consequently, changes in short-term rates and the yield curve have been significant. On average, real GDP has grown over 6 percent during the first year of previous postwar economic recoveries, generating a significant rise in short-term rates and flattening curve. The pattern of rates of this cycle is expected to be different: if real GDP grows 2-3 percent—not significantly different than the Federal Reserve's "central tendency" forecast of 1 3/4- 2 1/2 percent—then short-term rates should stay in a relatively narrow range and rise only gradually beginning in late 1992. With inflation projected to recede gradually, the yield curve is projected to flatten further, although the magnitude of the decline in long-term rates may be inhibited by excessive monetary easing.

The U.S. dollar is projected to appreciate further as improving economic performance in the U.S. relative to other industrialized nations and the associated shift in relative short-term interest rates raise the demand for dollar-denominated assets. Economic performance in Japan continues to weaken, Japanese asset prices continue to decline, and money growth is slowing, placing pressure on the Bank of Japan (BoJ) to ease short-term interest rates. Economic growth in Germany is also slowing, but heightened inflation pressure deters the Bundesbank from easing monetary policy. This policy constrains other European central banks from lowering short-term interest rates and thus limits domestic demand growth in those nations. Recently, the dollar has appreciated approximately 7 percent versus the D-mark and most continental currencies, but only 3 percent versus the yen due to coordinated intervention by the U.S. Treasury and BoJ. Such intervention can only temporarily inhibit the fundamental trend; thus, look for more U.S. dollar appreciation, particularly versus the yen.

### **More Misguided Fiscal Policy**

President Bush and Democratic leaders propose traditional countercyclical stimulative packages aimed primarily at lifting the economy from recession and reducing the impact of those already hurt by recession (extension of unemployment insurance benefits). They pay lip service to the need to raise investment and productivity, but recommend more deficit spending to provide a short-term boost to consumption and housing activity. The President proposes a higher share of



federal spending for entitlement programs, and no material cuts in the non-means-tested entitlements. The President's package, even if enacted immediately, would not have as large of a broad-based, short-run stimulative impact as the Administration expects, in part because of its design and in part because its traditional countercyclical (demand management) thrust would be ineffective in overcoming some of the non-cyclical factors that have been inhibiting expansion. The leading Democratic tax cut initiative is directed almost exclusively at redistributing income and stimulating short-term consumption at the expense of long-term investment and growth. The current fiscal debate sidesteps mounting long-term problems whose solutions involve microeconomic policy adjustments and a reallocation of national resources designed to raise productivity and standards of living.

The Administration asserts that enactment of its proposal will lift real GDP growth over its baseline projection by 0.6 percent in 1992 and an average of 0.5 percent per year in 1993-1997. I question this assertion. Lower withholding taxes will lift real disposable income by approximately \$25 billion in 1992 but it does so effectively by allowing taxpayers to "borrow" from next year's expected tax refunds. This one-time shift may raise consumption now at the expense of consumption later, but it certainly will not *permanently* raise spending growth. Moreover, it may have less impact than expected due to the extent of households use the additional disposable income to reduce debt burdens (save). The proposed 15 percent temporary additional first year depreciation allowance will change the timing of business investment but will not *permanently* raise investment growth.

All else equal, some other provisions of the President's proposal would have their announced impacts. The proposed \$500 increase in the personal exemption for certain households would raise consumption, although a portion of the increase in after-tax incomes would be saved. The tax credit for certain first-time home buyers would modestly increase new housing starts, but probably not beyond a 1.4 million annual pace on a sustainable basis. The proposed permanent extension of the tax credit for research and development as well as the President's already rejected capital gains tax cut would raise investment and output. However, the positive permanent impact on investment and jobs of the latter may fall short of the President's expectations, particularly if the savings from lower capital gains taxes are added as a preference item to the Alternative Minimum Tax (AMT) base, as is now proposed. In contrast, the short-run impact of cuts in defense purchases is contractionary. In fact, a cut in defense purchases offset by a rise in government transfer payments *lowers* national output. How defense resources are reallocated through the budget process and into the private sector is key to long-run productivity and economic performance.

The negative financial market response to the President's budget package, the Administration's separate \$100 billion health insurance plan that was proposed without a clear method of how to pay for it, and the substantially higher deficit projections, have pushed up interest rates. This constrains the potential impact of the budget proposal on aggregate output. Accordingly, if enacted, the President's fiscal initiative may raise consumption spending and housing starts, and temporarily lift business fixed investment in 1992, but these gains would be achieved at the expense of future investment, productivity, and output.

The pending Democratic initiatives would generate similar outcomes, only more accentuated, through an aggressive redistributive tax scheme. The latest bill, passed by the U.S. House of Representatives includes a 20 percent credit on FICA taxes, up to \$200 per year for individuals and \$400 for couples (cost, \$45.3 billion), and several provisions to subsidize real estate, all to be paid for by and increase from 31 percent to 35 percent in the top marginal tax bracket on individual income, a 10 percent surcharge on the highest income taxpayers, and an increase in the AMT rate to 25 percent. While not likely to be enacted, this legislation shows the misdirection of the fiscal debate.

The fiscal debate ignores the failures of traditional countercyclical fiscal policies since the 1960s and why they failed. Countercyclical policies primarily aimed at increasing aggregate demand fail to permanently lift output because they do nothing to remove factors inhibiting supply. At most they can have a temporary impact. Moreover, the tradeoffs they imply between short-run and long-run growth and between investment (saving) and consumption are undesirable. Presently, they are particularly inappropriate remedies to the widespread non-cyclical adjustments underway in the private economy. There is also a glaring gap in the debate about what should be the government's role in effectively reallocating valuable resources from national defense into productive private sector uses.

The economy would be better served, even in the near term, if policy makers focussed more on efforts to lift productive capacity and long-term growth, particularly in light of the demographic trend of slower labor force growth. Raising productivity is the best way to lift real earnings and living standards. The bases for these efforts should center on microeconomic adjustments that provide more resources and incentives to invest in productivity-enhancing capital (physical and human) and to save; to eliminate barriers to growth (including economic and non-economic regulations, breaking down trade barriers, etc.); and to consider the federal spending budget within the context of how to best allocate national resources in order to create an environment conducive to long-term growth, as well as achieve redistributive objectives.

This requires less emphasis on the size of the deficit and whether it is in conflict with the Budget Enforcement Act of 1990, and more on what we are deficit spending for, the incentives created by the mix of spending and the structure of taxes, and the implications for long-run economic performance. In recent years, the budget has been allocating a smaller share of resources into programs where more resources are needed, like education and skill training, research and development, investment and infrastructure, but increasing outlays into non-means-tested entitlement programs, which add to national debt but not productive capacity. In fact, this spending bias has been institutionalized by the budget process: first by Gramm-Rudman-Hollings, which excluded from sequestration many entitlements programs including social security, and now by the Budget Enforcement Act, which places absolute dollar caps on so-called discretionary programs, which include most productivity-enhancing investment programs, but allows spending increases in the so-called mandatory (entitlement) programs. Certainly, these entitlement programs are well intended and necessary. But many are inefficiently structured, costly economically, and generate significant intragenerational and intergenerational inequities.

Two changes are desirable: first, institute the opposite set of constraints in the budget process, placing absolute caps on the entitlements, but allow more spending for investment-oriented discretionary programs, and secondly, restructuring some of the entitlement programs to improve their fairness and efficiency, ensure their long-run financial viability, and provide more resources for the truly needy and other national needs.

Cuts in projected defense spending are not a substitute for these needed reforms.

CHART 1

QUARTERLY DATA	Levels				Quarterly % Change (annualized)				Yr-to-Yr % Change							
	1991				1991				1991							
	I	II	III	IV	I	II	III	IV	I	II	III	IV				
Nominal GDP	5589.0	5652.6	5709.2	5746.7	2.3	4.6	4.1	2.7	3.1	2.7	2.5	3.4				
GDP	4824.0	4840.7	4862.7	4872.2	-2.5	1.4	1.8	0.8	-1.2	-1.2	-0.8	0.4				
GNP	4843.7	4847.8	4872.0	NA	-2.8	0.3	2.0	NA	-1.0	-1.1	-0.8	NA				
Domestic Demand	4842.6	4853.1	4893.8	4889.8	-3.5	0.9	3.4	-0.3	-1.9	-2.0	-1.5	0.1				
Final Sales	4875.4	4883.5	4893.7	4878.9	-3.4	0.7	0.8	-1.2	-1.3	-1.0	-1.2	-0.8				
Consumption	3241.1	3252.4	3271.2	3269.5	-1.3	1.4	2.3	-0.2	-0.5	-0.2	-0.3	0.5				
Residential Investment	170.7	172.0	176.5	182.0	-24.8	3.1	10.9	13.1	-18.0	-13.8	-7.5	-0.7				
Business Investment	519.1	514.8	510.0	504.1	-17.4	-3.3	-3.7	-4.5	-5.7	-5.4	-8.2	-7.4				
Inventory Investment	-32.8	-30.4	0.1	10.9	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A				
Government Spending	944.5	944.3	936.1	923.2	2.8	-0.1	-3.4	-5.4	2.3	1.7	0.9	-1.6				
Exports	512.5	535.7	545.2	562.2	-7.4	19.4	7.3	13.1	3.3	6.7	8.7	7.6				
Imports	531.1	548.0	576.3	579.8	-15.4	13.3	22.3	2.5	-3.8	-1.2	1.6	4.7				
GDP Deflator	115.3	115.7	116.4	117.0	2.8	1.4	2.4	2.1	3.8	3.0	2.5	2.2				
Employment Costs (Private)	111.4	113.2	115.1	116.7	5.6	6.6	6.9	5.7	5.9	6.1	6.3	6.2				
Unit Labor Costs (Non-Farm)	131.6	132.5	133.1	133.5	2.8	2.8	1.8	1.2	5.4	4.6	3.0	2.1				
Productivity (Non-Farm)	107.9	108.4	108.6	108.9	0.0	1.9	0.7	1.1	-0.2	-0.2	0.6	0.9				
Compensation (Non-Farm)	142.0	143.6	144.5	145.4	2.8	4.7	2.6	2.3	5.2	4.4	3.7	3.1				
Corporate Profits A/T	(a) 189.7	182.7	189.6	2918.5	-4.7	-3.7	3.8	1439.3	-4.7	-5.7	-3.4	1366.6				
Operating Profits A/T	(a) 182.7	180.0	177.5	2919.2	8.1	-1.5	-1.4	1544.6	-9.9	-10.8	10.2	1627.4				
Net Cash Flow	(a) 418.4	416.6	428.7	3165.3	-1.9	-0.4	2.9	638.4	-4.1	-2.7	0.3	641.8				
Current Account	(c) 10.5	3.0	-20.4	NA	135.6	-30.1	-93.5	NA	132.7	100.6	13.9	NA				
MONTHLY DATA	Levels				Monthly % Change				12 Month % Change							
	1991				1992				1991				1992			
	Nov	Dec	Jan	Feb	Nov	Dec	Jan	Feb	Nov	Dec	Jan	Feb				
Purchasing Managers Index	50.3	47.4	47.4	52.4	-5.5	-5.8	0.0	10.5	20.6	15.0	22.5	34.0				
Non-Farm Payrolls	(b) 108,843	108,846	108,755	NA	-230	3	-91	NA	-0.8	-0.7	-0.6	NA				
Manufacturing Payrolls	(b) 18,337	18,290	18,238	NA	-40	-47	-52	NA	-2.5	-2.4	-2.3	NA				
Unemployment Rate	(c) 6.9	7.1	7.1	NA	-0.02	0.22	0.01	NA	0.87	0.95	0.86	NA				
Avg. Hourly Earnings (sa)	10.44	10.48	10.47	NA	0.4	0.4	-0.1	NA	3.1	3.0	2.8	NA				
Domestic Unit Auto Sales	6.2	5.9	5.9	NA	1.9	-3.8	-0.9	NA	-2.6	-8.8	0.3	NA				
Industrial Production	108.1	107.6	106.7	NA	-0.3	-0.5	-0.8	NA	-0.2	0.4	0.1	NA				
Capacity Utilization	79.3	78.8	78.0	NA	-0.6	-0.6	-1.0	NA	-2.8	-2.2	-2.5	NA				
PPI	121.6	121.5	121.1	NA	0.0	-0.1	-0.3	NA	-0.4	-0.2	-0.7	NA				
PPI Ex. Food & Energy	132.9	133.2	133.6	NA	0.2	0.2	0.3	NA	3.1	3.1	2.5	NA				
CPI	137.9	138.2	138.3	NA	0.4	0.2	0.1	NA	3.1	3.0	2.7	NA				
CPI Ex. Food & Energy	144.4	144.7	145.1	NA	0.3	0.2	0.3	NA	4.6	4.4	3.9	NA				
Retail Sales	152.5	152.7	153.5	NA	0.0	0.1	0.6	NA	-0.1	1.6	3.9	NA				
Housing Starts	1085	1106	1167	NA	0.0	1.9	5.5	NA	-4.1	15.0	38.3	NA				
Permits	993	1055	1118	NA	-3.4	6.2	6.0	NA	8.4	23.5	39.4	NA				
Federal Budget	(d) -44.5	-2.4	-15.7	NA	3.1	4.9	-17.4	NA	-27.0	-26.5	-28.3	NA				
Durable Goods Orders	124.0	117.8	119.6	NA	0.6	-5.1	1.5	NA	6.8	-2.0	1.5	NA				
Manufacturing Orders	243.1	234.1	NA	NA	0.4	-3.7	NA	NA	1.6	-1.7	NA	NA				
Personal Income (\$82)	4046.9	4075.3	NA	NA	-0.3	0.7	NA	NA	-0.4	-0.1	NA	NA				
Consumption (\$82)	3263.0	3263.5	NA	NA	0.1	0.0	NA	NA	0.4	0.4	NA	NA				
Personal Saving Rate	(c) 5.0	5.7	5.3	NA	-0.52	0.75	-0.42	NA	-0.23	0.12	-0.42	NA				
Leading Economic Indicators	145.5	145.2	146.5	NA	-0.2	-0.2	0.9	NA	4.0	4.0	5.5	NA				
Total Business Inventories	813.9	817.4	NA	NA	0.1	0.4	NA	NA	-2.0	-1.0	NA	NA				
Inventory/Total Sales	(c) 1.50	1.53	NA	NA	0.00	0.03	NA	NA	-0.02	-0.01	NA	NA				
Merchandise Trade	-4.2	-5.9	NA	NA	-34.0	42.3	NA	NA	-56.3	-6.1	NA	NA				
3 Month Bill	(c) 4.73	4.24	3.94	3.95	-45	-49	-30	1	-257	-278	-255	-217				
2 Year Note	(c) 5.56	5.03	4.96	5.21	-35	-53	-7	25	-204	-228	-217	-166				
10 Year Note	(c) 7.42	7.09	7.03	7.34	-11	-33	-6	31	-97	-99	-106	-51				
30 Year Bond	(c) 7.92	7.70	7.58	7.85	-1	-22	-12	27	-62	-54	-69	-18				
DJIA	2986.1	2958.6	3227.1	3257.3	-1.1	-0.9	9.1	0.9	18.6	13.3	24.7	13.6				
S&P 500	385.92	388.51	416.08	412.56	-0.2	0.7	7.1	-0.8	22.4	18.2	27.8	13.7				
U.S. Dollar (FRB)	88.0	85.7	86.1	88.0	-3.0	-2.6	0.5	2.3	7.1	2.8	3.1	7.2				
Yen/\$	130	128	125	128	-0.9	-1.2	-2.0	1.8	0.3	-4.4	-6.2	-2.2				
DM/\$	1.62	1.56	1.58	1.62	-4.1	-3.6	1.0	2.5	9.1	4.3	4.6	9.3				
M1	891.4	898.1	910.4	NA	1.2	0.8	1.4	NA	8.2	8.7	10.2	NA				
M2	3434.4	3442.3	3452.1	NA	0.4	0.2	0.3	NA	3.2	3.3	3.5	NA				
M3	4170.8	4175.2	4180.5	NA	0.2	0.1	0.1	NA	1.3	1.5	1.3	NA				
C&I Loans & Non-Financial CP	757.1	NA	NA	NA	0.5	NA	NA	NA	NA	NA	NA	NA				
Consumer Credit	730.1	728.4	NA	NA	-0.0	-0.2	NA	NA	-0.9	-0.9	NA	NA				

(a) Quarterly % changes are not annualized

(b) Monthly changes are in levels

(c) All changes are in levels or basis points

(d) Monthly: change from same month last year; Annual: sum of past 12 months

03-Mar-92

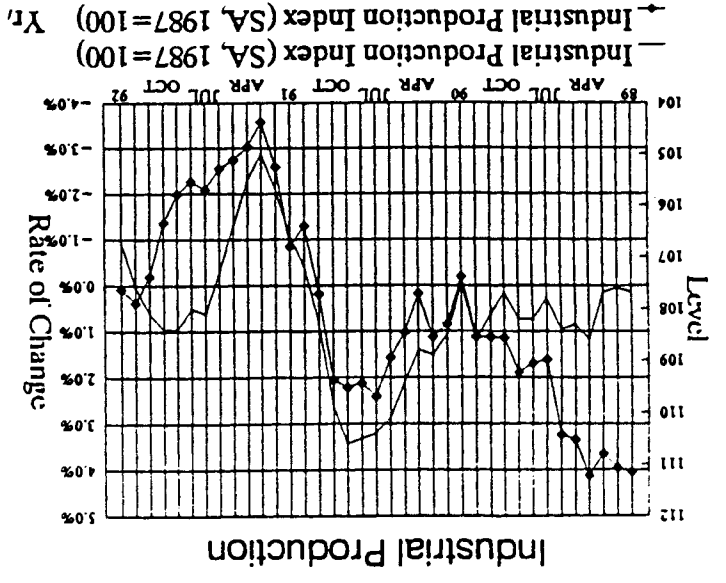
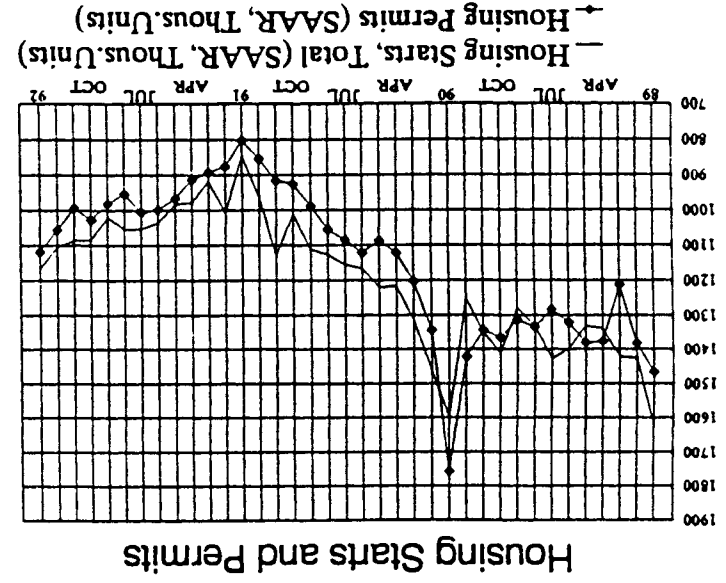
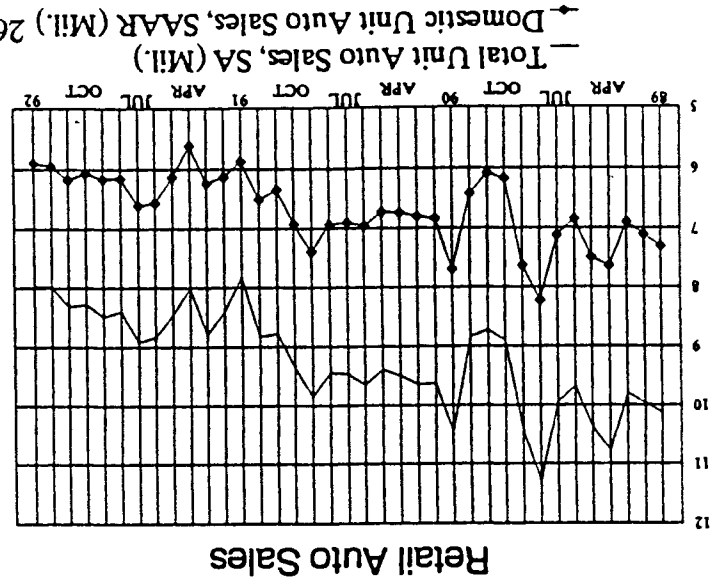
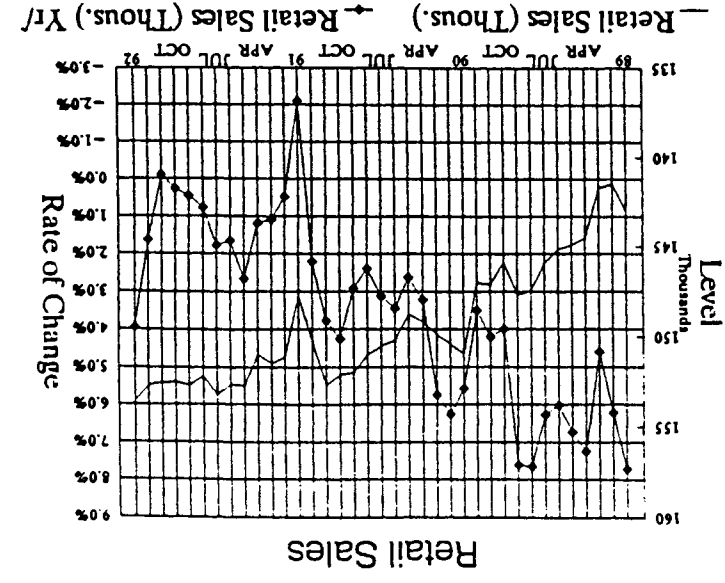
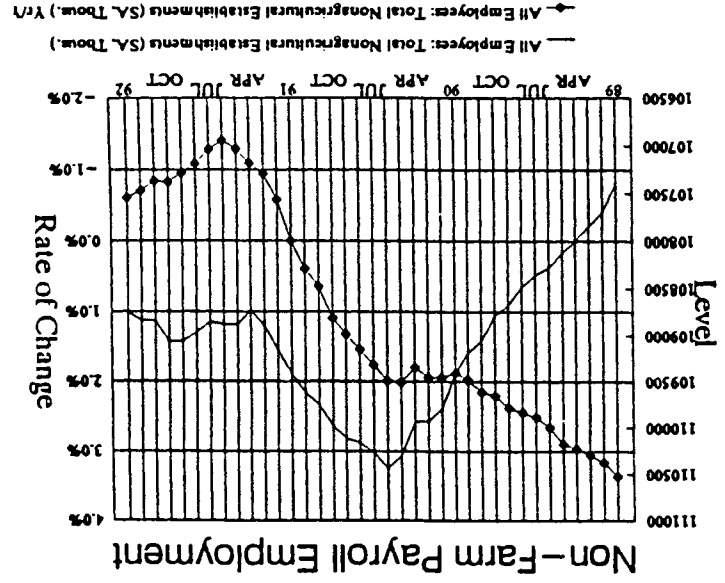
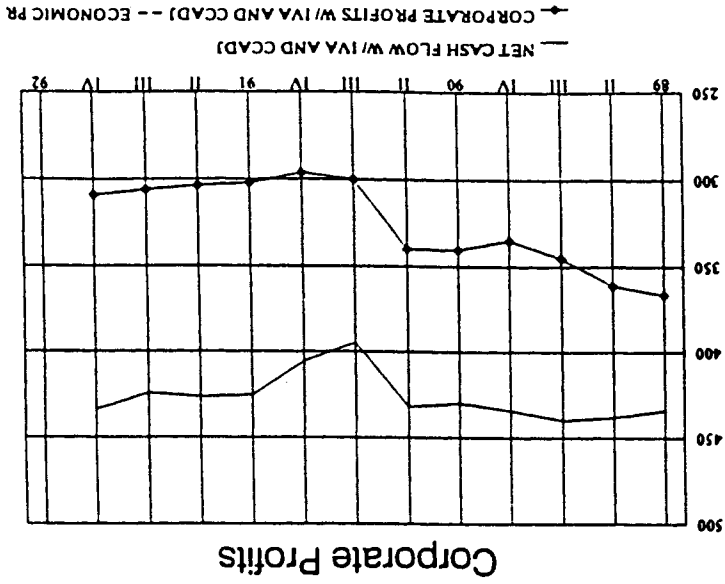
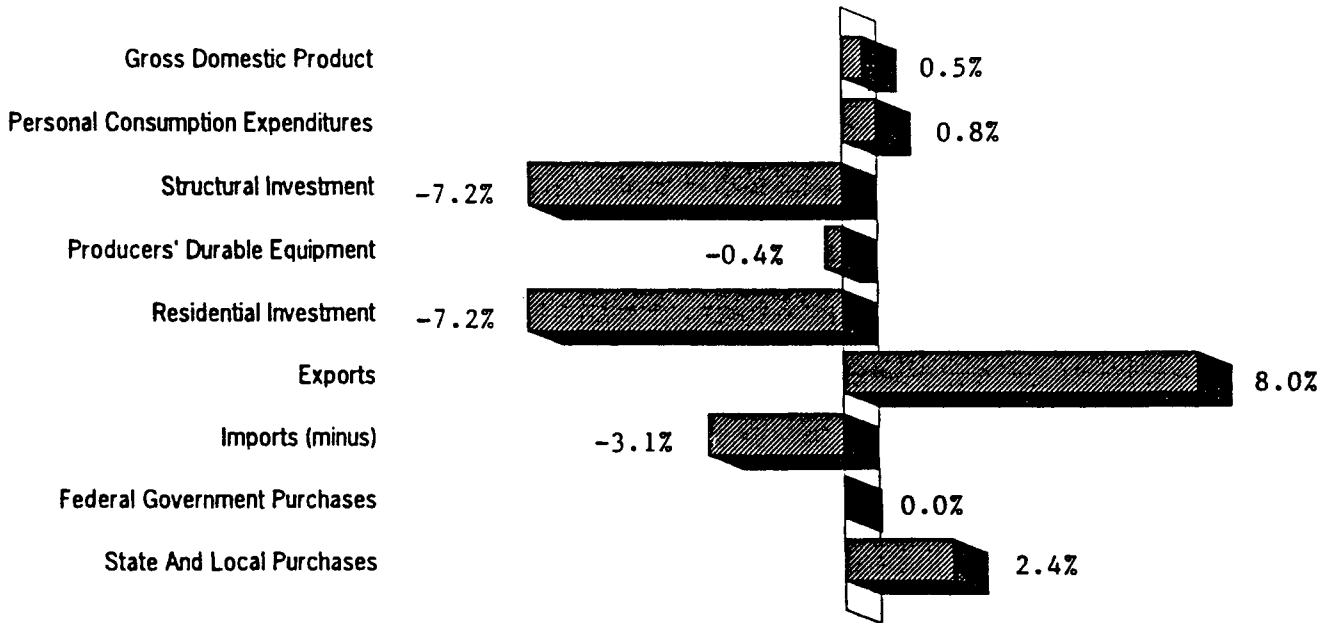


CHART 3

# Growth of Real GDP and Its Components From 89:Q1 to 91:Q4 (Annualized Growth Rates)



## Mix of GDP 1986 vs 1991

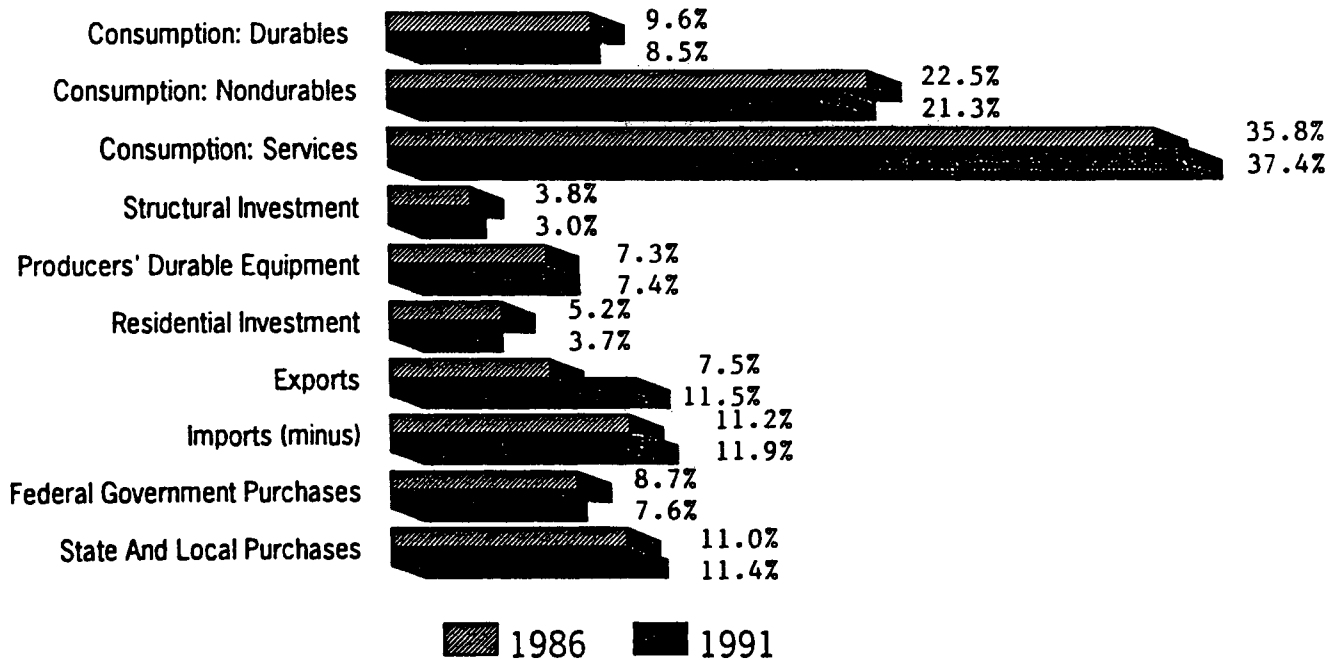
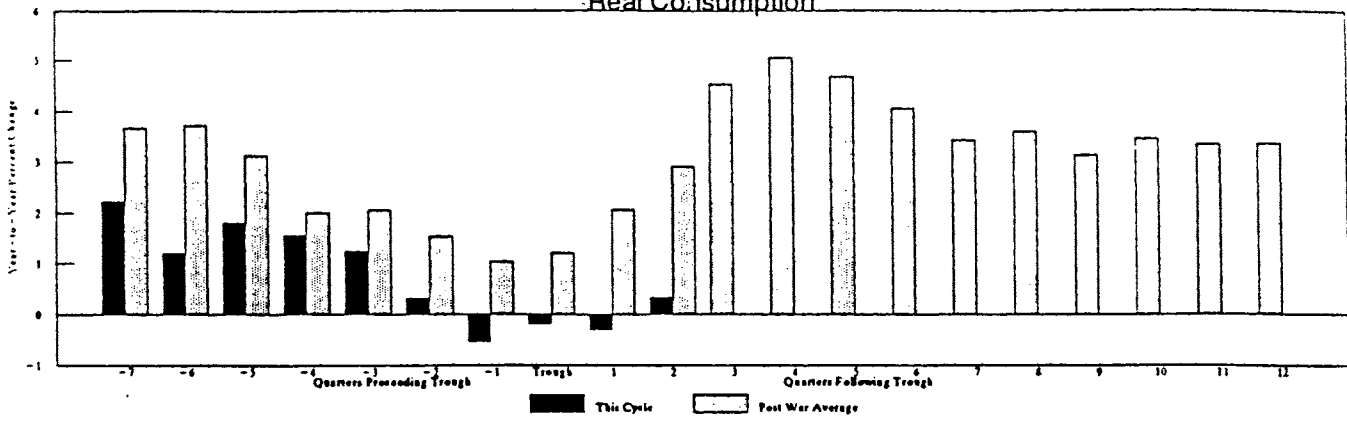
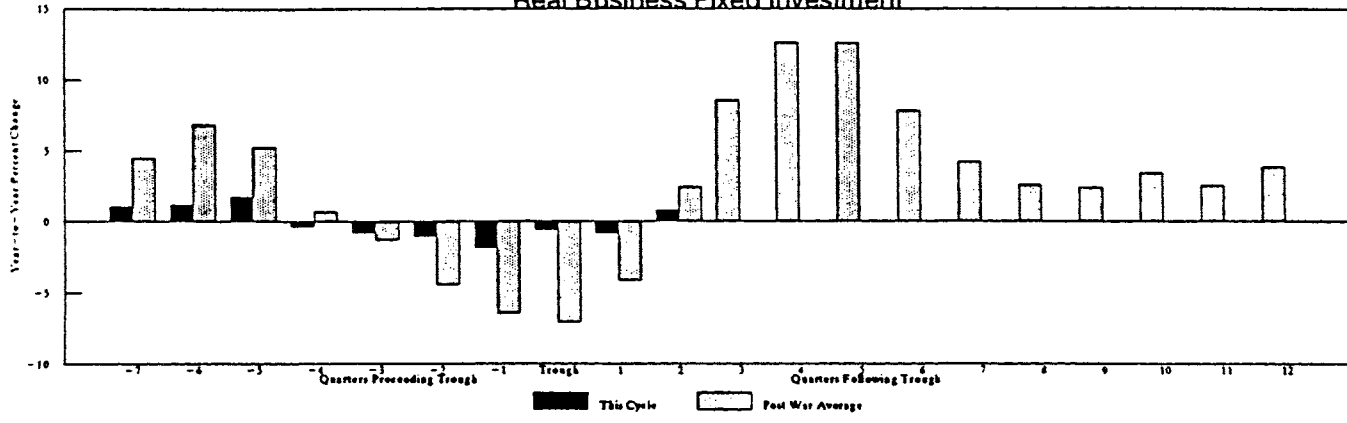


CHART 4

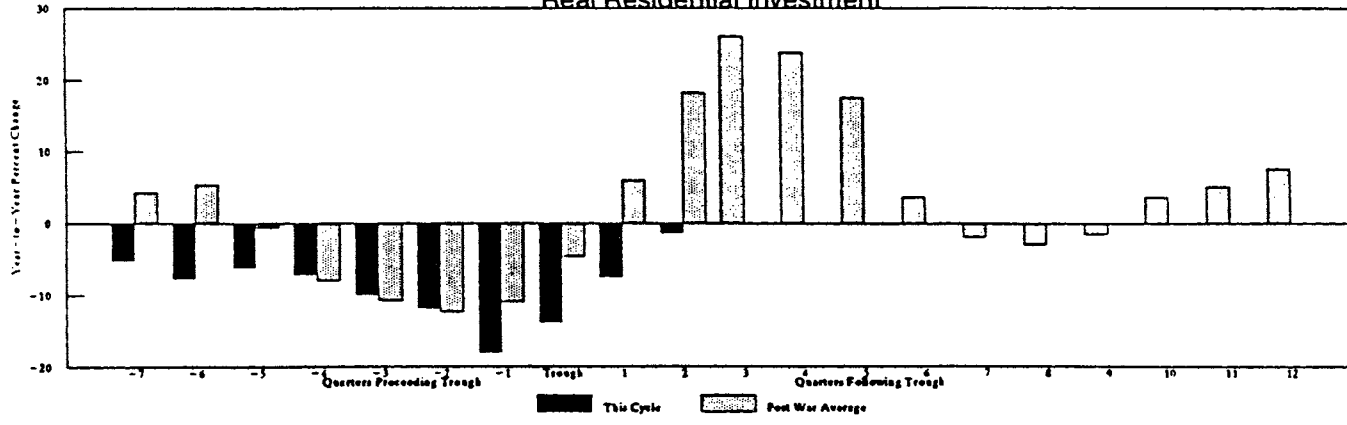
Real Consumption



Real Business Fixed Investment



Real Residential Investment



Real Exports of Goods and Services

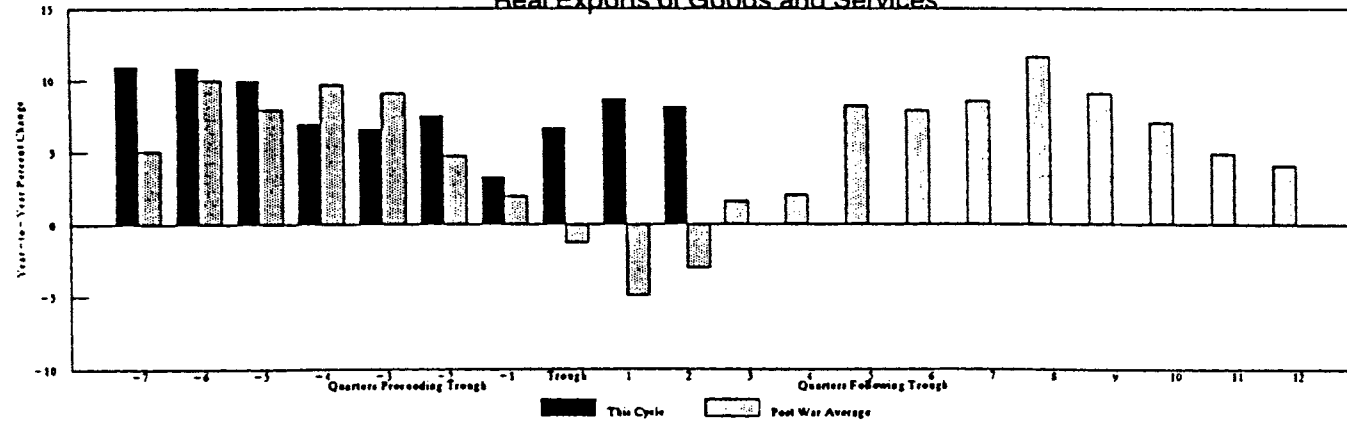
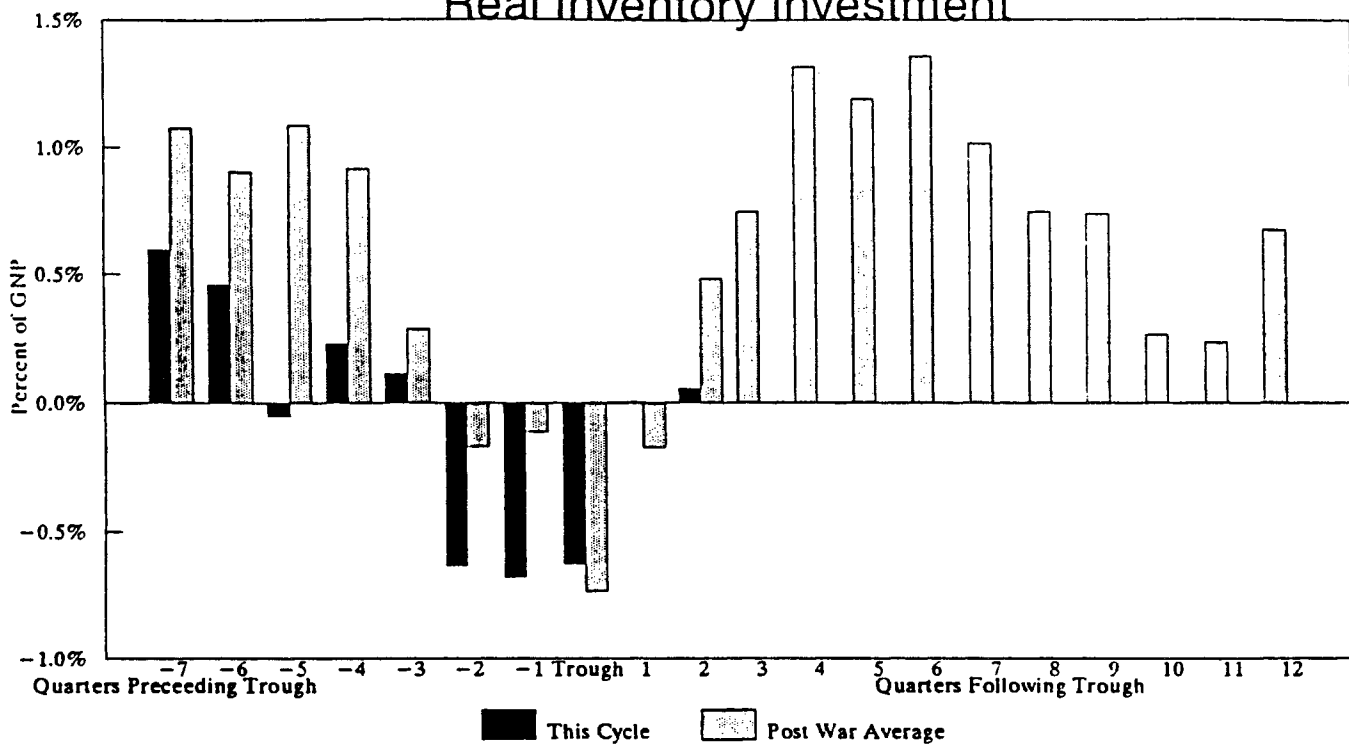


CHART 5

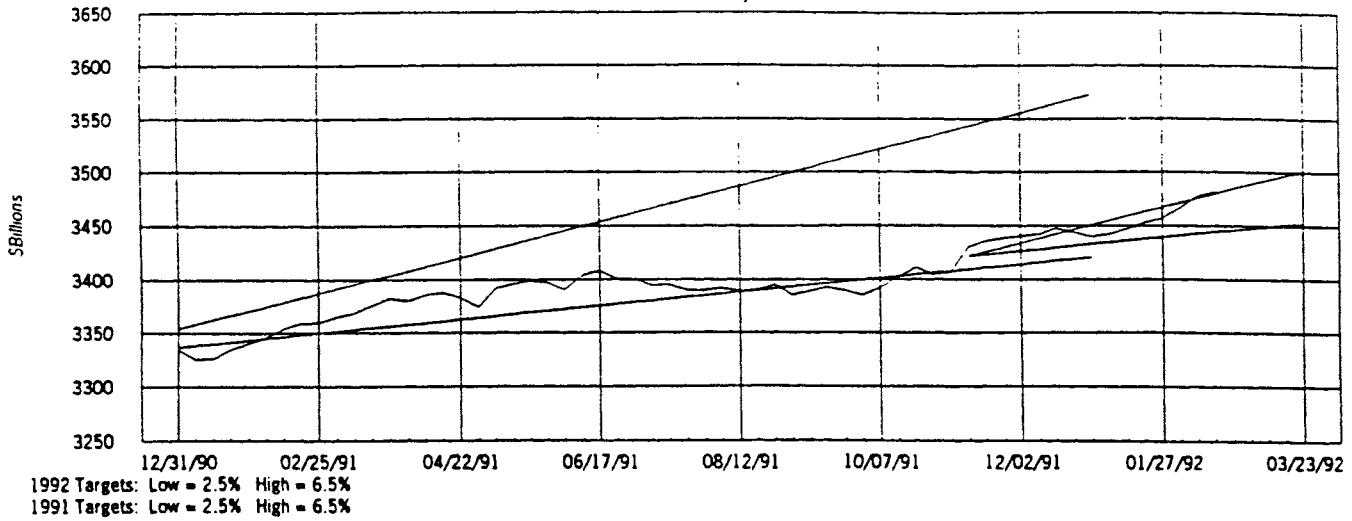
### Real Inventory Investment



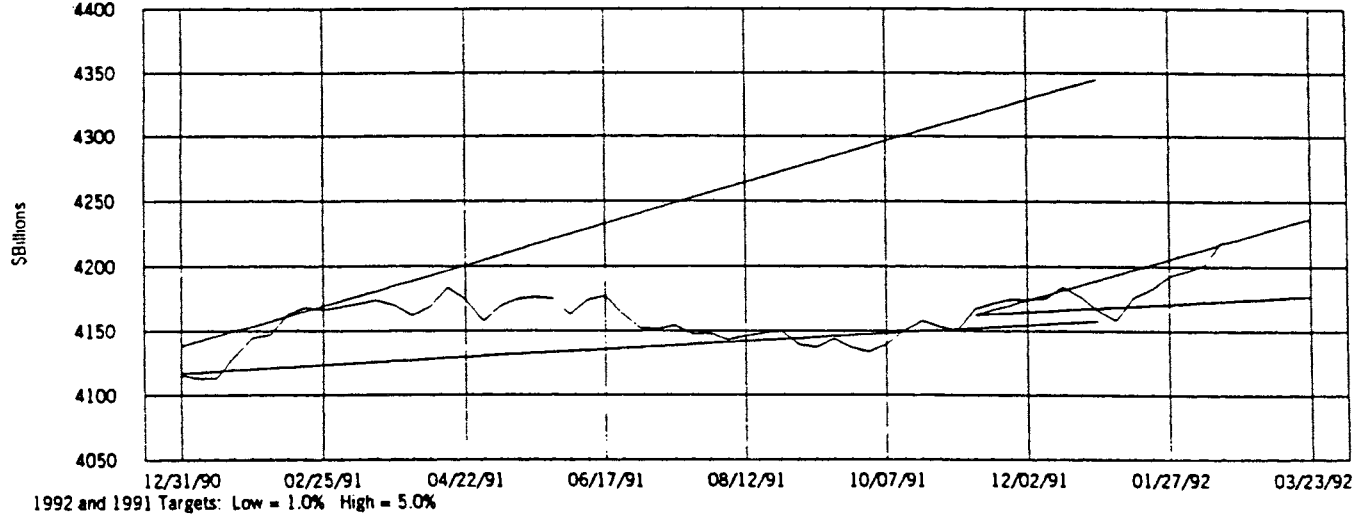


# Money Growth vs. the Fed's Target Ranges

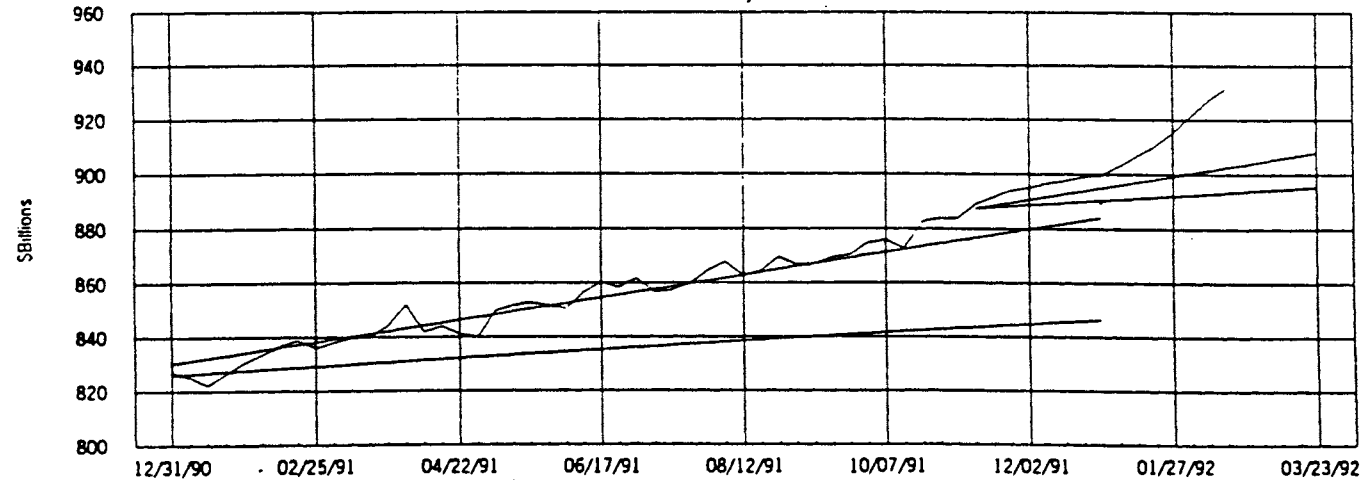
Weekly M2



Weekly M3



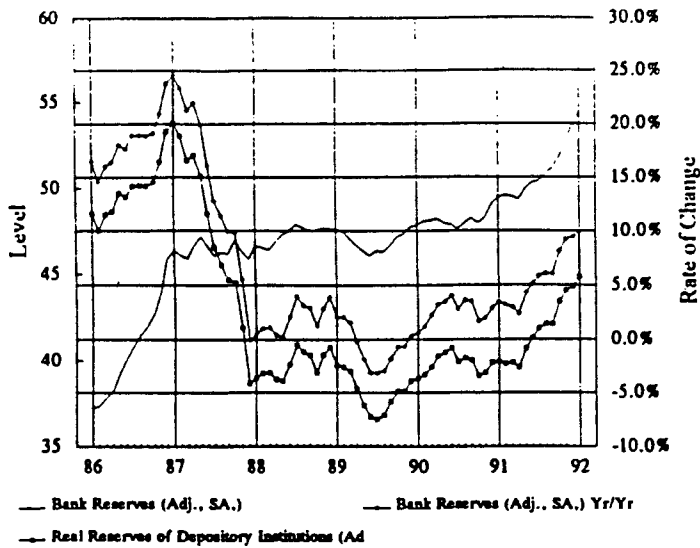
Weekly M1



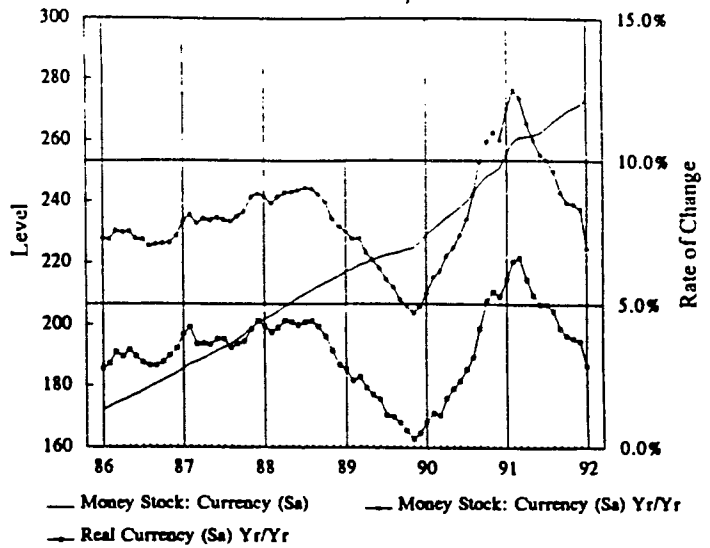
Note: The Fed does not currently maintain target ranges for M1.  
For comparison with M2 growth the range shown above is the M2 target 2.5%-6.5%.

Data Through 2/17/92

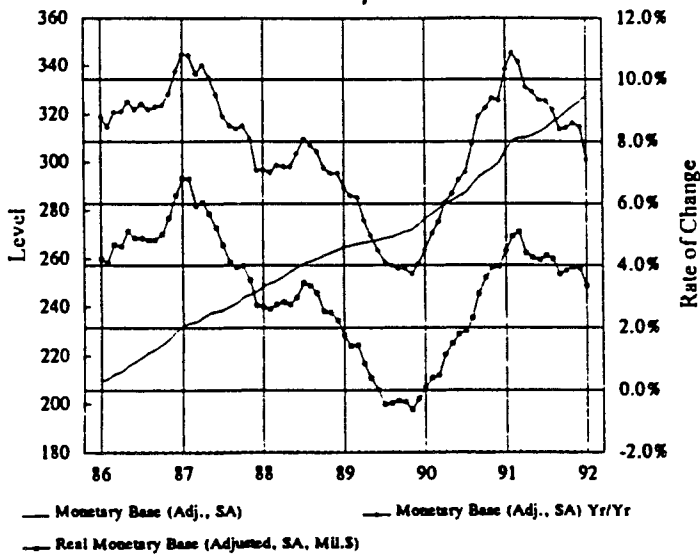
Bank Reserves



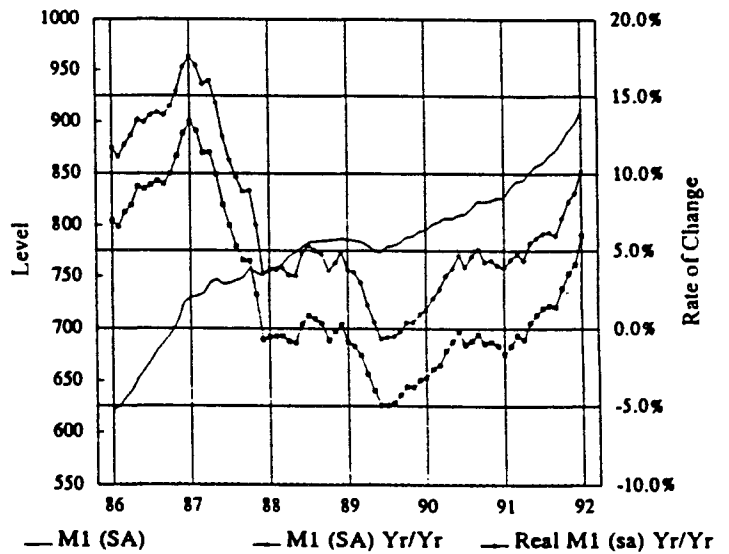
Currency



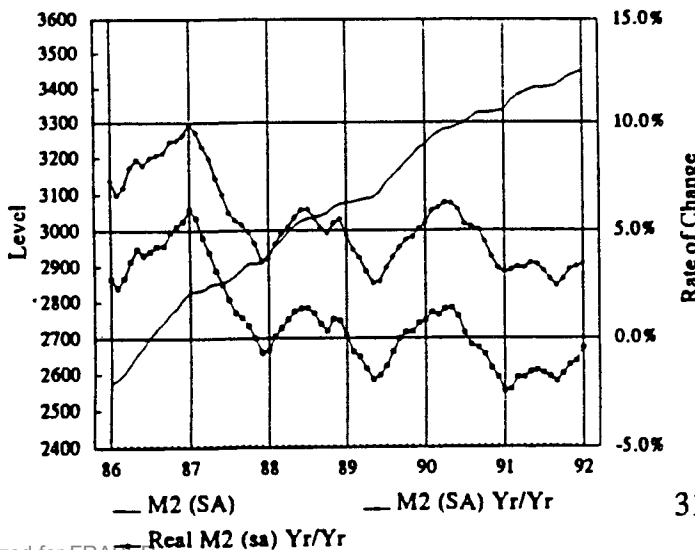
Monetary Base



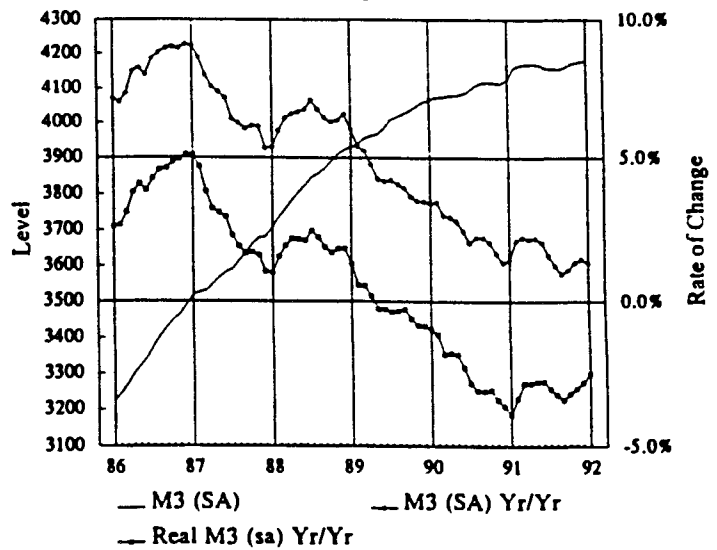
M1



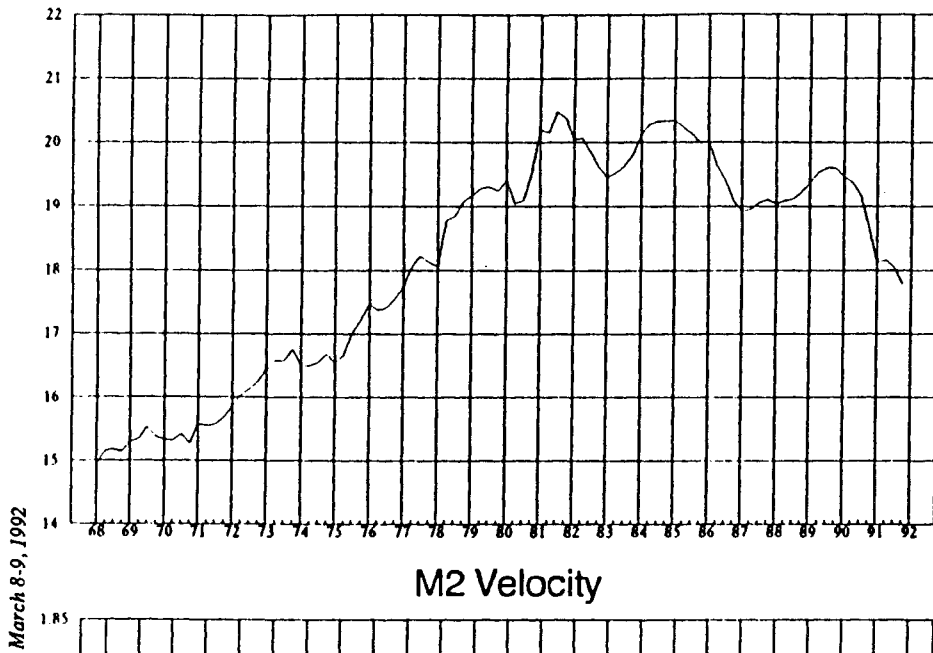
M2



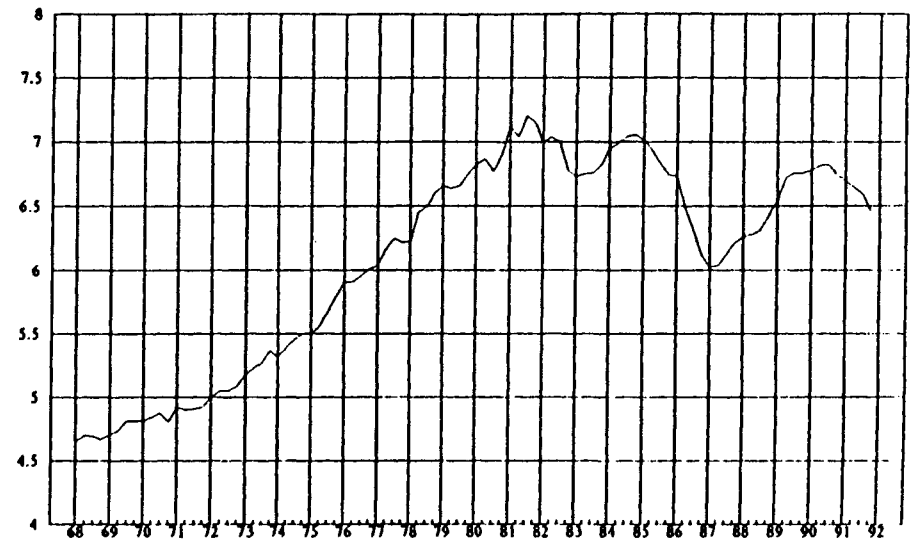
M3



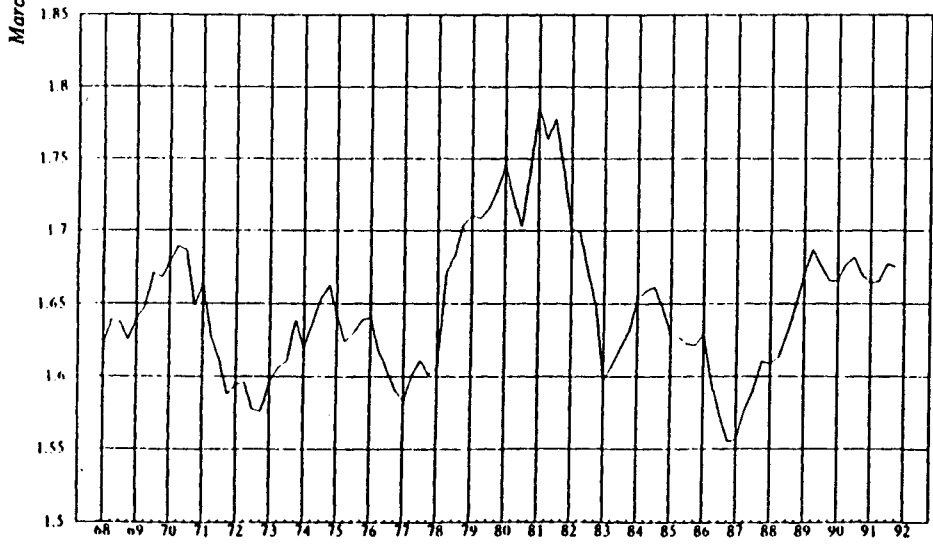
Monetary Base Velocity



M1 Velocity



M2 Velocity



M3 Velocity

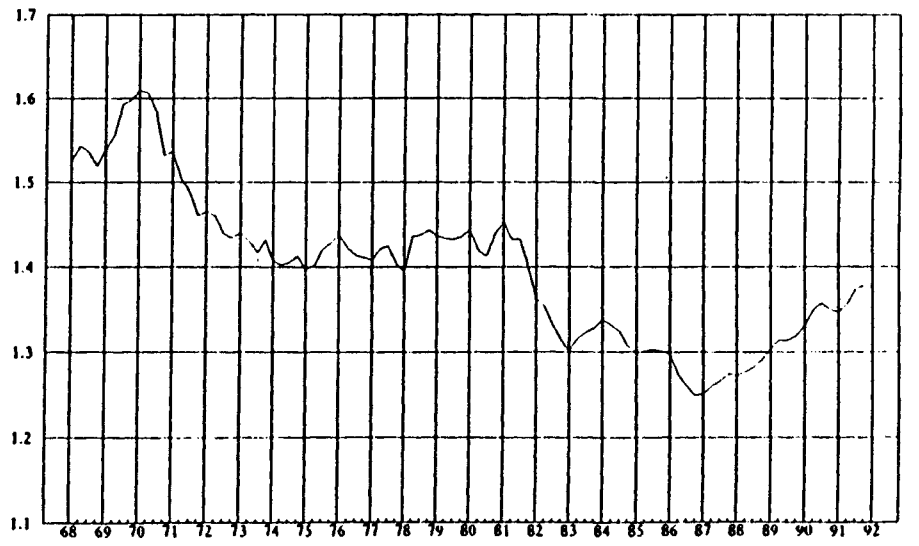


TABLE 1

**Trends in Selected Inflation Measures  
(Annualized % Changes)**

INFLATION MEASURES	1989	1990	1991	1991			
				I	II	III	IV
CPI	4.8%	5.4%	4.2%	3.5%	2.1%	3.0%	3.2%
CPI EXCLUDING FOOD & ENERGY	4.5%	5.0%	4.9%	6.8%	3.3%	4.2%	3.5%
PPI	5.1%	4.9%	2.1%	-2.2%	-0.3%	-0.5%	3.7%
PPI EXCLUDING FOOD & ENERGY	4.4%	3.7%	3.5%	5.5%	2.4%	1.6%	3.4%
GDP DEFLATOR	4.4%	4.1%	3.7%	5.0%	3.1%	2.1%	1.7%
AVERAGE HOURLY EARNINGS	4.0%	3.7%	3.3%	2.9%	4.7%	2.6%	2.1%
UNIT LABOR COSTS	4.3%	5.2%	NA	2.8%	2.5%	1.8	NA

*March 8-9, 1992*

## MEMO TO THE SHADOW OPEN MARKET COMMITTEE

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

The trashing of the economy by national news organizations is a disgrace to American journalism. News people wrap their craft in the flag of the First Amendment to the Constitution. Cantankerous news persons, they say, are trustees of the institutions of freedom. However, that trust will erode if its custodians abuse their role.

Reporting of economic news is a complex affair. To track the daily activity of more than 250 million souls in the world's richest economy requires abstract measurements often far removed from the realities of daily life. As an example, the alchemy of seasonal adjustment routinely transforms ups into downs and vice versa.

In such a setting, opportunities for bias and distortion are endless. A slanted story may be hard to detect, even by specialists who spend full time crunching economic numbers. That said, the negative spin on current economic news is obvious to even a casual reader or viewer.

News people have used real and imagined signs of weakness to attack the White House. The message is plain. With the economy in trouble, the President should leave town. By sending a garbled message, journalists have helped ensure an inappropriate and misdirected policy response.

*Wall Street Journal* publisher Peter R. Kann warned recently that when pack journalism preempts a story, common sense and fairness are the losers. "Standards drop to the lowest common denominator," he said. "... The larger the pack, the poorer the performance." Mr. Kann charged that "there is a tendency toward exaggerated pessimism in much of what we read and hear. The point isn't to dispense 'good news.' The press has obligation to tell the truth, which involves problems, failings, promises unkept. Pessimism, however, is a mind-set that assumes the worst and bends reality to fit."

Not long ago, the cover of a national magazine asked, "How Do We Get Back to Prosperity?" The picture, hardly surprising, was a wrecked automobile, with Uncle Sam sitting to one side holding his injured head.

The U.S. has many problems, short- and long-term. Growth is slow. Real income per worker has shown little change in recent years. Debt is high. Net investment and productivity are low. Living standards are under pressure. However, the economy—now close to \$5 trillion a year—is neither bankrupt nor in a recession. Neither manufacturing in general, nor autos in particular, are wrecked.

To the contrary, the U.S. is recovering, albeit slowly. Gross domestic product rose \$17 billion in the second quarter of 1991, \$22 billion in the third and \$9.5 billion in the fourth. Jobs have begun to rebound, after dropping 1.5 percent during the recession. A Total of 93.7 million people had full time jobs in February. This was the third consecutive monthly gain for a total jump of 784,000. The drop in jobs during the recession was well below the average postwar downturn.

Personal income after tax, adjusted for inflation, came to \$3.5 trillion last year, little changed from the second set in 1990. The net worth of the U.S. "household sector" is more than \$17 trillion, including \$2 trillion in residential real estate.

U.S. exports have risen 80 percent in the past six years. Trade in goods and services is close to balance; exclusive of oil imports (which reflect geography, not economics); the nation has a substantial payments surplus. The much-maligned auto industry represents a slightly larger share of the economy today than in the 1960s, when firms such as General Motors were highly profitable.

### **Don't Give Up The Myth**

The national news pack has been reluctant to abandon the myth that activity is in a sharp decline. For instance, network news organizations routinely report weekly data on initial claims for unemployment insurance. Few bother to put such data in context. In the last year, approximately 23 million Americans filed unemployment claims. Yet over the same span, total employment was unchanged.

This means that over the past year 23 million workers were either recalled to their former jobs or found new ones. Reporters properly include news of layoffs in their dispatches. However, they rarely include reports of the route hiring that is essential to the normal working of the economy. In fact, the U.S. has a labor market that is as big as it is diverse and dynamic. The flows of workers through the market are huge. Jobs are tough to get right now, but let's not invent difficulties.

Many of the sins are of commission, no omission. Malodorous material is pouring out of the information sewer. *The New York Time* said that "payrolls fell by 2.3 million jobs between July,

1990 and April, 1991. That's almost as many jobs as were lost in the 1981-82 recession." According to *The Washington Post*, "between June, 1990 and December, 1991, total employment dropped nationwide by more the 3 million jobs."

These assertions were false, as a quick check of standard government data would have shown. The facts are as follows:

Non-farm payroll employment was 110,269,000 in July, 1990; it was 108,736,000 in April, 1991, a decline of 1,533,000. During the 1981-82 recession, payrolls went down 2,823,000. Moreover, the 1990-91 slump was a drop of 1.5 percent; a decade earlier, with a smaller work force, the decline was 3.1 percent. Total employment—which measures the number of people who have jobs rather than the number of jobs—came to 116,728,000 in December, 1991, down 1,539,000 from the June, 1990 total of 118,267,000.

According to ABC News and *Money Magazine*, "public confidence in the economy dropped another notch to a new all time low" this winter. Look at what actually happened. Retail sales rose across the board. Sales of new homes exploded. Cancellation rates on new home contracts fell sharply. Total vehicle sales rose to an annual rate of 12.5 million units in February, up 800,000 units from a month earlier.

### Who Gets What?

Democratic presidential candidates have been trying hard to transform alleged inequities in the distribution of income into a campaign issue. Their task will be easier because of spurious reporting in *The New York Times*. *The Times* asserted that "an outsize 60 percent of the growth in aftertax income of all American families between 1977 and 1989—and an even heftier three-fourths of the gain in pretax income—went to the wealthiest 660,000 families." That was one percent of the 66.3 million families in the U.S.

However plausible that claim might appear, it was absurd on its face. During the 12-year period 1977 through 1989, real after tax income rose by \$960 billion to a total of \$3.5 trillion. (*The Times* reported this gain as \$740 billion in its first edition and \$583 billion in its second. There was no explanation about what happened to the missing \$157 billion.) If one percent of all families had really accounted for \$576 billion of the \$960 billion gain, that would have left only \$384 billion for everybody else.

Yet in the same span, real consumer spending went up \$926 billion to a total of \$3.2 trillion. Where did all that money come from? The increase in consumer debt was nowhere near big enough, even without an inflation adjustment. Moreover, that's only part of the story.



In current dollars, the net worth of the household sector rose \$10 trillion to \$17.3 trillion in this period. That included a \$2.4 trillion jump in home equity and a \$1 trillion rise in net investment in consumer durables. In addition, there was a whopping \$5.9 trillion gain in net financial assets.

What *The Times* was actually trying to account for was not the change in TOTAL incomes (what the headline and the illustration with the pie said in all editions of the paper), but rather the change in AVERAGE incomes, which is very different. Michael Milken's outlandish \$500 million bonus probably accounts for most of the anomaly.

If *The Times'* initial report had been accurate (it was not), this would mean that it would be irrational for national firms to spend billions of dollars every year to reach mass markets through advertising on network television. In such an event, presumably, the only truly valuable advertising media would be publications such as *The Times*, with their narrow, affluent, upper-crust readerships.

### Teenage Recession

Among many important stories that news organizations have ignored is the impact of the increase in the minimum wage on teenage employment. Teenagers (people aged 16 to 19) are typically hit hard during a business downturn. They have few skills, little or no seniority and weak attachment to the labor force. When business slows down, they are always among the first to be laid off.

Because teenage jobs are far more volatile than the adult work force, shifts in teen employment are a leading indicator. Teenage jobs were unusually weak in the 1990-91 downturn. Changes in teenage employment usually account for about one-third of the variance in total employment. By contrast, during the 1990-91 downturn, the number of employed teens fell by 950,000, or 66 percent of the drop in total jobs.

Teenage unemployment rose far less. Most of the young people who lost their jobs simply dropped out of the labor force and did not look for work. More recently, teenage employment has started to rise once again, a further sign that an accelerated recovery is now underway.

The Labor Department regularly publishes data that track the reasons why individuals are not in the work force. During the fourth quarter, 65 million people were neither working nor looking for work. Of this total, 91 percent were out of the labor force by choice. They were keeping house, retired, going to school, or were ill or disabled.

Some 5.8 million individuals who said they would like a job did not look for work. They cited a variety of reasons: school, ill health, home responsibilities, plus about 1.1 million "discouraged workers." These are individuals who stopped looking for a job/work because they thought they could not get one. Government statisticians break these figures down by sex, race, age and prior work experience.

It is hard to separate the impact of the recession on teenage jobs from these other factors. However, the 27 percent increase in the minimum wage from \$3.35 a hour to \$4.25 in 1990 and 1991 plainly played a role in reducing jobs available to low-skill, inexperienced and poorly-motivated workers. In an effort to head off such a result, current law provides for a special, sub-minimum "training wage" for young people. Unfortunately, the red tape in this program has discouraged employers from using it.

Debate about the minimum wage is usually framed in terms of social equity. Such issues play well, but they are irrelevant. The facts are simple: the minimum wage is an inefficient and inequitable method to give a subsidy to low income workers. It gives benefits to people who don't need them (for example, teenagers from upper income families) and it reduces employment opportunities. The increase in the minimum wage made the performance of the job market appear bleaker than it really was.

### **Flash Point For Inflation**

In an environment of near-hysteria about the economic outlook, the Federal Reserve's easy money policy is now out of control. Preliminary data indicate that total bank reserves—the raw material for the money supply—rose at a compound annual rate of about 60 percent in February.

Money growth has passed the flash point for inflation. While price changes are subdued at present, that reflects tight money from 1987 through 1990. Easy money in 1991, 1992 and beyond will eventually result in higher prices, higher rates and another slump. Assuming George Bush wins in November, he may regret his victory.

The value of financial assets—equity and debt—is likely to ride a wild roller coaster in 1990s. For the immediate future, prices should continue to rise as the Fed floods the market with high powered money. Talk of a new era in Wall Street will likely become commonplace. However, easy money always gives way to tight money. The only question is when.

The growth of total bank reserves in 1991-92 has retraced the near-vertical pattern it traced in 1986. The massive surge of fresh liquidity in 1985 and 1986 was followed in 1987 by an abrupt reversal. Reverse growth dropped from 25 percent to zero, thus setting the stage for the stock market meltdown on Monday, October 19, 1987. The spike in reserve growth this winter is an obvious warning for investors. Too fast leads to too slow, which leads to too fast, which leads to ...

Fed chairman Alan Greenspan has painted himself into a corner. He is pegging the price of bank reserves, the Fed funds rate, at 4 percent. This is far below market equilibrium. He must pump huge amounts of high powered money into the credit market to keep the funds rate from rising.

Attempts to hold down credit costs in an expansion always boomerang. Holding rates down forces the Fed to print money. The more money Mr. Greenspan prints, the more the expected rate of inflation will rise. As a result, interest rates will go up at an accelerating pace as investors seek to maintain the real return on their assets.

The Federal Reserve's dilemma is likely to become more difficult in months to come. The White House and Capital Hill are flailing around trying to jump start the economy in time for the election. Mr. Greenspan would be lynched if he allowed short-term rates to rise.

Last month, with the economy still moving in very slow motion, the Fed had to pump out funds at a pace more appropriate in Latin America than the U.S. As the recovery gathers momentum, the equilibrium rate will also go up. The longer Mr. Greenspan holds rates down, the more money he will have to print, and the further rates will ultimately rise.

According to *The Wall Street Journal*, "bond investors" have frustrated the Federal Reserve's "grand plan" to lower interest rates. Editors of the paper seemed puzzled why long rates should be rising, in face of the Fed's determination to hold short rates down. There is no mystery why long-term rates have gone up, and why they will likely continue to rise. By pegging the funds rate at 4 percent, the Fed is in effect offering to sell reserves at a bargain price.

A simple model will illustrate. To hold Fed funds at 4 percent, the Fed must supply whatever quantity of reserves banks desire to hold at that price. It cannot control the demand for reserves in the short run. Clearly the demand for reserves is very large at a rate of 4 percent.

Investors (bond or otherwise) were not "responsible" for higher rates. In fact, Fed officials themselves were primarily to "blame." Bond buyers simply responded rationally to the inflationary signals from the central bank. Rates rose because investors wanted to protect the real value of their principle.

Meanwhile, Washington is alive with talk about schemes to manipulate long interest rates by reducing Treasury sales of long-term bonds or by having the Fed peg long bond prices. Such efforts will fail. Investors set bond prices and interest rates by judging the expected value of debt already outstanding—not by watching changes in the supply of new issues.

If the Fed wanted to influence long-term rates directly, it would have to buy bonds, which would add to an already swollen money supply. That would fan fears of future inflation even more, which would lead to higher, not lower, rates.

Were the Fed to offset its purchases of long bonds with sales of short-term paper, that would put upward pressure on short rates. The Fed attempted to twist the yield curve in this fashion during the 1960s, with poor results. They never learn.

Moreover, as Mr. Greenspan pointed out in a recent letter to the chairman of the Senate Banking Committee, Donald W. Riegle, Jr. (D-MI), the Treasury scope for cutting back its security sales in one or another maturity sector is limited by "the huge size of the deficit. Considerable sales will likely be needed in all maturities.

"Large shifts toward the short end could distort (read boost) yields, thereby dissipating any advantage to the Treasury. A major shortening of Treasury debt would also alter the liquidity profile of the economy, with possible implications for the stance of monetary policy."

Mr. Greenspan did not say so, but a significant drop in the maturity of the debt would also expose taxpayers to an immediate increase in interest costs when the Fed tightens, as it inevitably will.

### **Get America Moving**

Growth, or the lack of it, will surely dominate the election campaign this fall. Ironically, the economy's current difficulties are nowhere near as bad as commentators on the nightly news maintain. Despite its sluggish aftermath, the recession was short and shallow.

Business should be expanding at a good clip well before election day, driven by strong exports, capital spending, housing as well as moderate gains in consumer spending. The long-run story is more discouraging. The economy has moved in slow motion for almost 20 years. The long-term trend of real growth is now 2.5 percent or lower, a full percentage point below where it was during the first 25 years after World War II.

This difference adds up. For example, last year real disposable income per employed worker was \$30,240 in constant 1987 dollars. If the nation had maintained its early post-war trend, the average real income per worker (wages, salaries, benefits and income from investments) would have been 41 percent higher, or \$42,574.

The chief culprit is an equally long-term slump in the profitability of American corporations, which led to a parallel drop in net investment and productivity. What America needs, and what Washington has failed to provide, is a strategy to reverse this trend and get the economy moving.

Voters elected Presidents Reagan and Bush in part because of their pro-growth rhetoric. However, neither President tried to implement the radical shift in financing of U.S. health, safety and environmental regulation needed to reinvigorate the economy

The pending overhaul of the health care system may be the litmus test for future performance. If Congress decided to finance national medical insurance with explicit or implicit corporate taxes, the result will be less investment, less productivity and even lower rates of growth.

The economic virus that has infected the nation is easy to identify. As a share of the economy, saving and investment have eroded far below the standard of the last 50 years. In effect, U.S. workers have lacked the tools they needed to maintain their productivity, or output per hour. As productivity has lagged, so too have real incomes, growth and living standards—especially in relation to other industrial nations.

Saving and investment declined because the return on investment went down, which dulled the incentive for firms to spend for new facilities. Profits as a share of national income are now a fraction of their postwar norm. Corporate cash pays for the bulk of productive investment. Thus, growth in the capital stock has stalled.

U.S. workers have gained a progressively larger share of the economic pie over the last 30 years. In the jargon, labor income has accounted for a larger part of national income; the share of income from property has gone down. Even though the share has gone up, living standards are under pressure because total income has grown at slower rates.

There were many reasons for the erosion in profits. Congress boosted EXPLICIT corporate taxes \$120 billion in 1986 by repealing investment incentives. Substandard returns created a setting where financial engineers were more important than product engineers. While merger mania made Wall Street rich, it backfired horribly, leaving companies with little else but crushing burdens of debt and interest.

More fundamental over the long run was the huge, largely uncharted, increase in IMPLICIT corporate taxes to pay for federal health, safety and environmental regulation. The nation must shift the burden of such taxes toward income from labor and away from income from property to resume its former growth rate. If voters refuse to act, they will pay the price in lower living standards in relation to other advanced industrial countries.

Americans want clear air, clean water and safe places to work. They want to protect endangered species and have comprehensive medical care. They are less clear how to pay for such benefits. Enter the mandated environmental expenditure, the politician's dream and the economist's nightmare. Such laws require companies to use the "best available" technology to reach environmental and/or social goals.

Raising taxes would produce an immediate response from voters. However, mandating corporate outlays, at whatever cost, effectively masks the expenditure. It is almost impossible to trace who pays for such regulations or find out precisely what the costs are.

According to Robert Crandall, a senior fellow at the Brookings Institution, a Washington think tank, "federal environment policy is absurdly inefficient. The cost of environmental policy has been rising steadily and draining valuable resources from other productive uses. Much of this cost is unnecessary—the result of poorly designed legislation."

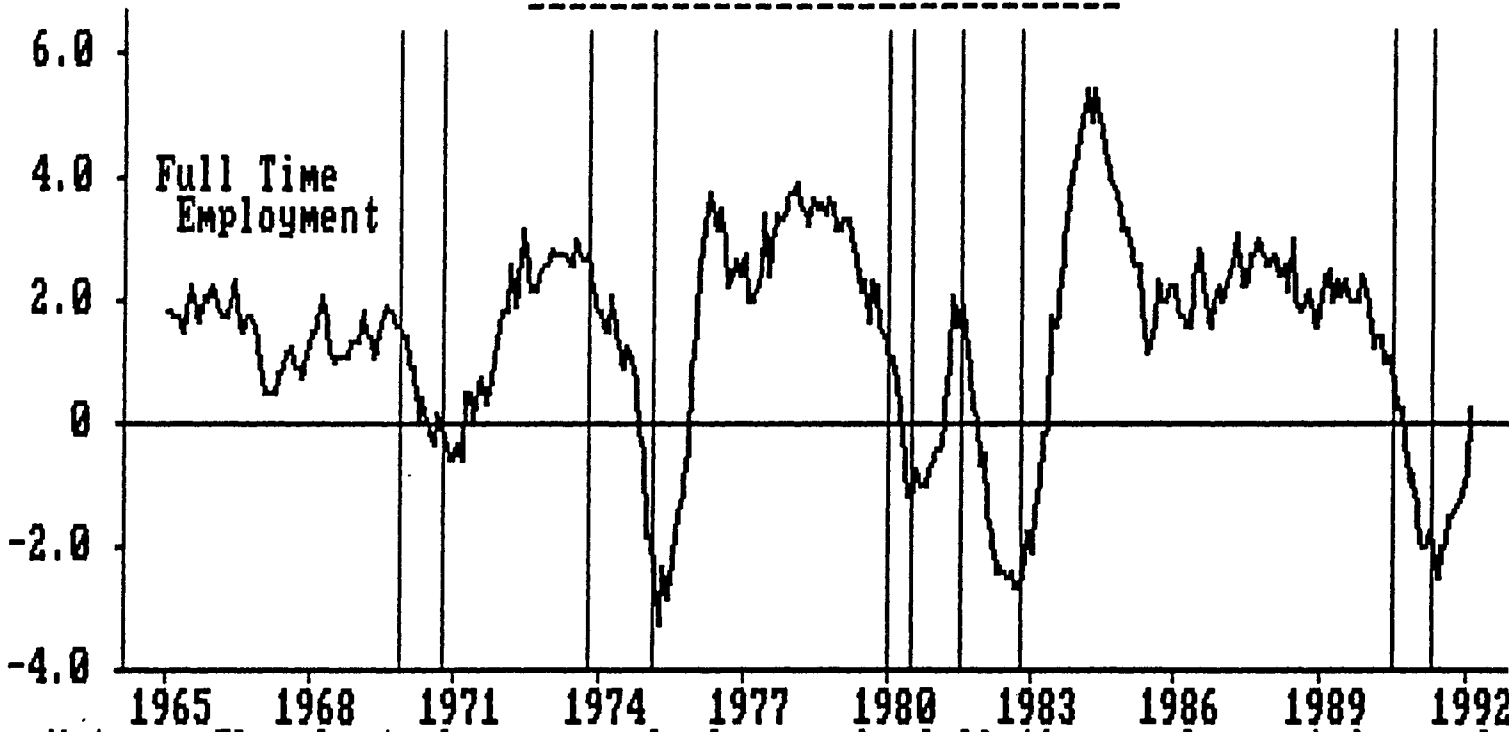
Mr. Crandall argues that Congress has ignored "years of research into marketed-based approaches to solving environmental problems. . . We continue to spend far too much for the environmental results we obtain." He speculated that "it is possible for this inefficiency is deliberate"—aimed at keeping the lid on growth.

"There are many Americans," he added, "who believe that economic progress is necessarily associated with environmental degradation. . . These largely populist groups see environmental policy as a means to rein in untrammled economic progress." In other words, slow growth (no growth?) is an objective of regulation rather than an unintended consequence.

Whatever the motivation, the growth slowdown is real. Average Americans are working harder and earning less. This pattern will not reverse without more investment and more productivity. In turn, that requires a higher rate of return. Corporate profits are too low!

**PEOPLE ARE GOING BACK TO WORK**

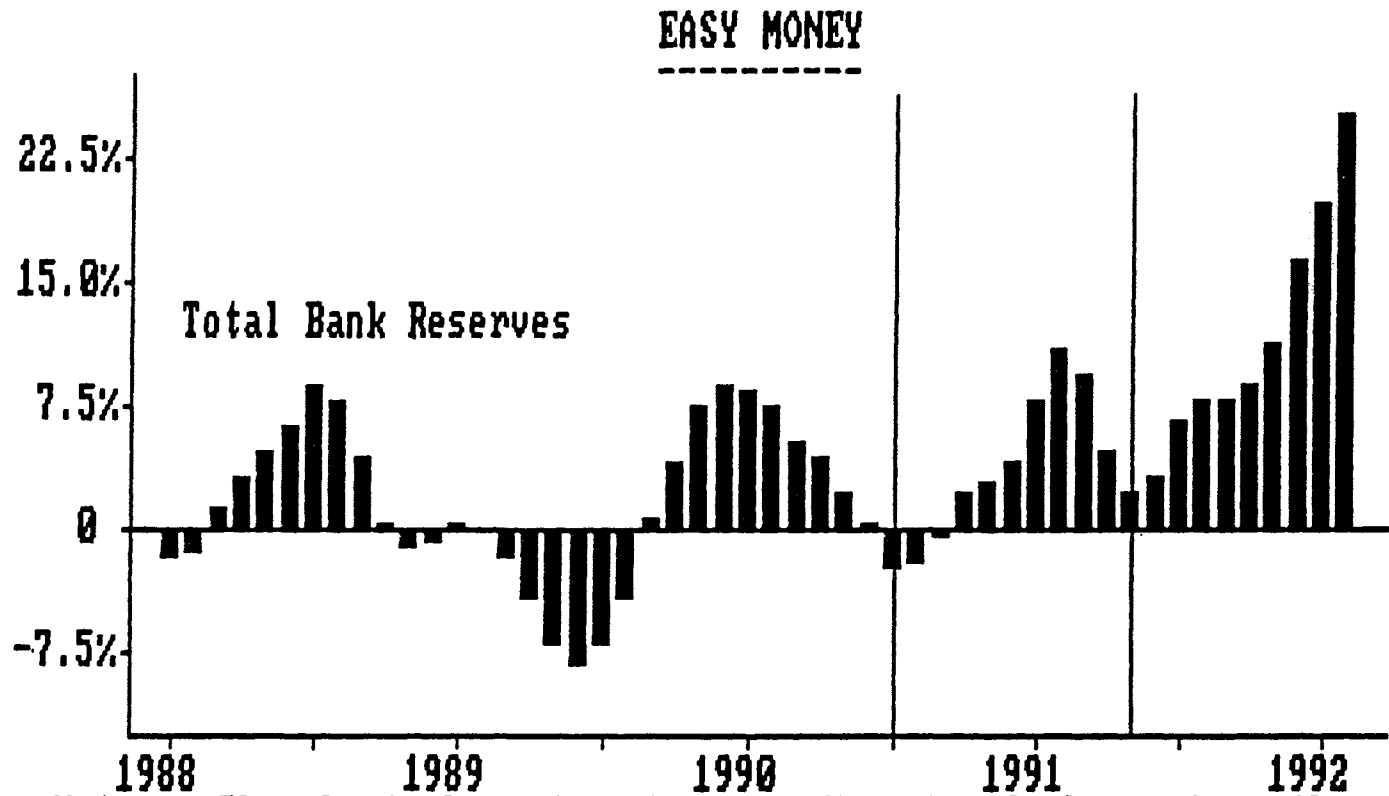
1  
2  
MONTH  
CHANGES



Notes: The chart shows annual changes in full-time employment in nonfarm occupations. Data are millions of employees, seasonally adjusted. Household survey. Total nonfarm employment less voluntary and involuntary part timers. Vertical lines show recessions.

Sources: Haver Analytics; Heinemann Economic Research

THREE MONTH CHANGES



Notes: The chart shows the three-month rate of change in a three-month moving average of total bank reserves adjusted for shifts in legal reserve requirements. Data at seasonally adjusted annual rates. The vertical lines show the recession.

Sources: Haver Analytics; Heinemann Economic Research



TOTAL BANK RESERVES (FRB)  
(Millions of Dollars)  
Compound Annual Rates of Change

05-Mar-92		Initial Month																							
Terminal	Feb 90	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan 91	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan 92	Feb
Month	48048	48112	48202	47982	47898	47836	47973	48262	47942	48245	49104	49459	49590	49530	49344	50000	50345	50410	50888	51147	51818	52895	53752	54388	56417
Mar 90	1.81																								
Apr	1.94	2.27																							
May	-0.71	-1.88	-5.81																						
Jun	-0.95	-1.78	-3.75	-1.64																					
Jul	-2.05	-2.04	-4.81	-4.01	-8.32																				
Aug	-0.31	-0.69	-1.42	0.09	0.97	8.83																			
Sep	0.78	0.82	0.30	1.89	3.09	8.15	7.47																		
Oct	-0.33	-0.60	-1.08	-0.10	0.29	2.59	-0.39	-7.87																	
Nov	0.55	0.41	0.15	1.18	1.78	3.88	2.29	-0.21	7.85																
Dec	2.64	2.78	2.82	4.12	5.11	7.58	7.24	7.18	15.45	23.59															
Jan 91	3.21	3.37	3.49	4.72	5.88	7.80	7.60	7.83	13.27	18.08	9.03														
Feb	3.21	3.36	3.47	4.55	5.35	7.13	6.85	6.73	10.67	11.63	8.09	3.23													
Mar	2.84	2.95	3.01	3.94	4.57	6.02	5.63	5.32	8.13	8.21	3.52	0.86	-1.44												
Apr	2.31	2.36	2.37	3.15	3.64	4.81	4.32	3.87	5.93	5.55	1.47	-0.93	-2.94	-4.41											
May	3.24	3.35	3.44	4.25	4.80	5.98	5.87	5.45	7.47	7.41	4.44	3.32	3.35	5.83	17.17										
Jun	3.58	3.70	3.80	4.58	5.11	6.22	5.98	5.80	7.81	7.58	5.12	4.35	4.64	6.75	12.81	8.90									
Jul	3.45	3.58	3.65	4.36	4.84	5.82	5.55	5.38	8.92	8.81	4.60	3.88	4.01	5.43	8.93	5.02	1.58								
Aug	3.90	4.04	4.15	4.85	5.33	6.28	6.07	5.95	7.41	7.38	5.49	5.00	5.30	6.70	9.67	7.28	8.82	11.94							
Sep	4.03	4.18	4.27	4.94	5.39	6.29	6.09	5.98	7.31	7.28	5.59	5.18	5.44	6.64	8.99	7.04	8.53	9.10	8.33						
Oct	4.63	4.80	4.94	5.81	6.08	6.98	6.83	6.78	8.08	8.10	6.88	6.40	6.81	8.04	10.27	8.94	9.02	11.63	11.48	18.88					
Nov	5.42	5.61	5.78	6.46	6.97	7.86	7.80	7.82	9.12	9.22	8.00	7.90	8.43	9.74	11.92	11.07	11.57	14.22	15.00	19.59	22.37				
Dec	8.31	8.54	8.78	7.46	7.99	8.90	8.91	9.00	10.30	10.49	9.47	9.51	10.15	11.52	13.69	13.21	13.99	16.08	17.87	21.98	24.82	28.91			
Jan 92	6.66	8.90	7.12	7.81	8.33	9.21	9.24	9.35	10.59	10.78	9.88	9.93	10.56	11.83	13.80	13.39	14.09	16.32	17.22	20.11	21.20	20.63	14.85		
Feb	6.36	8.88	8.98	9.72	10.32	11.28	11.41	11.65	12.98	13.34	12.64	12.92	13.77	15.26	17.44	17.47	18.63	21.29	22.62	26.54	29.07	31.39	33.09	55.88	

March 8-9, 1992

Source: Heinemann Economic Research

05-Mar-92

Table 1 - Part 1

(Federal Reserve Board Monetary Base)

## Federal Reserve Action and Monetary Growth

(\$ Billions)

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
Date	Monetary Base	Currency	Total Adjusted Bank Reserves	Demand Deposits	Savings & Small Time Deposits*	Large Time Deposits	Non- deposit Liabl.	Foreign Deposits	Treasury Deposits	Total Deposits**
Jul 1989	268.6	217.8	50.8	554.1	1989.7	574.7	296.9	11.7	23.0	3450.1
Aug	269.1	218.7	50.4	554.0	2001.9	571.2	286.4	10.5	15.8	3439.8
Sep	270.0	219.2	50.6	555.4	2009.5	568.1	275.5	11.0	24.9	3444.4
Oct	271.3	220.0	51.3	560.6	2017.6	566.2	266.5	11.5	20.7	3443.1
Nov	272.0	220.5	51.5	581.0	2028.1	565.3	264.5	10.8	14.7	3444.4
Dec	274.2	222.2	52.0	563.9	2036.1	563.5	257.0	11.1	19.6	3451.2
Jan 1990	276.5	224.5	52.0	563.4	2040.7	560.0	252.9	11.3	23.2	3451.5
Feb	278.7	226.6	52.1	566.9	2047.3	554.9	251.2	10.6	22.0	3452.9
Mar	280.6	228.4	52.2	568.7	2055.8	549.3	247.0	10.6	16.7	3448.1
Apr	282.6	230.3	52.3	569.8	2063.0	543.7	242.9	10.7	20.0	3450.1
May	284.0	231.9	52.1	567.8	2065.3	540.5	249.6	11.1	25.2	3459.5
Jun	285.8	233.7	52.1	570.0	2068.7	538.0	249.0	10.6	20.9	3457.2
Jul	287.4	235.7	51.7	567.3	2072.9	535.0	249.3	10.5	15.3	3450.3
Aug	290.5	238.4	52.1	570.1	2076.9	529.2	252.8	11.0	23.5	3463.5
Sep	293.8	241.9	51.9	572.6	2085.6	511.5	248.0	11.7	31.1	3460.5
Oct	295.9	244.2	51.7	569.7	2086.0	507.1	247.1	10.9	21.0	3441.8
Nov	297.8	245.4	52.2	570.0	2087.4	503.8	241.0	10.7	19.2	3432.1
Dec	299.8	246.8	53.0	571.0	2089.4	494.9	233.0	10.5	23.1	3421.9
Jan 1991	305.1	251.5	53.6	566.4	2091.6	496.6	229.8	10.9	29.4	3424.7
Feb	308.9	254.6	54.3	573.4	2100.5	499.6	226.9	9.8	39.3	3449.5
Mar	310.9	256.0	54.9	578.1	2107.6	492.8	220.9	9.6	28.4	3437.4
Apr	310.2	256.3	53.9	578.6	2112.4	487.7	217.0	10.0	20.4	3426.1
May	311.3	256.6	54.7	586.1	2117.0	483.5	211.1	9.7	19.6	3427.2
Jun	312.5	257.6	54.9	591.7	2117.4	478.3	207.9	9.1	23.6	3428.0
Jul	314.2	259.3	54.9	592.9	2115.6	471.2	206.4	9.5	20.8	3416.4
Aug	316.7	261.3	55.4	597.4	2114.9	465.5	209.3	9.4	17.1	3413.6
Sep	318.5	262.9	55.6	601.2	2113.4	458.5	204.6	9.3	26.9	3413.9
Oct	320.9	264.8	56.1	608.3	2110.6	450.0	208.0	9.2	28.6	3414.7
Nov	323.1	266.0	57.1	617.3	2109.2	442.2	209.3	9.4	28.6	3418.0
Dec	325.2	267.3	57.9	622.7	2107.6	437.0	205.1	9.8	25.3	3407.5
Jan 1992	327.7	269.4	58.3	632.8	2106.2	427.1	206.2	10.0	33.3	3415.6
Feb PE	332.2	271.5	60.6	649.8	2105.4	420.8	208.1	9.2	26.4	3419.6

\* Includes Money Market Deposit Accounts

\*\*(4+5+6+7+8+9)

Shadow Open Market Committee

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Table 1 - Part 2

Federal Reserve Action and Monetary Growth

Date	(11)	(12)	(13)	(14)	(15)	(16)	(17)	(18)
	Adjusted Reserve Ratio	Currency Ratio	Savings & Small Time Deposit Ratio	Large Time Deposit Ratio	Non- deposit Liabil. Ratio	% Foreign Deposit Ratio	Treasury Deposit Ratio	Money Multi- plier
	(3/10)	(2/4)	(5/4)	(6/4)	(7/4)	(8/4)	(9/4)	(2+4/1)
Jul 1989	0.0147	0.3931	3.5909	1.0372	0.5358	0.0211	0.0415	2.8743
Aug	0.0147	0.3948	3.6135	1.0310	0.5170	0.0190	0.0285	2.8710
Sep	0.0148	0.3947	3.6181	1.0229	0.4980	0.0198	0.0448	2.8686
Oct	0.0149	0.3924	3.5990	1.0100	0.4754	0.0205	0.0369	2.8772
Nov	0.0149	0.3930	3.6152	1.0077	0.4715	0.0193	0.0262	2.8732
Dec	0.0151	0.3940	3.6107	0.9993	0.4558	0.0197	0.0348	2.8672
Jan 1990	0.0151	0.3965	3.6221	0.9940	0.4489	0.0201	0.0412	2.8495
Feb	0.0151	0.3997	3.6114	0.9788	0.4431	0.0187	0.0388	2.8478
Mar	0.0151	0.4018	3.6149	0.9659	0.4343	0.0186	0.0294	2.8408
Apr	0.0152	0.4042	3.6206	0.9542	0.4283	0.0188	0.0351	2.8309
May	0.0151	0.4084	3.6374	0.9519	0.4396	0.0195	0.0444	2.8181
Jun	0.0151	0.4100	3.6293	0.9439	0.4368	0.0186	0.0367	2.8125
Jul	0.0150	0.4155	3.6540	0.9431	0.4395	0.0185	0.0270	2.7938
Aug	0.0150	0.4182	3.6430	0.9283	0.4434	0.0183	0.0412	2.7835
Sep	0.0150	0.4225	3.6423	0.8933	0.4331	0.0204	0.0543	2.7723
Oct	0.0150	0.4286	3.6616	0.8978	0.4337	0.0191	0.0369	2.7502
Nov	0.0152	0.4305	3.6921	0.8896	0.4228	0.0188	0.0337	2.7404
Dec	0.0155	0.4322	3.6582	0.8823	0.4061	0.0184	0.0405	2.7280
Jan 1991	0.0156	0.4440	3.6928	0.8738	0.4057	0.0192	0.0519	2.6908
Feb	0.0156	0.4440	3.6632	0.8661	0.3957	0.0171	0.0685	2.6801
Mar	0.0160	0.4428	3.6457	0.8642	0.3821	0.0166	0.0491	2.6627
Apr	0.0157	0.4430	3.6509	0.8517	0.3750	0.0173	0.0353	2.6913
May	0.0160	0.4378	3.6120	0.8321	0.3802	0.0166	0.0338	2.7073
Jun	0.0160	0.4354	3.5785	0.8171	0.3514	0.0154	0.0399	2.7180
Jul	0.0181	0.4373	3.5682	0.8067	0.3461	0.0160	0.0351	2.7121
Aug	0.0182	0.4374	3.5402	0.7888	0.3504	0.0157	0.0288	2.7115
Sep	0.0183	0.4373	3.5153	0.7743	0.3403	0.0155	0.0447	2.7131
Oct	0.0164	0.4353	3.4897	0.7537	0.3419	0.0151	0.0470	2.7205
Nov	0.0167	0.4309	3.4186	0.7290	0.3391	0.0152	0.0483	2.7335
Dec	0.0170	0.4293	3.3846	0.7101	0.3294	0.0157	0.0409	2.7366
Jan 1992	0.0171	0.4257	3.3284	0.6906	0.3259	0.0158	0.0526	2.7531
Feb PE	0.0177	0.4178	3.2400	0.6573	0.3202	0.0141	0.0409	2.7738

March 8-9, 1992

Table 2

Federal Reserve Action and Monetary Growth

(Compound Annual Rates of Change)

This is accounted for by changes in the:

Date	Monetary Growth (M-1)	Federal Reserve Actions (Monetary Base Growth)	Contribution of the Money Multiplier	This is accounted for by changes in the:								
				Adjusted Reserve Ratio	Currency Ratio	Savings & Small Time Deposit Ratio	Large Time Deposit Ratio	Non-Deposit Liability Ratio	Foreign Deposit Ratio	Treasury Deposit Ratio		
Jul 1989	8.79	4.21	4.58	-0.94	4.02	0.41	0.36	0.49	0.01	0.23		
Aug	1.25	2.64	-1.39	0.78	-2.85	-0.87	0.24	0.73	0.08	0.50		
Sep	2.99	4.01	-1.02	-1.46	0.16	-0.17	0.31	0.60	-0.03	-0.82		
Oct	9.70	5.63	3.67	-2.26	3.66	0.73	0.49	0.79	-0.03	0.30		
Nov	1.39	3.10	-1.71	-0.78	-1.01	-0.81	0.09	0.15	0.05	0.41		
Dec	7.30	10.03	-2.73	-1.78	-1.75	0.18	0.34	0.64	-0.02	-0.35		
Jan 1990	2.78	10.74	-7.95	-0.17	-7.54	-0.47	0.22	0.28	-0.02	-0.28		
Feb	8.87	9.72	-0.85	-0.12	-2.20	0.45	0.63	0.24	0.08	0.10		
Mar	5.58	6.77	-3.19	-1.08	-3.23	-0.14	0.52	0.35	0.00	0.38		
Apr	4.61	6.96	-4.35	-0.39	-4.29	-0.23	0.47	0.32	-0.01	-0.23		
May	-0.60	5.83	-6.43	1.81	-6.79	-0.65	0.09	-0.52	-0.03	-0.36		
Jun	6.17	7.82	-1.65	-0.10	-2.64	0.32	0.32	0.11	0.04	0.30		
Jul	-1.04	7.20	-8.24	1.07	-6.66	-0.95	0.03	-0.10	0.00	0.36		
Aug	6.54	13.48	-4.92	-0.66	-4.53	0.44	0.60	-0.18	-0.03	-0.37		
Sep	9.28	14.73	-5.45	0.53	-7.31	0.03	1.46	0.43	-0.05	-0.54		
Oct	-0.88	9.09	-9.97	-0.23	-9.53	-0.73	-0.17	-0.02	0.05	0.67		
Nov	2.23	6.74	-4.50	-2.30	-3.06	-0.02	0.32	0.43	0.01	0.12		
Dec	3.59	9.38	-5.79	-3.78	-2.75	0.11	0.29	0.58	0.02	-0.27		
Jan 1991	0.15	23.45	-23.31	-2.83	-18.97	-1.45	0.37	0.10	-0.04	-0.50		
Feb	15.67	18.21	-0.34	-1.40	0.02	0.93	0.24	0.31	0.07	-0.52		
Mar	9.21	7.98	1.23	-3.12	2.06	0.76	0.06	0.59	0.02	0.64		
Apr	1.18	-2.85	3.81	3.10	-0.17	-0.18	0.39	0.22	-0.02	0.44		
May	11.81	4.09	7.71	-2.48	7.53	1.37	0.69	0.52	0.03	0.05		
Jun	9.81	4.75	5.07	-0.42	3.59	1.22	0.54	0.32	0.04	-0.22		
Jul	4.18	6.92	-2.74	-0.55	-3.44	0.46	0.47	0.14	-0.03	0.21		
Aug	9.55	9.84	-0.29	2.44	0.12	-1.59	-1.01	0.13	-0.02	-0.36		
Sep	7.81	7.09	0.72	-0.25	0.10	0.64	0.37	0.26	0.01	-0.41		
Oct	13.24	9.58	3.66	-1.37	2.60	1.64	0.74	-0.08	0.01	-0.06		
Nov	14.98	6.56	8.39	-3.07	6.48	1.86	0.91	0.11	-0.00	0.03		
Dec	9.49	6.04	1.45	-2.34	1.68	0.95	0.55	0.28	-0.01	0.17		
Jan 1992	17.75	9.53	8.22	-0.27	5.67	2.36	0.82	0.15	-0.00	-0.50		
Feb PE	26.60	17.56	11.02	-7.80	12.98	3.88	1.37	0.23	0.07	0.49		
1988	1988	1988	1988	1988	1988	1988	1988	1988	1988	1988		
1989	5.02	7.00	-1.98	0.47	-1.94	-0.16	-0.21	-0.13	0.00	-0.00		
1990	0.92	4.09	-3.17	0.11	-2.92	-0.52	-0.15	0.29	0.00	0.02		
1991	18.00	9.00	8.22	-0.27	5.67	2.36	0.82	0.15	-0.00	-0.50		
1992	4.09	9.37	-5.28	-0.45	-5.21	-0.15	0.40	0.16	0.00	-0.02		
1991-IH	1991-IH	1991-IH	1991-IH	1991-IH	1991-IH	1991-IH	1991-IH	1991-IH	1991-IH	1991-IH		
1991-IIH	8.00	8.97	-0.97	-1.19	-0.99	0.44	0.39	0.34	0.02	0.02		
1991-IIIH	9.87	8.33	1.54	-0.66	1.32	0.68	0.34	0.14	-0.01	-0.06		
	1.67	-0.64	2.51	0.34	2.30	0.23	-0.05	-0.20	-0.02	-0.09		

Table 3

Federal Reserve Action and Monetary Growth  
(Compound Annual Rates of Change)

## THREE-MONTH MOVING AVERAGES

This is accounted for by changes in the:

Date	Monetary Growth (M-1)	Federal Reserve Actions (Monetary Base Growth)	Contri- bution of the Money Multi- plier	This is accounted for by changes in the:						
				Adjusted Reserve Ratio	Currency Ratio	Savings & Small Time Deposit Ratio	Large Time Deposit Ratio	Non- Deposit Liability Ratio	Foreign Deposit Ratio	Treasury Deposit Ratio
Jul 1989	-1.27	3.08	-4.35	0.51	-3.78	-0.88	-0.28	0.12	-0.03	-0.07
Aug	2.07	3.11	-1.04	-0.03	-1.36	-0.53	0.09	0.39	0.00	0.42
Sep	4.34	3.62	0.72	-0.54	0.45	-0.21	0.30	0.67	0.02	0.04
Oct	4.65	4.18	0.49	-0.99	0.39	-0.10	0.35	0.77	0.01	0.08
Nov	4.69	4.31	0.38	-1.51	1.00	-0.02	0.30	0.58	-0.00	0.03
Dec	8.13	6.32	-0.19	-1.62	0.37	0.10	0.31	0.53	0.00	0.12
Jan 1990	3.82	7.99	-4.13	-0.91	-3.43	-0.30	0.22	0.36	0.01	-0.07
Feb	6.32	10.18	-3.84	-0.69	-3.83	0.05	0.40	0.39	0.01	-0.17
Mar	5.75	9.74	-4.00	-0.45	-4.32	-0.05	0.46	0.29	0.01	0.07
Apr	6.35	9.15	-2.80	-0.53	-3.24	0.03	0.54	0.31	0.02	0.06
May	3.20	7.66	-4.66	0.12	-4.77	-0.34	0.36	0.05	-0.01	-0.07
Jun	3.39	7.55	-4.15	0.44	-4.57	-0.19	0.29	-0.03	0.00	-0.10
Jul	1.51	6.98	-5.45	0.93	-6.03	-0.43	0.15	-0.17	0.00	0.11
Aug	4.56	9.49	-4.94	0.10	-5.28	-0.08	0.32	-0.05	0.00	0.04
Sep	5.59	11.79	-6.20	0.31	-6.83	-0.16	0.70	0.06	-0.03	-0.25
Oct	5.64	12.43	-6.78	-0.12	-7.12	-0.09	0.63	0.08	-0.01	-0.15
Nov	3.54	10.19	-6.64	-0.87	-6.64	-0.24	0.54	0.28	0.01	0.06
Dec	1.65	8.40	-6.76	-2.10	-5.12	-0.21	0.15	0.33	0.03	0.18
Jan 1991	1.99	13.19	-11.20	-2.97	-6.26	-0.45	0.33	0.37	-0.00	-0.21
Feb	6.53	16.35	-9.81	-2.67	-7.23	-0.13	0.30	0.33	0.02	-0.43
Mar	8.41	15.88	-7.47	-2.45	-5.83	0.08	0.23	0.33	0.02	-0.06
Apr	8.74	7.18	1.56	-0.47	0.64	0.51	0.24	0.38	0.02	0.25
May	7.39	3.14	4.25	-0.83	3.14	0.69	0.39	0.44	0.01	0.44
Jun	7.59	2.06	5.53	0.07	3.85	0.81	0.54	0.35	0.02	0.06
Jul	8.60	5.25	3.35	-1.15	2.56	1.02	0.57	0.33	0.01	0.02
Aug	7.65	7.17	0.68	0.49	0.09	0.03	-0.00	0.20	-0.00	-0.12
Sep	7.18	7.95	-0.77	0.55	-1.07	-0.18	-0.08	0.16	-0.01	-0.19
Oct	10.20	8.83	1.37	0.27	1.01	0.23	0.03	0.11	0.00	-0.29
Nov	12.00	8.40	3.60	-1.56	3.12	1.42	0.67	0.10	0.01	-0.16
Dec	12.56	8.72	3.84	-2.26	3.71	1.52	0.73	0.11	-0.00	0.04
Jan 1992	14.07	8.71	5.35	-1.89	4.66	1.78	0.76	0.16	-0.01	-0.10
Feb PE	18.61	11.72	6.90	-3.47	8.83	2.33	0.91	0.22	0.02	0.05

March 8-9, 1992

Table 4

Federal Reserve Action and Monetary Growth  
 (Compound Annual Rates of Change)  
 (Memo)

<u>Date</u>	<u>Reserve Growth Rate Month to Month</u>	<u>Reserve Growth Rate Three-month Moving Average</u>
Jul 1989	7.94	-0.37
Aug	-7.24	-0.18
Sep	9.50	3.40
Oct	11.89	4.72
Nov	4.58	8.68
Dec	11.65	9.37
Jan 1990	0.93	5.72
Feb	1.04	4.54
Mar	3.75	1.91
Apr	2.65	2.48
May	-5.74	0.22
Jun	-0.28	-1.12
Jul	-7.56	-4.53
Aug	8.18	0.11
Sep	-3.52	-0.97
Oct	-3.68	0.33
Nov	9.99	0.93
Dec	20.92	9.07
Jan 1991	14.72	15.21
Feb	17.96	17.87
Mar	13.66	15.45
Apr	-19.70	3.98
May	17.74	3.90
Jun	4.59	0.88
Jul	1.01	7.78
Aug	10.70	5.43
Sep	4.71	5.47
Oct	12.11	9.17
Nov	23.73	13.52
Dec	17.89	17.91
Jan 1992	8.07	18.57
	60.48	28.81
	1988	
	4.58	
	1989	
	0.87	
	1990	
	2.22	
	1991-IH	
	8.16	
	1991-IIH	
	11.09	
	3.53	

Source: Federal Reserve Board; Heinemann Economic Research

*March 8-9, 1992*

## WHERE DO WE STAND IN THE BATTLE AGAINST INFLATION?

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My bottom line in answering the question that makes up the title of this paper is: 1) Disciplined monetary policy over the last few years has reduced U.S. inflation another notch, leaving two to three percentage points to go to achieve price stability; 2) However, the current situation is fraught with peril for the Federal Reserve; further progress in reducing inflation in the near future, or even in sustaining gains already achieved, will be difficult to achieve, in part because of uncertainties over the economic impacts of reductions in defense spending.

The paper has two major sections. The first contains an analysis of recent inflation experience and an argument that we should consider the battle won when broad indexes of goods prices, rather than price indexes covering both goods and services, are stable. The second section contains an analysis of the current business situation with an emphasis on the importance of reductions in defense spending for the slow recovery so far from the 1990-91 recession. I'll argue that we run a risk of an excessively expansionary monetary policy because of a misinterpretation of the proper policy response to defense cuts.

### **The Inflation Situation Today**

Figure shows that CPI inflation rate since 1980 as measured by 12-month changes continuously compounded. I've shown Consumer Price Indexes for All Items and for All Items less food and energy. The change in the latter index is sometimes said to measure "core inflation." This term is somewhat misleading in that it seems to imply that increases in food and energy prices are somehow less important than increases in other prices, but I'll stick with it anyway. The reason

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<sup>1</sup>I thank Data Resources, Inc. for providing access to its data bank, from which I drew much of the data used in this paper. I also thank David McNicol and Paul Dickins of the Department of Defense, Office of the Assistant Secretary of Defense (Program Analysis and Evaluation), who sent me the material on defense impacts by state that I use in the second part of this paper.



for examining this index is that food and energy prices are often volatile in the short run; excluding them provides a measure of underlying inflation that is less subject to temporary aberrations than is the full index.

The average rate of core inflation from January 1983 to January 1992 was 4.4 percent; the rate over the 12 months ending January 1992 was slightly lower—3.9 percent. From past experience in the neighborhood of business cycle troughs, we might expect core inflation to fall a bit further in the months ahead. Table 1 shows how inflation has behaved just before and just after cycle troughs since World War II. Not counting the most recent recession, core inflation is 1.6 percentage points lower on the average over the twelve months following a recession than over the twelve months ending with the trough. Over the subsequent twelve months—that is, from 12 to 24 months after the trough—core inflation fell on the average by another 0.6 percentage point. We should not make too much of these averages; for core inflation data, the sample is small—only six troughs—and the table makes clear the variability around the averages due to special circumstances such as the two back-to-back recessions in the early 1980s. Nevertheless, if we take the averages at face value and assume that the most recent recession trough was May, 1991, which seems to me likely, then we cannot expect much additional decline in inflation in the months ahead as we are already through most of the first 12 months following the trough. If, however, the trough has not yet been reached, then we might expect some further easing of core inflation over the months ahead.

*What Does Zero Inflation Mean?* At the beginning of this paper I said that the U.S. economy was 2-3 percentage points away from achieving price stability, and I made this statement even though CPI core inflation over the 12 months ending January, 1992 was 3.9 percent. I now want to argue that the goal of price stability should be stated in terms of goods prices, putting services prices aside.

Changes in the quality of services makes services price indexes suspect. The problems of adjusting services prices are severe both conceptually and practically. The case of medical care prices, which account for 6.9 percent of the CPI at present, nicely illustrate the nature of the problem. On the one hand, rapid improvements in medical care technology have led to large unmeasured quality improvements for many medical services. On the other hand, prices of medical care are increasingly subject to distortion from the continuously growth involvement of government. Cost containment in medicine involves price control to some extent, and we know that price control generally leads to quality deterioration. At the conceptual level, it is hard to say exactly what service is being performed, and therefore what is being priced, from many extreme medical interventions

to extend life. If we cannot define the service in the first place, we cannot make any sense of the question of whether quality is improving or deteriorating and we do not really know what the prices indexes are measuring.

The necessity of thinking through the meaning of the price indexes, and especially the services component, has become more and more important. Services are growing as a proportion of the total economy, and the differential between indexes of services prices and goods prices is also growing. Table 2, which reports the three major components of the implicit price deflator for personal consumption expenditures in the National Income and Product Accounts, provides some numbers relevant to this issue.

The right-hand side of Table 2 reports differences in the inflation rates in the left-hand side of the table. We can see that the difference between services inflation and durables inflation, and between services inflation and non-durables inflation, have both tended to grow. The differential between services and durables inflation was 0.8 percentage point in the 1960s and 3.0 percentage points in the 1980s, and the non-durables differential was 0.4 and 1.9 percentage points for the 1960s and 1980s, respectively. If the total PCE deflator rises at a rate of about 2 percent, the durables and non-durables components will probably show little or no inflation.

Figure 2 shows the story of the Producers Price Index for finished goods since 1980. Core PPI inflation was just above 2 percent over the four quarters ending 1991:4. Reducing inflation by a further 2 percentage points will leave the PPI at about 0 inflation, on the average. Over the entire period from January 1947 to January 1992, the PPI for finished goods increased at an annual rate of 3.46 percent whereas the All Items CPI increased at a rate of 4.14 percent. For January 1983 to January 1992, the average rates for the PPI and CPI were 1.59 percent and 3.84 percent, respectively. Over this same period, these indexes excluding food and energy rose at rates of 2.05 percent for the PPI and 4.39 percent of the CPI. Thus, over the postwar period as a whole the gap between the CPI and PPI is about 0.7 percentage point but the gap may have now risen to about 2 percentage points, or even a little more.

*A Possible Danger in Falling Goods Prices.* If monetary policy were to achieve 0 increase, on the average, in the total CPI or the total PCE deflator, then we can reasonably expect that price indexes for durable and non-durable goods would be falling, perhaps at a rate of around 2 percent per year. The danger in a situation of declining goods prices is that the rate of decline might exceed the real rate of interest consistent with full-employment equilibrium. Because the nominal rate of interest on money cannot fall below zero, declining goods prices might yield a higher real rate of return from holding money than from holding physical capital or inventories of goods. U.S.

experience suggesting that the riskless real rate of interest is in the neighborhood of 2-3 percent on the average. Thus, achieving stability in broad price indexes that include services might put the U.S. economy quite close to the point at which the prices of goods are declining at a rate about equal to the real rate of interest. Many goods—certainly durable goods by definition—are storable; their purchases can be either accelerated or delayed by changes in expectations of their future prices relative to current prices.

Just as expectation of rising inflation can stimulate the economy, so also can expectations of falling goods prices depress the economy. The process is self-limiting during an inflationary period, provided the central bank does not accommodate the inflation by increasing money growth, because nominal interest rates rise, which increases the real rate of interest on interest-bearing assets denominated in money. However, this same process cannot work in reverse to limit the depressing effects of falling prices when the rate of deflation exceeds the real rate of interest. When the nominal rate of interest reaches zero, further deflation increases the expected real rate of return on assets denominated in money and by holding it above the real rate of return on goods reduces the demand for goods, further depressing economic activity. Economic activity is likely to be more stable if monetary policy yields stable goods prices rather than falling goods prices. Price indexes including services prices will then be rising.

### **The Inflation Outlook**

Given past experience immediately following cyclical troughs, given that the economy has developed a degree of slack, and given the lack of economic momentum in recent months, it seems safe to forecast that inflation is unlikely to become a problem over the next year or so. The issue is whether inflation is likely to rise starting one or two years from now. That is above all an issue of what kind of monetary policy the Federal Reserve will follow over the next several years. In addressing that issue, we need to focus on the role of defense cuts and public understanding of the implications of the cuts, and on the current and future stance of monetary policy. With regard to defense cuts, it would be unfortunate indeed if today's cuts led to monetary policy mistakes that caused more inflation. And it would be ironic, too, given that the Vietnam War build-up led to monetary policy mistakes that caused the beginning of the inflation that we are now in sight of vanquishing. With regard to monetary policy, a key issue today is the divergent behavior of M2 and other monetary aggregates.

*Defense Cuts.* Reductions in defense procurement spending started before 1989, but that was the last "normal" cold war year. The revolutions in Eastern Europe in 1989 and the collapse of the Soviet Union in 1990-91 have created a completely different environment for defense spending. Every worker in a defense industry now feels at risk even though, when the dust settles, many will in fact remain employed. These workers and their industries have begun to adjust to the changed situation. Declines in defense employment and output are not immediately offset by increases in non-defense employment and output because defense workers and capital cannot be instantaneously transferred to new uses. Declines in defense output and the indirect effects from lost personal income are part of the explanation for the slow (perhaps temporarily aborted) recovery from the recession.

To gain a feel for the role of defense cuts in causing increased unemployment, I have examined estimates of defense spending by state in 1989.<sup>2</sup> The case for using the *level* of defense spending in 1989 rather than estimates of defense *cuts* is that many of the effects of likely *future* cuts are already appearing as affected industries and workers react. Current defense outlays reflects past commitments; we should not expect that changes in outlays to date would have much explanatory power. Moreover, because future defense budgets are still being debated in the Congress and administration, it is not possible to come up with accurate estimates of planned defense cuts by state. My working assumption is simply that the largest dollar cuts will occur where the largest spending was in 1989.

I have examined estimates of defense spending in 1988 dollars by state for three major categories of spending shown in Section I of the reference cited in footnote 2. One is defense procurement and research, development, test, and evaluation (hereafter, simply "procurement"). The second is total direct defense purchases and pay excluding procurement. The third is indirect defense purchases resulting from direct defense purchases. The indirect purchases arise as defense contractors buy parts and materials from other firms. For example, Electric Boat's payroll for its workers building subs in its Groton, Connecticut shipyard appear in the procurement category; pay for Navy personnel on subs at Electric Boat in Groton appear in the second category; Electric Boat's purchases of steel and other inputs from firms all over the United States appear in the third category.

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<sup>2</sup>The data source is Department of Defense, "Projected Defense Purchases, Detail by Industry and State, Calendar Years 1989 through 1994," Directorate for Inflation, Operations and Reports (DIOR), the Pentagon, Washington, D.C., November 1989.

The Defense Department estimates of this third category are developed using the U.S. input-output tables and estimates of the distribution of industry by state. I have converted the data in dollars by state to per capita dollars by dividing by state employment in 1989.<sup>3</sup>

Figure 3 relates the increase in state unemployment rates between August, 1989 and August, 1991 to the per capita level of defense spending for procurement by state in 1989.<sup>4</sup> The correlation coefficient is 0.37. I am not sure what correlation I expected before making the calculation and looking at the figure, but I do find the figure revealing. We would not expect the correlation to be extremely high; state unemployment is obviously affected by much more than defense spending. Rhode Island, for example, sits between two high-defense states and experiences spill-over effects from those states. Rhode Island has also had a banking crisis that had nothing to do with defense and its large yacht-building industry was hit hard by the luxury tax on yachts. States such as Michigan with above-average concentrations of durables manufacturing always experience larger effects from recessions than other states.

The second category of defense expenditures is direct defense expenditures excluding procurement. These expenditures are largely payroll and other expenses of armed forces stationed at various bases in the United States. The correlation direct defense excluding procurement in 1989 and the change in state unemployment is 0.06, or essentially zero. This result is not really surprising; cuts in armed services personnel have been small, and have mostly come from reducing personnel at bases abroad. However, we should expect to see effects from this source in coming years as bases are closed.

The third category is indirect expenditures arising from direct expenditures. Indirect expenditures in 1989 have a correlation of 0.37 with the change in unemployment rate by state. This result suggests that effects from indirect expenditures are just as important as those from direct expenditures for procurement. However, the indirect expenditures result may be entirely spurious. The distribution of manufactured inputs purchased by defense contractors by state is necessarily highly correlated with durable goods manufacturing in general. Therefore, estimates of indirect defense expenditures may simply be picking up the usual effects of recession on durable manufacturing. In fact, the input-output methodology used by the Defense Department to estimate

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<sup>3</sup> State employment data source: *1991 Statistical Abstract of the United States*, Table 636.

<sup>4</sup> Unemployment rate by state from *Monthly Labor Review*, November, 1991, Table 11 and November, 1990, Table 11.

indirect defense expenditures does not explicitly identify firms supplying defense contractors but instead assumes that the indirect defense expenditures are distributed by state in the same way as total indirect expenditures are distributed by state in the input-output tables.

From Figure 3 we can see that the recession left many state untouched. Between August of 1989 and August of 1991, unemployment actually remained unchanged or fell in nine states and rose by 0.5 percentage point or less in another six states. Only four states experienced unemployment rate increases of 3.0 percentage points or more: New Hampshire, 3.4 percentage points; Delaware, 3.6 percentage points; Rhode Island, 4.7 percentage points; and Massachusetts, 4.9 percentage points. Federal Reserve efforts to use monetary policy to stimulate employment in depressed states would almost certainly create inflationary pressure for the economy as a whole. Despite the distress in certain states, the recession has been mild on the average—the national unemployment rate has been about 7 percent in recent months. The unemployment rate was about the same or above 7 percent for every year from 1980 through 1986.

Many analysts are unduly pessimistic about the speed with which the economy can adjust to defense cuts. Table 3 provides some perspective by comparing projected defense cuts out to 1997 with prior experience after the Korean and Vietnam wars. This is not the place to argue about whether the recessions following these wars were *caused* by defense cuts; contractionary monetary policy certainly played a role in both episodes. My point is simply that however the recessions are explained, the economy recovered quickly even though substantial defense cuts were being made.

During the Korean War, defense spending reached a high of 13.2 percent of GNP in 1953, and then fell rapidly over the next two years, to 9.6 percent of GNP in 1955. The recession of 1953-54 was followed by a boom in 1955 despite the defense cuts. The economy also went through a mild recession in 1969-70 as defense cuts began with the Vietnam War tapering down, but this recession was followed by a boom in 1972.

The estimates shown in the right-hand block of Table 3 are based on defense outlays projected in the FY 1993 *Budget* and fiscal year GDP projected by the Congressional Budget Office. Defense cuts may be somewhat larger than administration proposal in the *Budget*, but such cuts would still be smaller as a percentage of GDP than were the cuts after the Korean War. Certain communities will be heavily affected by cuts, but the economy as a whole should have little difficulty in digesting them.

In sum, defense cuts and anticipations of future cuts may explain part of the recent recession and slow recovery. However, adjustments to those cuts are now well underway. The transfer of resources from defense to non-defense uses requires real adjustments that monetary policy can do little to affect. Policy makers should understand this fact and the fact that experience shows that the economy can handle large adjustments relatively smoothly. Policy makers must resist the temptation to follow expansionary policy; doing so will have little effect on the adjustment to smaller defense expenditures but will run the risk of delaying once again achievement of price stability.

*Recent Money Growth.* At the last SOMC meeting, I examined the behavior of the monetary aggregates and documented the fact that slow growth of M2 in 1990-91 was due to its small CD component. I argued that we should emphasize a definition of money that excluded small CDs. After the meeting, I learned that Brian Motley had published a paper in 1988 making roughly the same argument.<sup>5</sup> Motley's work and additional study on my part has led me to modify my preferred money definition by adding institution-only money market mutual funds, which are currently in M3. Thus, what I call "MZM" for "money zero maturity" equals present M2 plus institution-only MMMFs less small CDs. Figure 4 shows the behavior of MZM, M1, and M2 over the last few years.

Small CDs continue to run off at a rapid pace for the reasons I discussed at the last SOMC meeting. In the twelve months ending January, 1992, small CDs fell at a continuously compounded annual rate of 10.6 percent. Institution-only MMMFs have been growing rapidly and totaled \$182.4 billion in January, 1992, which reflects a 12-month growth rate of 27.7 percent continuously compounded. The well-known problems in the commercial banking and thrift industries are leading to changed flows of funds institutionally; we need to be sure that our definitions of monetary aggregates reflect the economic functions of various types of accounts in financial institutions rather than institutional patterns that have prevailed historically. We cannot yet be absolutely sure that M2 "ain't what she used to be," but I believe the case for adjusting our definitions is strong.

In my examination of the aggregates last fall, I used data ending with July, 1991. The 12-month growth rate for M1 was 5.9 percent; now the most recent figure is 9.7 percent. The 12-month growth rate for M2 was 2.9 percent; now the most recent figure is 3.4 percent. By every measure, monetary policy is more expansionary than it was six months ago. If I am right that M2 should be deemphasized, then monetary policy is not only more expansionary than it was but also quite expansionary on an absolute scale. If this monetary expansion has the usual, and intended, effect, then the economy

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<sup>5</sup>"Should M2 be Redefined?," Federal Reserve Bank of San Francisco, *Review*, Winter 1988.

will start to grow vigorously very soon, which will put upward pressure on interest rates. To keep inflation from rising next year, the Fed will have to let interest rates rise as much as necessary to reduce money growth from current rates.



Figure 1

CPI, 12-Month Change  
Jan. 1980 -- Jan. 1992

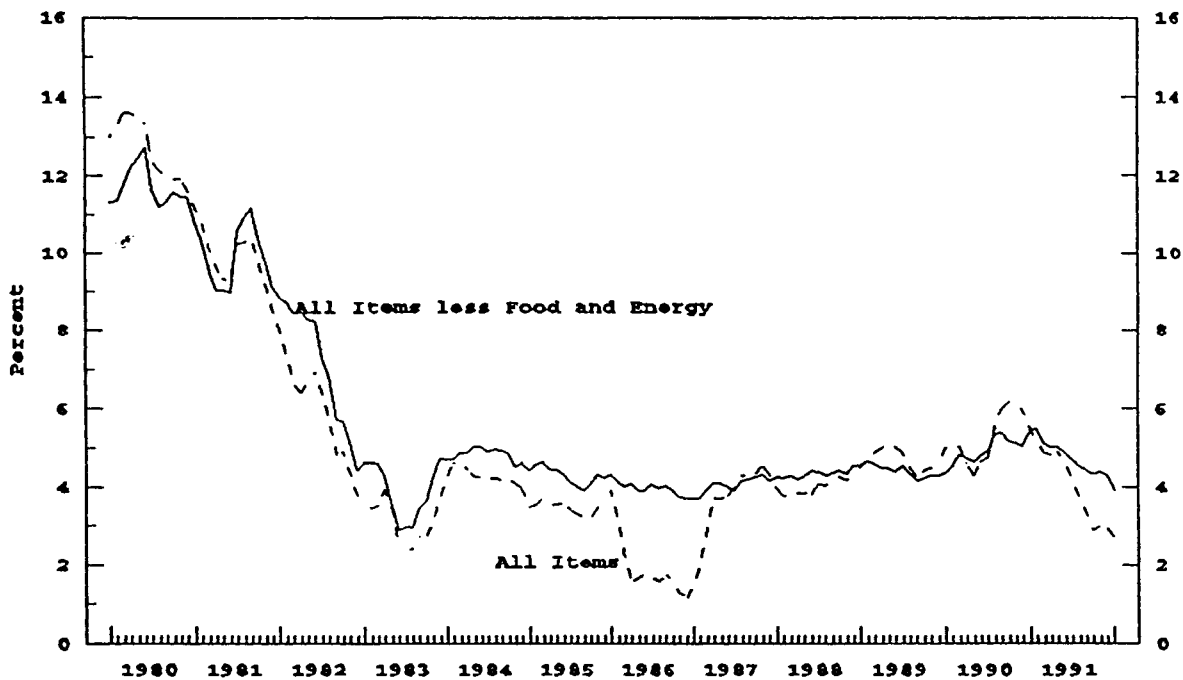


Table 1  
CPI Inflation Rate at NBER Reference Cycle Troughs  
(continuously compounded percentage annual rate)

Trough Month	All Items					All items less food and energy				
	12 Mo. Before	12 Mo. After	Change	Next 12 mo.	Change	12 Mo. Before	12 Mo. After	Change	Next 12 mo.	Change
1949:10	-2.7	3.4	6.1	6.6	3.1	NA	NA	NA	NA	NA
1954:5	0.9	-0.6	-1.5	1.0	1.6	NA	NA	NA	NA	NA
1958:4	3.6	0.1	-3.4	1.9	1.8	2.4	1.7	-0.7	2.0	0.3
1961:2	1.5	0.9	-0.6	1.2	0.3	0.7	1.3	0.6	1.0	-0.3
1970:11	5.4	3.5	-2.0	3.4	-0.1	6.4	3.3	-3.1	3.0	-0.3
1975:3	9.9	5.9	-4.1	6.2	0.3	10.8	6.4	-4.4	6.0	-0.4
1980:7	12.4	10.2	-2.1	6.4	-3.9	11.7	10.5	-1.1	7.3	-3.3
1982:11	4.4	3.1	-1.3	4.1	1.0	5.2	4.2	-0.9	4.5	0.3
Average			-1.1		0.5			-1.6		-0.6
1991:5 ?	4.9	2.6*				5.0	3.9*			

NA: Not available

\* 12 months ending 1992:1

Note: Due to rounding error, differences in inflation rates may not match table's entries, which are calculated from unrounded data.

Table 2 Implicit Price Deflator for Personal Consumption Expenditures Selected Periods							
	Average Inflation Percent Annual Rate				Inflation Differential* Services less:		
	Total	Durables	Non- durables	Services	Total	Durables	Non- durables
59:1-91:4	4.6	3.3	4.4	5.1	0.5	1.9	0.7
59:1-69:4	2.4	1.9	2.4	2.7	0.3	0.8	0.4
69:4-79:4	6.6	5.1	7.1	6.7	0.1	1.6	-0.3
79:4-91:4	4.9	3.0	4.1	6.0	1.1	3.0	1.9
90:4-91:4	2.9	1.8	1.2	4.0	1.1	2.2	2.7

\* Entries may not match differences in table entries for inflation rates due to rounding error.

Figure 2

PPI Finished Goods, 12-Month Change

Jan. 1980 -- Jan. 1992

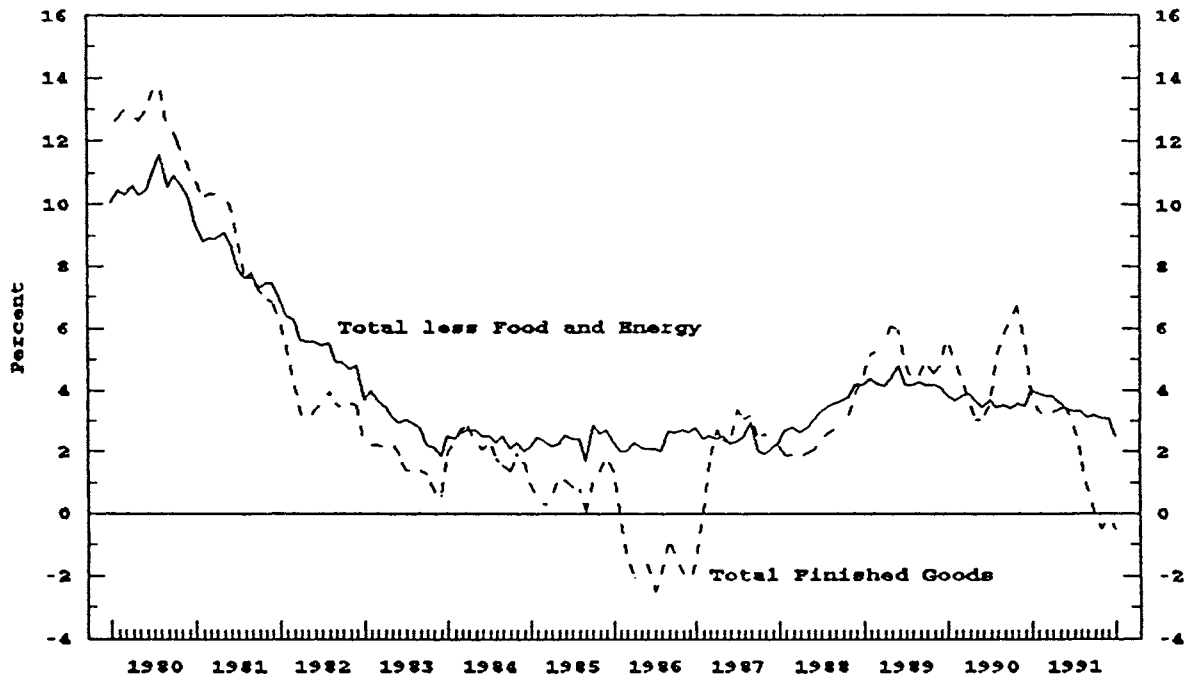
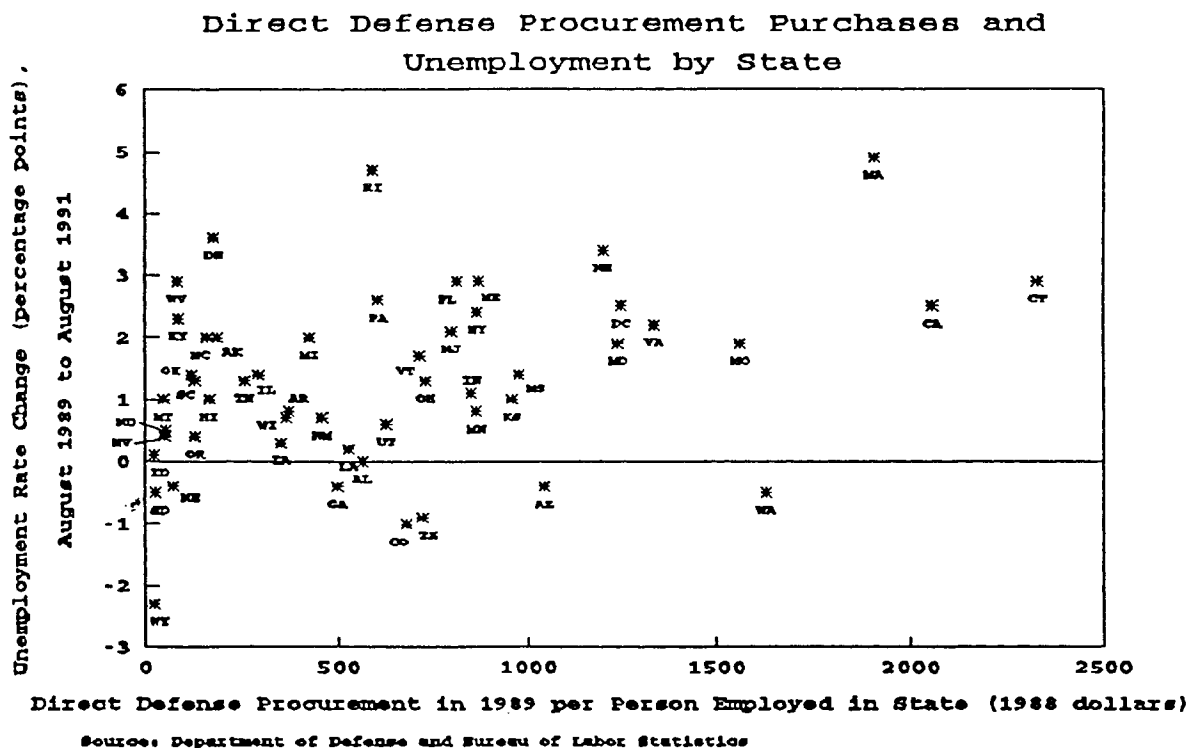


Figure 3



**Table 3**  
**Defense and the Economy, 1950-56, 1969-74, and 1989-97 (1992-97 Projected)**  
**Defense Purchases as Percentage of GNP or GDP**

% of GNP <sup>a</sup>		% of GDP <sup>b</sup>		% of GDP <sup>c</sup>	
1950	5.0	1969	8.2	1989	5.9
1951	10.1	1970	7.6	1990	5.5
1952	13.1	1971	6.7	1991	4.9
1953	13.2	1972	6.4	1992	4.8
1954	11.2	1973	5.7	1993	4.4
1955	9.6			1994	4.1
1956	9.5			1995	3.8
				1996	3.7
				1997	3.5

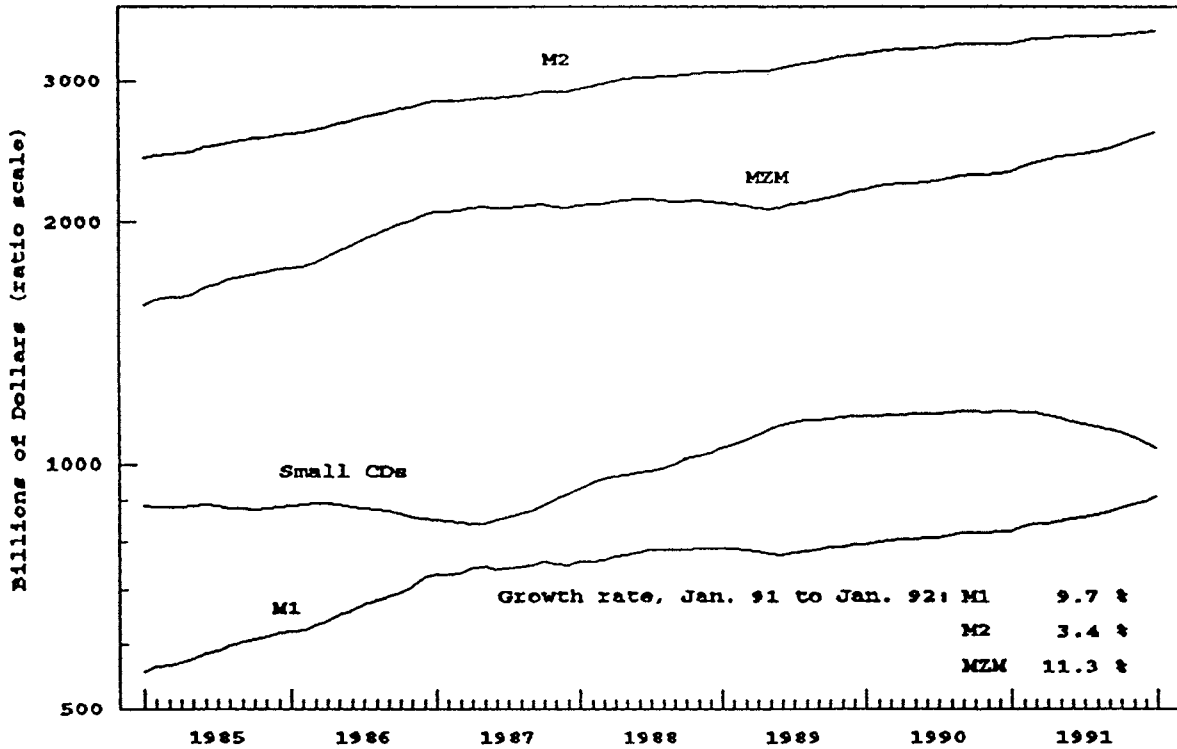
<sup>a</sup> Calculated from NIPA calendar year data, 1989 *Economic Report of the President*, Table B1.

<sup>b</sup> Calculated from NIPA calendar year data, 1992 *Economic Report of the President*, Table B1.

<sup>c</sup> Fiscal year basis; national defense budget outlays as percentage of GDP; actual, 1989-91, from 1992 *Economic Report of the President*, Tables B-74, B-75; projected, 1992-97, from *Budget of the United States, FY 1993*, Table 11-4 and Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1993-1997*, Table 1-5.

Figure 4

Monetary Aggregates, Monthly,  
1985:1 -- 1992:1



## SOME ISSUES IN THE INTERPRETATION OF RECENT MONETARY POLICIES

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Two articles have appeared in the *Wall Street Journal* in recent months which allege that the Federal Reserve's practice of targeting the Fed funds rate, in conjunction with the actions of the RTC, OTC and/or other bank regulators, has wiped out any monetary stimulus during the recent recession. In particular, Paul L. Kasriel argues that "although the Fed has been pushing down on the monetary throttle, the forward thrust has been overwhelmed by the activities of the FDIC and the RTC (*Wall Street Journal*, December 23, 1991). In a subsequent letter to the editor, James L. Grauer argues that "what appears to be a respectable buildup of reserves in the past few months can inauspiciously be ascribed to the conscription of surplus reserves to accounting recognition by the Fed as depositors shifted money out of accounts not requiring reserves into those M1 categories still requiring reserves." Both writers advocate that the Fed abandon funds rate targeting.

I certainly do not wish to quarrel with the policy position of these authors that Fed funds targets are, in general, not the best way to operationalize monetary policy. However, I believe that their interpretation of the monetary history of the recent recession is contradicted by the available evidence. Indeed, my interpretation is that in spite of its devotion to Fed funds targets, during the past year the Fed has avoided the pit into which it traditionally has plunged during recessions with its interest rate targets.

Consider first Mr. Kasriel's argument about the interaction of the FDIC and RTC actions with the Fed's interest rate targeting policy. The key assumption in his argument is that the actions of the RTC and the FDIC have generated conditions under which the actual excess reserves in the banking system exceed desired excess reserves at the funds rate target. If such a situation materialized, and if the Fed maintains its funds rate target, there is no doubt that reserves would be withdrawn from the banking system. The key here is that it does not follow that closing of insolvent depository institutions automatically generates excess reserves that exceed desired reserves at the established funds rate targets. If loan demand remains strong, all reserves that find their way into



the remaining depository institutions will be loaned out. If loan demand weakens, regardless of whether the RTC or FDIC is closing insolvent institutions, actual excess reserves will exceed desired excess reserves at the funds rate target and the Fed will withdraw reserves from the banking system if it tries to maintain the funds rate target. The necessary and sufficient condition for the Kasriel scenario to occur is that the rate of interest that banks can earn on loans and investments falls relative to the funds rate maintained by the Fed. Under these conditions, there is a net excess supply of Fed funds, to which the Fed must react either by changing the funds rate target or conducting open market sales.

The data do not support the case that the Fed has tried to prop up the funds rate in the face of weakening loan demand over the past year. From February, 1991 through December, 1991 the St. Louis Adjusted Monetary Base has grown at an annual rate of 8.4 percent. Adjusted Bank Reserves as measured by St. Louis have grown at an annual rate of 8.7 percent; the currency component of the money stock has grown at an annual rate of 8.3 percent; M1 has grown at an annual rate of 8.6 percent and Bill Poole's measure of M2, Small Time Deposits, has grown at an annual rate of 8.9 percent. Since the peak on the late expansion in July, 1990, through December, 1991, Adjusted Bank Reserves as measured by St. Louis have grown at an annual rate of 8.1 percent. This represents a substantial increase in the growth rate of adjusted reserves over that of the three years prior to the cyclical peak (see attached graph), as Erich Heinemann regularly reminds his readers. This is hardly a picture of a Fed that is steadily withdrawing reserves from the banking system to stem the fall of the funds rate during the contraction phase of the cycle.

The weakness in M2 and M3 growth in the second and third quarters of 1991 is concentrated totally in the Small and Large Certificate of Deposits components of those aggregates. From the second to the third quarter of 1991 when M2 stood still, M1 grew at an annual rate of 7.0 percent, the Adjusted Base at an annual rate of 5.7 percent, and Adjusted Reserves as defined by St. Louis grew at an annual rate of 4.7 percent. The lack of growth of M2 during this period is the next result of a decline in the ratio of the non-M1 components of M2 (primarily small CDs) and the increase in the monetary base or adjusted reserves. It does not result from negative growth, or a decline in the growth rate of either the base or adjust reserves that is required to support the Kasriel hypothesis.

Mr. Grauer argues that there is a "black hole" from which reserves are emerging as portfolio shifts occur from nonreservable deposits to reservable transactions deposits. The argument for the existence of this "black hole" rests on the definition used by the Board of Governors for bank

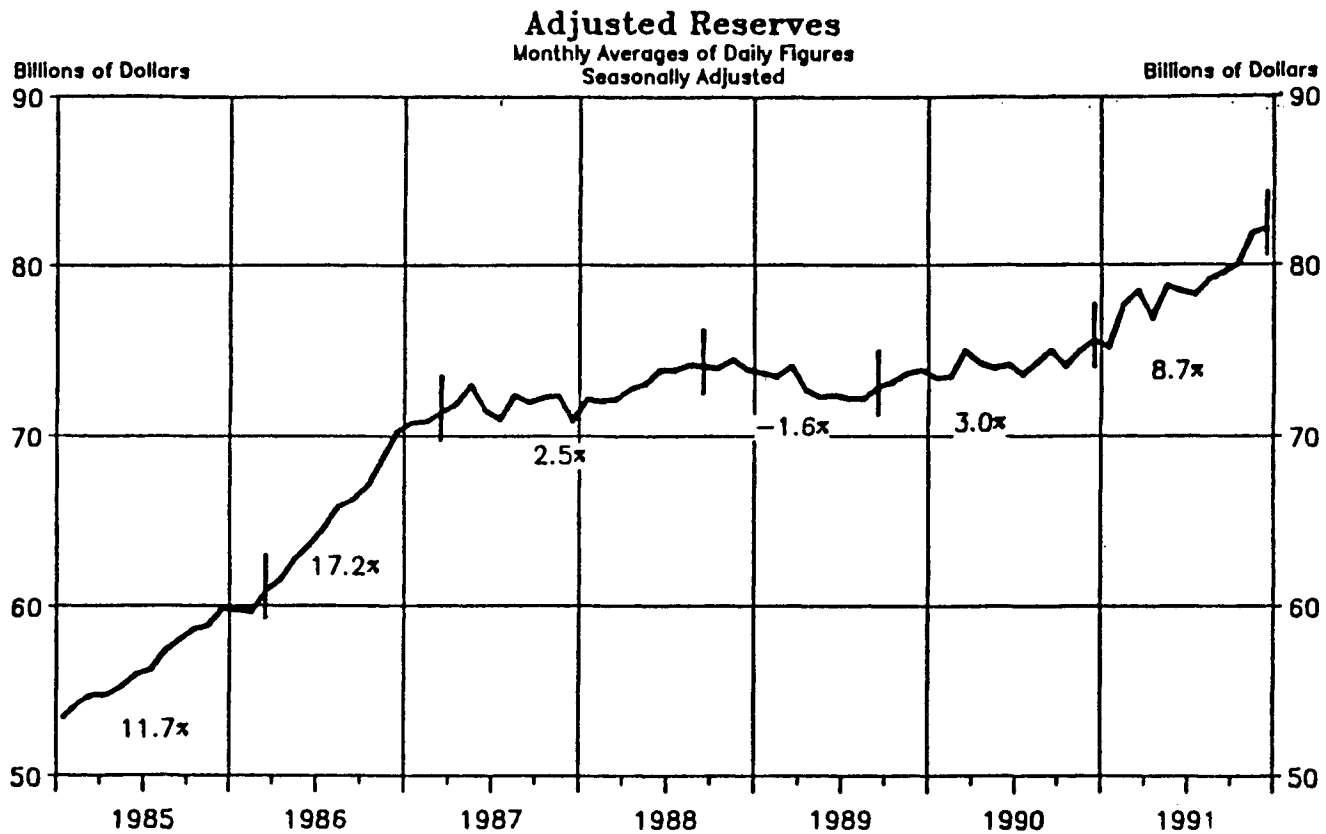
reserves. The current definition of such reserves *excludes* so called "surplus vault cash" of "non-bound depository institutions;" those depository institutions whose vault cash holdings exceed their required reserves.

The first important thing to note is that "surplus vault cash" is excluded only from the Board of Governors definition of bank reserves. It is *included* in the Board of Governors measure of the Monetary Base, and it is included in both the Adjusted Monetary Base and Adjusted Reserve Measures of the St. Louis Fed. (An excellent discussion of the measurement of the current Monetary Base concepts is "alternative Measures of the Monetary Base: What are the Differences and Are they Important," by Michelle R. Garfinkel and Daniel L. Thornton, Federal Reserve Bank of St. Louis, *Review*, November/December, 1991, pp. 19-35.) Since the latter three measures include all vault cash and deposits at the Fed they are invariant to shifts between nonreservable and reservable deposits, and their growth rates would not be artificially inflated by such shifts. Such shifts, if they were to occur could produce misleading signals from the Board of Governors measure of bank reserves. However, there is not evidence that surplus vault cash is merging from the "black hole" to confuse monetary signals. Table 1 shows monthly data for both surplus vault cash and excess reserves as measured by the Board of Governors for 1990-91. These data are from Table 1.12 in the *Federal Reserve Bulletin* and *are not seasonally adjusted*. Surplus Vault cash jumped after the reduction in required reserve ratios in December, 1990 and January, 1991. However, since April, 1991 it has remained quite constant in the range of 3.7-3.9 billion dollars, approximately 1.3-1.5 billion larger than during the corresponding months of 1990. Excess reserves, as measured by the Board of Governors have averaged close to 1.0 billion since April, 1991, around .1 billion higher than during the corresponding months of 1990. The sum of these two measures, which is probably the best available measure of "surplus reserves" in the banking system, has been quite steady in the range of 4.7-5.0 billion since April, 1991. Thus the data do not support the contention that reserves have emerged, or are emerging from the "black hole" of surplus vault cash to be captured in the measurement of required reserves and total reserves by the Board of Governors.

To the contrary, the important issue surrounding the surplus vault cash is not that posed by Mr. Grauer, but the question of measuring the impact of the reduction of reserve requirements when depository institutions are not effectively constrained in their portfolio decisions by such requirements. This is the issue that we discussed at our meeting in March, 1990.

Table 1  
Surplus Vault Cash and Excess Reserves

Month	Surplus Vault Cash	Excess Reserves	Surplus Vault Cash + Excess Reserves
Jan 1990	2.461	1.016	3.477
Feb 1990	2.795	.989	3.784
Mar 1990	2.330	.861	3.191
Apr 1990	2.178	.897	3.075
May 1990	2.351	.962	3.313
Jun 1990	2.314	.774	3.088
Jul 1990	2.460	.862	3.322
Aug 1990	2.563	.868	3.431
Sep 1990	2.473	.909	3.382
Oct 1990	2.590	.847	3.437
Nov 1990	2.433	.947	3.380
Dec 1990	2.893	1.665	4.558
Jan 1991	4.250	2.168	6.418
Feb 1991	4.753	1.809	6.562
Mar 1991	4.043	1.179	5.222
Apr 1991	3.764	1.030	4.794
May 1991	3.944	1.030	4.974
Jun 1991	3.801	1.008	4.809
Jul 1991	3.993	.906	4.899
Aug 1991	3.981	1.086	5.067
Sep 1991	3.869	.929	4.798
Oct 1991	3.919	1.083	5.002
Nov 1991	3.663	.893	4.556



Adjusted reserves is the difference between adjusted monetary base and currency component of M1.

Percentages are annual rates of change for periods indicated.

Prepared by Federal Reserve Bank of St. Louis

*March 8-9, 1992.*

## FOREIGN EXCHANGE MARKET INTERVENTION

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National Bureau of Economic Research

The Federal Reserve and the Treasury are reversing the policies of 1988-90 that increased authority of the Federal Reserve to warehouse holdings of foreign currency for the Treasury to \$25 billion. Warehousing is a term that refers to loans, not appropriated by Congress, from the Federal Reserve to the Treasury General Fund as well as the Exchange Stabilization Fund. The Treasury has used these loans to acquire foreign currencies. Apparently a decision has been reached by the two agencies for the Treasury gradually to repay the loans, and for the Fed not to eliminate its authority to warehouse but to reduce it to \$5 billion.

At the end of 1990 the combined portfolio of foreign exchange assets of the Treasury and Federal Reserve totaled \$52 billion. They sold off about \$8 billion in marks during the first seven months of 1991, reducing the portfolio to \$44 billion. In the three months, August-October 1991, the latest period reported by the Fed, there was no intervention. By the end of 1991, however, the authorities had increased their holdings by \$2 billion to \$46 billion.

In recent weeks there have been newspaper reports of interventions to purchase yen, but the magnitudes are not yet known. It is ironic that, according to written responses to questions from the Senate Banking Committee, released on February 11, 1992, Chairman Greenspan said, a policy that "seeks to depreciate the dollar against the yen . . . is not an appropriate way to stimulate the economy" (*Wall Street Journal*, February 12, 1992). Contrary to economists who advocated such a policy to spur U.S. exports, Chairman Greenspan said it could be counterproductive.

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## HOW TO HELP RUSSIA

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U.S. taxpayers are being urged to give financial aid to Russia and other states of the former U.S.S.R. The impetus comes from many sides, including Harvard professors, international organizations, and some of our European allies. The administration seems to share this view. Secretary Baker has promised aid once a reform plan is in place.

The reasoning of some of these groups differs, but their end is the same—subsidized loans and financial aid to supplement the humanitarian aid that many countries have sent. The short-term aim is to stabilize the ruble and contribute to the success of reform. The broader objective is to assure the transition to a free society.

Although there is reason to doubt that the Russians need more food, shipments of food and medicine should be sent if needed to prevent hunger and disease. Our long tradition of disaster relief and humanitarian aid is ample reason to provide relief.

Financial aid is very different. Whether it is \$30 billion a year for five years, as some now urge, or a lesser amount to stabilize the currency, the arguments made for financial assistance are weak. Often they are little more than threats that we must pay now or face chaos, disorder, and a return to communism.

It is hardly credible that people freed from a brutal totalitarian system would welcome its return or support a coup when faced with their first crisis. No one can know with certainty, but many of the fears seem overblown.

Even if the threats and fears are correct, they are not a reason for government loans. We in the west cannot determine the fate of the Soviet people. Grants of \$30 billion provide about \$100 for each former Soviet citizen. The survival of democracy and freedom will not be determined by this modest sum. The fate of Soviet citizens must depend on their decisions and actions, not ours.



Some propose a new Marshall plan to give the former Soviets the type of support we gave to western Europe in the early postwar years. This, too, is a mistake. The Marshall plan provided capital to market economies in which competition was the norm. All of these economies had legal, financial and accounting systems, property rights and enforceable contracts.

None of these institutions are present in the former Soviet states. Economic development cannot be expected until these economies introduce the institutions that permit markets to function effectively and the tradition of honoring or enforcing contracts. If prices are free to change, markets will function, but the response of output to price changes will remain modest. Production will be held back by uncertainty. Producers will not know whether raw materials will be delivered at the right time, with the right specifications, or at the contract price.

Nor can the former Soviets' problems be solved by grants or loans to stabilize the ruble. A popular argument presents these loans as costless because we give the Russians paper dollars that the Russian state bank would hold as backing for the ruble. If the plan works, the ruble will be convertible at a stable value, and the dollars will not be spent.

More likely the stabilization plan will fail as so many have in Latin America and Africa. A safe thing for Russians to do is hold dollars instead of rubles. The dollars we lend or give would quickly disappear from the central bank. This would be certain to happen if Russia fails to close its enormous budget deficit. The deficit is currently financed by printing rubles as fast as the presses can run. Inflation is rampant, and lifetime savings are destroyed.

Any dollars we give are a claim against U.S. wealth. If instead we let the International Monetary Fund (IMF) advance the dollars, the only difference to U.S. taxpayers is that we share the cost with other countries. Ours is the largest share, and it would be paid from the money U.S. taxpayers have given to the IMF. But the IMF would soon ask for new money and, as always in the past, our government will contribute.

There are better ways to help the Russian economy. First, we should remove barriers to trade and urge the Europeans to do the same, if Eastern Europe can sell goods, including food, to Western Europe and the U.S., they will earn hard currency to pay for Russian oil, coal and minerals. The Russians will earn foreign exchange which they can use to stabilize and develop their economy.

Second, Russia is rich in mineral resources. It lacks the management skills and technology to exploit many of these resources. These will not come from government to government loans or from the IMF. The most effective way to develop the Russian economy is to let foreign investors

buy assets. The new owners will bring technology and managements skills. But not much will happen until the Russians establish the institutions and economic structure under which markets function efficiently.

Russia has decontrolled many prices. This is a first step; it took courage to make it. But it is not enough. With the present budget deficit and no clear rules for ownership and contract, the economy will at best limp ahead. Foreign aid will be wasted.

The mark of successful reform will be a flow of private capital to Russia and its neighbors. Private capital from loans or assets sales can be used to stabilize the ruble and, if the budget is balanced, bring down inflation and put the economy on a positive, sustainable growth path. Protecting U.S. taxpayers interests will do more to help the Russians than the well-intentioned schemes of some Harvard professors.