

SHADOW OPEN MARKET COMMITTEE

Policy Statement and Position Papers

March 7, 1977

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International Economic Policy – Wilson Schmidt, Virginia Polytechnic Institute and State University

Policy Statement

Shadow Open Market Committee

March 7, 1977

For the past several years the Administration and the Federal Reserve have pursued policies that fostered recovery, increased employment and reduced inflation. The economy is now closer to the long-term goal of high employment without inflation than many believed possible a year or two ago.

Currently, statements by the Administration and actions of the Administration and the Congress suggest that this approach has ended. Emphasis appears to have shifted to the system of priorities and fine tuning based on the mistaken belief that policy-makers can reduce unemployment without increasing inflation. Fine tuning, whenever it has been tried, has resulted in higher inflation and often higher unemployment.

At its meeting today, the Shadow Open Market Committee took note of some disquieting policy proposals and actions. These include (1) a package of stimulants to bring about a short-term blip in employment and consumption, but little encouragement to capital formation -- a crucial determinant of productivity increases that sustain long-term growth of employment and standards of living; (2) proposed changes in taxes and in minimum wages that increase unemployment and reduce incentives to work; (3) pressure on foreign governments to inflate their economies in the hope of gaining support for inflationary policies in the United States; (4) an increased growth rate of money, currency and demand deposits that stimulates the economy now, but raises the rate of inflation in future years.

We do not accept the view that capital formation can be encouraged only by stimulating consumption expenditures. Lagging investment is more likely to revive if businessmen can confidently look forward to an environment in which government deficits do not absorb \$100-\$150-billion of private sector savings in the next two years. Real savings would then be available to finance expenditures on plant and equipment.

It is misguided to attempt to stimulate consumption expenditures by expansive monetary and fiscal policies in response to supply cutbacks in a period such as the extremely cold winter of 1976-77. Production of money is no cure for the shortfalls in the production of goods.

If the proposal to raise minimum wages is adopted, this will lead to higher unemployment, particularly for new entrants into the labor force. The result will be to increase pressure on the Federal Reserve to increase the monetary growth rate and ultimately to raise the inflation rate.

We should refrain from pressuring foreign governments to inflate their economies. They are better judges than we are of their own national interests.

A return to high employment without inflation will not be achieved by fine tuning the economy. It is doubtful that employment and output will be increased, on average, during the next three to five years, by a policy of increasing employment now and slowing inflation "later." A lasting recovery with low inflation can be achieved if, instead of fine tuning, we proceed gradually to achieve both goals; higher employment and a stable price level.

The Committee recommends that the growth rate of money -- currency and demand deposits -- be held in the range of 4 to 4-1/2% for the next year. A 4 to 4-1/2% rate of monetary growth would bring the stock of money to approximately \$320-billion in the third quarter 1977 and to \$326-billion in the first quarter 1978. These projections are made from the average \$313-billion that would have prevailed in first quarter 1977 if our previous recommendations had been followed. Currently, we anticipate an average money stock of \$315-billion for the first quarter, so the policy we recommend requires the Federal Reserve to offset the recent surge in money and then maintain a less inflationary policy.

The Choices Before Us

We recognize that the policy we recommend reduces the measured growth rate of money, temporarily, by removing the recent bulge in money growth. From 4th quarter 1976 to 4th quarter 1977, our proposal brings the growth of money to approximately 4-1/2%, near the lower end of the Federal Reserve target for money, but is still far above the rate ultimately required to achieve price stability. The recommended rate of growth is one percentage point lower than the growth rate endorsed by Chairman Reuss of the House Banking Committee and more than thirty members of Congress.

A more rapid growth of money in the next few quarters might possibly lead to a temporary increase in employment and real product.

The effects of higher monetary growth are not, however, limited to the response of output in 1977 or 1978. Increased monetary growth raises actual and anticipated inflation. The increase in inflation is not immediately apparent but would become apparent in 1978 and 1979. Once again, we would be faced with the choice we had in 1966, 1969, 1974 and in the intervening years -- to accept more inflation or to shift "priorities" from reducing unemployment to reducing inflation. Guidelines and guideposts -- under old or new names -- will neither reduce inflation nor change the outcome.

The choice before us is to trade a short-term increase in employment for higher long-term inflation, or to gradually but steadily move toward high employment without inflation. The Administration and much of the Congress appear to have chosen a course that will lead to higher inflation. The Federal Reserve flirts with the prospect of supporting the policy by increasing the rate of monetary growth.

The rate of monetary expansion consistent with high employment and stable prices is in the neighborhood of 2% per year. Higher rates of monetary expansion move us away from

our long-term goals and increase the difficulty of restoring full employment and ending inflation.

SHADOW OPEN MARKET COMMITTEE MEMBERS

Prof. Karl Brunner, Director of the Center for Research in Government Policy and Business, Graduate School of Management, University of Rochester, Rochester, NY

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Dr. William Wolman, Senior Editor, BUSINESS WEEK, New York, N.Y.

	ACTUAL									FORECAST			
	76:4	77:1	77:2	77:3	77:4	78:1	78:2	78:3	78:4	Years			
										75	76	77	78
GROSS NATL PRODUCT	1748.5	1788.0	1845.0	1893.0	1943.0	1991.0	2041.0	2092.0	2144.0	1516.3	1692.4	1867.2	2067.0
ZCH	9.4	9.3	13.4	10.8	11.0	10.3	10.4	10.4	10.3	7.3	11.6	10.3	10.3
CONSTANT DOLLAR GNP	1281.5	1295.7	1319.7	1335.9	1351.2	1365.6	1380.9	1394.7	1406.8	1191.7	1265.0	1325.6	1387.0
ZCH	3.0	4.5	7.6	5.0	4.6	4.3	4.6	4.0	3.5	-1.8	6.2	4.8	4.6
PRICE DEFLATOR	1.3644	1.3800	1.3980	1.4170	1.4380	1.4580	1.4780	1.5000	1.5240	1.2721	1.3377	1.4083	1.4900
ZCH	6.2	4.7	5.3	5.5	6.1	5.7	5.6	6.1	6.6	9.2	5.2	5.3	5.8
CONSUMPTION EXPENDITURES	1117.5	1144.3	1176.2	1207.3	1234.7	1264.2	1294.9	1327.4	1358.6	973.2	1078.6	1190.6	1311.3
ZCH	11.1	9.9	11.6	11.0	9.4	9.9	10.1	10.4	9.7	9.7	10.8	10.4	10.1
DURABLES	161.2	165.3	174.5	180.4	185.0	190.5	196.2	201.8	206.6	131.7	156.3	176.3	198.8
ZCH	9.5	10.6	24.2	14.2	10.6	12.4	12.5	11.9	9.9	8.3	18.7	12.8	12.7
NONDURABLES	455.5	467.6	478.0	491.0	501.0	512.5	524.3	536.9	549.2	409.1	440.3	484.4	530.7
ZCH	13.0	11.1	9.2	11.3	8.4	9.5	9.5	10.0	9.5	8.7	7.6	10.0	9.6
SERVICES	500.8	511.4	523.7	535.9	548.7	561.2	574.4	588.7	602.8	432.4	482.0	529.9	581.8
ZCH	9.9	8.7	10.0	9.6	9.9	9.4	9.7	10.3	9.9	11.0	11.5	9.9	9.8
INVESTMENT EXPENDITURES	249.0	254.2	271.6	284.0	294.4	304.2	316.1	327.6	333.6	183.7	241.2	276.0	320.4
ZCH	3.3	8.6	30.3	19.6	15.5	14.0	16.6	15.4	7.5	-14.5	31.3	14.5	16.1
NONRES FIXED EXPEND	165.5	171.2	177.6	184.0	191.0	198.0	204.5	211.0	217.3	147.2	160.0	180.9	207.7
ZCH	6.3	14.5	15.8	15.2	16.1	15.5	13.8	13.3	12.5	-1.4	8.7	13.1	14.8
PRODUCERS DUR EQUIP	108.0	111.0	115.0	119.0	123.5	128.0	132.0	136.0	140.0	95.1	104.5	117.1	134.0
ZCH	3.8	11.6	15.2	14.7	16.0	15.4	13.1	12.7	12.3	-0.0	9.9	12.0	14.4
BUSINESS STRUCTURES	57.5	60.2	62.6	65.0	67.5	70.0	72.5	75.0	77.3	52.0	55.4	63.8	73.7
ZCH	11.2	20.1	16.9	16.2	16.3	15.7	15.1	14.5	12.8	-3.8	6.4	15.2	15.5
RES FIXED EXPEND	75.6	79.0	83.0	87.0	90.0	92.0	93.0	94.0	95.0	51.2	67.8	84.7	93.5
ZCH	44.9	19.2	21.8	20.7	14.5	9.2	4.4	4.4	4.3	-7.0	32.4	25.0	10.3
INVENTORY CHANGE	7.9	4.0	11.0	13.0	13.4	14.2	18.6	22.6	21.3	-14.6	13.5	10.4	19.2
NET EXPORTS	5.2	4.0	3.0	1.0	1.0	0.0	0.0	0.0	0.0	20.5	6.9	2.3	0.0
GOVT PURCHASES	376.9	385.0	394.0	400.5	413.0	422.5	430.0	437.0	452.0	339.0	365.7	398.1	435.4
ZCH	8.3	8.9	9.7	6.8	13.1	9.5	7.3	6.7	14.5	11.8	7.9	8.9	9.4
FEDERAL	138.9	141.0	143.5	145.0	151.5	155.0	157.0	159.0	167.0	124.4	131.1	145.2	159.5
ZCH	13.7	6.2	7.3	4.2	19.2	9.6	5.3	5.2	21.7	11.4	7.2	8.9	9.8
MILITARY	91.3	92.5	94.0	95.0	98.5	100.0	101.5	103.0	108.0	84.3	88.2	95.0	103.1
OTHER	47.6	48.5	49.5	50.0	53.0	55.0	55.5	56.0	59.0	40.1	45.2	50.3	56.4
STATE & LOCAL	238.0	244.0	250.5	255.5	261.5	267.5	273.0	278.0	285.0	214.5	232.3	252.9	275.9
ZCH	5.2	10.5	11.1	8.2	9.7	9.5	8.5	7.5	10.5	12.0	8.3	8.8	9.1

NOTE: PERCENTAGE CHANGES AT ANNUAL RATES; PRELIMINARY DATA FOR 76:4

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

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	ACTUAL									FORECAST			
	76:4	77:1	77:2	77:3	77:4	78:1	78:2	78:3	78:4	Years			
										75	76	77	78
PRETAX PROFITS*	157.4	160.6	168.1	175.7	179.1	184.8	189.6	193.7	198.3	114.5	148.7	170.9	194.6
ZCH	20.6	8.4	20.0	19.3	8.0	13.4	10.8	8.9	9.8	-10.2	29.8	14.9	12.1
TAX LIABILITY	68.3	69.7	70.6	73.8	75.2	77.6	79.6	81.4	83.3	49.3	64.6	72.3	80.5
ZCH	21.2	8.4	5.3	19.3	8.0	13.4	10.8	8.9	9.8	-6.1	31.1	12.0	11.3
AFTER TAX PROFITS	89.1	90.9	97.5	101.9	103.9	107.2	110.0	112.3	115.0	65.3	84.1	98.5	111.1
ZCH	20.1	8.4	32.4	19.3	8.0	13.4	10.8	8.9	9.8	-13.1	28.9	17.1	12.8
AFT TAX PROF ADJ ¹⁾	52.688	59.900	63.498	65.906	65.878	66.184	66.968	67.346	68.014	42.375	54.047	63.795	67.128
ZCH	-26.5	67.0	26.3	16.1	-0.2	1.9	4.8	2.3	4.0	30.8	27.5	18.0	5.2
PERSONAL INCOME	1422.1	1457.0	1500.0	1538.0	1578.0	1617.0	1657.0	1698.0	1740.0	1249.7	1375.3	1518.2	1678.0
ZCH	10.8	10.2	12.3	10.5	10.8	10.3	10.3	10.3	10.3	8.4	10.1	10.4	10.5
TAX & NONTAX PAYMENT	205.3	212.3	186.2	225.5	233.5	237.3	245.3	253.5	261.9	168.8	193.6	214.4	249.5
ZCH	20.9	14.3	-40.8	115.1	15.0	6.6	14.2	14.1	13.9	-0.9	14.7	10.7	16.4
DISPOSABLE INCOME	1216.9	1244.7	1313.8	1312.5	1344.5	1379.7	1411.7	1444.5	1478.1	1080.8	1181.8	1303.9	1428.5
ZCH	9.3	9.5	24.1	-0.4	10.1	10.9	9.6	9.6	9.6	10.0	9.3	10.3	9.6
PERSONAL OUTLAYS	1144.0	1170.2	1202.5	1234.0	1261.8	1291.7	1322.8	1355.7	1387.3	996.9	1104.0	1217.1	1339.4
ZCH	11.1	9.5	11.5	10.9	9.3	9.8	10.0	10.3	9.7	9.5	10.7	10.2	10.0
PERSONAL SAVINGS	72.9	74.5	111.3	78.5	82.7	88.0	88.9	88.8	90.8	84.0	77.8	86.8	89.2
ZCH	-14.4	9.2	398.0	-75.2	23.2	28.3	4.2	-0.4	9.3	16.3	-7.4	11.6	2.8
SAVING RATE(%)	6.0	6.0	8.5	6.0	6.2	6.4	6.3	6.2	6.1	7.8	6.6	6.6	6.2
EMPLOYMENT	88.085	88.600	89.300	89.800	90.400	90.900	91.400	91.900	92.400	84.784	87.480	89.525	91.650
ZCH	0.8	2.4	3.2	2.3	2.7	2.2	2.2	2.2	2.2	-1.4	3.2	2.3	2.4
LABOR FORCE	95.717	96.000	96.500	97.000	97.400	97.900	98.300	98.700	99.100	92.652	94.789	96.725	98.500
ZCH	1.6	1.2	2.1	2.1	1.7	2.1	1.6	1.6	1.6	1.7	2.3	2.0	1.8
UNEMPLOYMENT RATE(%)	8.0	7.7	7.5	7.4	7.2	7.2	7.0	6.9	6.8	8.5	7.7	7.4	7.0
PRODUCTIVITY*	14.548	14.624	14.779	14.877	14.947	15.023	15.109	15.176	15.225	14.054	14.460	14.806	15.133
ZCH	2.1	2.1	4.3	2.7	1.9	2.1	2.3	1.8	1.3	-0.5	2.9	2.4	2.2
INDUSTRIAL PRODUCTION	1.317	1.325	1.372	1.404	1.422	1.438	1.454	1.469	1.479	1.178	1.298	1.381	1.460
ZCH	2.4	2.5	15.0	9.7	5.2	4.6	4.5	4.2	2.8	-8.9	10.1	6.4	5.7
MONEY SUPPLY-(M1)	310.5	315.8	321.2	327.0	333.0	339.0	345.0	351.5	358.0	289.5	304.0	324.3	348.4
ZCH	6.2	7.0	7.0	7.4	7.5	7.4	7.5	7.7	7.6	4.2	5.0	6.7	7.4
VELOCITY OF M1	5.631	5.649	5.721	5.771	5.817	5.856	5.899	5.935	5.972	5.236	5.567	5.740	5.915
ZCH	3.0	1.3	5.2	3.6	3.2	2.7	3.0	2.5	2.5	2.9	6.3	3.1	3.1
MONEY SUPPLY-(M2)	732.5	752.0	772.0	791.0	811.0	831.0	852.0	874.0	896.0	641.0	703.8	781.5	863.2
ZCH	12.7	11.1	11.1	10.2	10.5	10.2	10.5	10.7	10.5	7.7	9.6	11.0	10.5
VELOCITY OF M2	2.387	2.378	2.390	2.393	2.396	2.396	2.396	2.394	2.393	2.365	2.405	2.389	2.394
ZCH	-3.0	-1.6	2.1	0.5	0.4	0.0	-0.1	-0.3	-0.1	-0.4	1.7	-0.7	0.2

NOTE: PROFITS FOR 76.4 ARE ESTIMATES; PRODUCTIVITY IS CALCULATED AS CONSTANT DOLLAR GNP PER WORKER
1) AFT-TAX PROFITS ADJUSTED TO EXCLUDE INVENTORY PROFITS AND ALLOW FOR DEPRECIATION AT REPLACEMENT COST

ECONOMIC OUTLOOK

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	ACTUAL		FORECAST							Years			
	76:4	77:1	77:2	77:3	77:4	78:1	78:2	78:3	78:4	75	76	77	78
INTEREST RATES													
S&P COMP. AAA BONDS	8.080	8.000	8.200	8.300	8.400	8.600	8.700	8.800	9.000	8.635	8.358	8.225	8.775
NEW ISSUE AA INDUS BONDS	7.850	8.200	8.400	8.600	8.800	9.000	9.200	9.300	9.500	8.910	8.250	8.500	9.250
PRIME RATE	6.51	6.25	6.50	7.00	7.50	7.75	8.00	8.00	8.25	7.86	6.83	6.81	8.00
COMMERCIAL PAPER 4-6MTHS.	4.99	5.25	5.75	6.25	6.75	7.00	7.25	7.75	8.00	6.32	5.35	6.00	7.50
AUTO SALES 1)													
DOMESTIC	9.9	9.9	10.6	11.2	11.3	11.3	11.3	11.3	11.3	8.7	10.1	10.8	11.3
IMPORTS	8.3	8.4	9.1	9.6	9.7	9.7	9.6	9.6	9.6	7.1	8.6	9.2	9.6
HOUSING STARTS 1)													
	1.823	1.750	1.900	1.900	1.850	1.800	1.750	1.700	1.650	1.163	1.561	1.850	1.725

1) IN MILLIONS OF UNITS--SEASONALLY ADJUSTED ANNUAL RATES
 2) IN BILLIONS OF DOLLARS--SEASONALLY ADJUSTED ANNUAL RATES

PROJECTIONS FOR THE ECONOMY

Prepared for the
SHADOW OPEN MARKET COMMITTEE MEETING
March 7, 1977

By
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- 1) The accompanying projections assume that the narrowly defined money stock (M1) will grow near the upper end of the current Federal Reserve range, but that is not intended here to be a recommendation nor a preference.
- 2) Real output growth in 1977 will be stronger than the final three quarters of 1976 even with M1 growth at the lower-end of the Federal Reserve range, i.e. - 4.5%.
- 3) Growth of velocity (V1) is projected above trend because of the lagged effects of accelerated money growth in Q4/76 and Q1/77.
- 4) If these projections are accurate, the "gap" between actual real output and "potential output" will be essentially eliminated by late 1977 or early 1978, and real output growth must slow to the 3 to 3.5% range to avoid accelerating inflation associated with excess demand.

JLJ

JLJ/lp
Enclosures

PROJECTIONS FOR 1977
(all figures annual rates of change)

	<u>M¹</u>	<u>M²</u>	<u>V¹</u>	<u>V²</u>
<u>Actual</u>				
Q4/75 - Q4/76	5.5	10.9	4.1	-0.9
1975 - 1976	5.0	9.8	6.2	+1.6
<u>Projected</u>				
Q4/76 - Q4/77	6.0	9.0	4.0	1.2
1976 - 1977	6.0	9.9	3.6	- .02

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	<u>GNP</u>	<u>Real Output</u>	<u>Price Deflator</u>
<u>Actual</u>			
Q4/75 - Q4/76	9.8	5.0	4.6
1975 - 1976	11.6	6.1	5.1
<u>Projected</u>			
Q4/76 - Q4/77	10.3	5.9	4.2
1976 - 1977	9.9	5.0	4.6

Note: Real output growth in the final three quarters of 1976 was only at a 3.6% annual rate, so growth in 1977 to 5 to 6% represents a significant acceleration

NOMINAL GNP
COMPOUND ANNUAL RATES OF GROWTH

TO	FROM											
	75:1	75:2	75:3	75:4	76:1	76:2	76:3	76:4	77:1	77:2	77:3	
1975:1	1446.2											
1975:2	1482.3	10.4										
1975:3	1548.7	14.7	19.2									
1975:4	1588.2	13.3	14.8	10.6								
1976:1	1636.2	13.1	14.1	11.6	12.6							
1976:2	1675.2	12.5	13.0	11.0	11.3	9.9						
1976:3	1709.8	11.8	12.1	10.4	10.3	9.2	8.5					
1976:4	1744.3	11.3	11.5	10.0	9.8	8.9	8.4	8.3				
1977:1	1791.0	11.3	11.4	10.2	10.1	9.5	9.3	9.7	11.1			
1977:2	1837.7	11.2	11.3	10.3	10.2	9.7	9.7	10.1	11.0	10.8		
1977:3	1880.8	11.1	11.2	10.2	10.1	9.7	9.7	10.0	10.6	10.3	9.7	
1977:4	1924.0	10.9	11.0	10.1	10.1	9.7	9.7	9.9	10.3	10.0	9.6	9.5

REAL GNP
COMPOUND ANNUAL RATES OF GROWTH

TO	FROM											
	75:1	75:2	75:3	75:4	76:1	76:2	76:3	76:4	77:1	77:2	77:3	
1975:1	1161.1											
1975:2	1177.1	5.6										
1975:3	1209.3	8.5	11.4									
1975:4	1219.2	6.7	7.3	3.3								
1976:1	1246.3	7.3	7.9	6.2	9.2							
1976:2	1260.0	6.8	7.0	5.6	6.8	4.5						
1976:3	1272.2	6.3	6.4	5.2	5.8	4.2	3.9					
1976:4	1279.9	5.7	5.7	4.6	5.0	3.6	3.2	2.4				
1977:1	1300.0	5.8	5.8	4.9	5.3	4.3	4.3	4.4	6.4			
1977:2	1320.2	5.9	5.9	5.1	5.4	4.7	4.8	5.1	6.4	6.4		
1977:3	1337.6	5.8	5.8	5.2	5.4	4.8	4.9	5.1	6.1	5.9	5.4	
1977:4	1355.1	5.8	5.8	5.2	5.4	4.9	5.0	5.2	5.9	5.7	5.4	5.3

IMPLICIT PRICE DEFLATOR (1972=100)
 COMPOUND ANNUAL RATES OF GROWTH

TO		75:1	75:2	75:3	FROM 75:4	76:1	76:2	76:3	76:4	77:1	77:2	77:3
1975:1	124.55											
1975:2	125.93	4.5										
1975:3	128.07	5.7	7.0									
1975:4	130.27	6.2	7.0	7.1								
1976:1	131.29	5.4	5.7	5.1	3.2							
1976:2	132.96	5.4	5.6	5.1	4.2	5.2						
1976:3	134.40	5.2	5.3	4.9	4.2	4.8	4.4					
1976:4	136.29	5.3	5.4	5.1	4.6	5.1	5.1	5.7				
1977:1	137.74	5.2	5.3	5.0	4.6	4.9	4.8	5.0	4.3			
1977:2	139.19	5.1	5.1	4.9	4.5	4.8	4.7	4.8	4.3	4.3		
1977:3	140.60	5.0	5.0	4.8	4.5	4.7	4.6	4.6	4.2	4.2	4.1	
1977:4	142.01	4.9	4.9	4.7	4.4	4.6	4.5	4.5	4.2	4.2	4.1	4.1

M1
COMPOUND ANNUAL RATES OF GROWTH

TO		FROM										
		75:1	75:2	75:3	75:4	76:1	76:2	76:3	76:4	77:1	77:2	77:3
1975:1	282.8											
1975:2	287.7	7.2										
1975:3	292.8	7.2	7.2									
1975:4	294.6	5.6	4.8	2.5								
1976:1	296.7	4.9	4.2	2.7	2.9							
1976:2	302.8	5.6	5.2	4.6	5.7	8.5						
1976:3	306.0	5.4	5.0	4.5	5.2	6.3	4.2					
1976:4	310.8	5.6	5.3	4.9	5.5	6.4	5.3	6.5				
1977:1	315.4	5.6	5.4	5.1	5.6	6.3	5.6	6.3	6.1			
1977:2	320.0	5.7	5.5	5.2	5.7	6.2	5.7	6.2	6.0	6.0		
1977:3	324.7	5.7	5.5	5.3	5.7	6.2	5.7	6.1	6.0	6.0	6.0	
1977:4	329.5	5.7	5.6	5.4	5.8	6.2	5.8	6.1	6.0	6.0	6.0	6.0

V1
COMPOUND ANNUAL RATES OF GROWTH

TO		FROM										
		75:1	75:2	75:3	75:4	76:1	76:2	76:3	76:4	77:1	77:2	77:3
1975:1	5.1145											
1975:2	5.1516	2.9										
1975:3	5.2893	7.0	11.1									
1975:4	5.3910	7.3	9.5	7.9								
1976:1	5.5140	7.8	9.5	8.7	9.4							
1976:2	5.5318	6.5	7.4	6.2	5.3	1.3						
1976:3	5.5882	6.1	6.7	5.7	4.9	2.7	4.1					
1976:4	5.6123	5.5	5.9	4.9	4.1	2.4	2.9	1.7				
1977:1	5.6785	5.4	5.7	4.8	4.2	3.0	3.6	3.3	4.8			
1977:2	5.7428	5.3	5.6	4.8	4.3	3.3	3.8	3.7	4.7	4.6		
1977:3	5.7924	5.1	5.3	4.6	4.2	3.3	3.8	3.7	4.3	4.1	3.5	
1977:4	5.8392	4.9	5.1	4.5	4.1	3.3	3.7	3.6	4.0	3.8	3.4	3.3

M2
COMPOUND ANNUAL RATES OF GROWTH

TO		75:1	75:2	75:3	75:4	FROM 76:1	76:2	76:3	76:4	77:1	77:2	77:3
1975:1	618.7											
1975:2	634.2	10.4										
1975:3	650.2	10.4	10.5									
1975:4	660.7	9.2	8.6	6.6								
1976:1	677.0	9.4	9.1	8.4	10.2							
1976:2	694.8	9.7	9.6	9.3	10.6	10.9						
1976:3	710.7	9.7	9.5	9.3	10.2	10.2	9.5					
1976:4	732.5	10.1	10.1	10.0	10.9	11.1	11.1	12.8				
1977:1	748.4	10.0	9.9	9.8	10.5	10.5	10.4	10.9	8.9			
1977:2	764.7	9.9	9.8	9.7	10.2	10.2	10.1	10.3	9.0	9.0		
1977:3	781.4	9.8	9.7	9.6	10.1	10.0	9.8	9.9	9.0	9.0	9.0	
1977:4	798.4	9.7	9.6	9.6	9.9	9.9	9.7	9.8	9.0	9.0	9.0	9.0

V2
COMPOUND ANNUAL RATES OF GROWTH

TO		75:1	75:2	75:3	75:4	FROM 76:1	76:2	76:3	76:4	77:1	77:2	77:3
1975:1	2.3374											
1975:2	2.3374	0.0										
1975:3	2.3819	3.8	7.8									
1975:4	2.4037	3.8	5.8	3.7								
1976:1	2.4167	3.4	4.6	2.9	2.2							
1976:2	2.4109	2.5	3.1	1.6	0.6	-1.0						
1976:3	2.4057	1.9	2.3	1.0	0.1	-0.9	-0.9					
1976:4	2.3812	1.1	1.2	-0.0	-0.9	-2.0	-2.5	-4.0				
1977:1	2.3931	1.2	1.4	0.3	-0.4	-1.0	-1.0	-1.0	2.0			
1977:2	2.4032	1.2	1.4	0.5	-0.0	-0.4	-0.3	-0.1	1.9	1.7		
1977:3	2.4070	1.2	1.3	0.5	0.1	-0.3	-0.1	0.1	1.4	1.2	0.6	
1977:4	2.4098	1.1	1.2	0.5	0.1	-0.2	-0.0	0.1	1.2	0.9	0.6	0.5

Comments on Fiscal Policy Developments for Shadow
Open Market Committee Meeting, March 7, 1977

Thomas Mayer
University of California, Davis

At this meeting we face a new problem with regard to fiscal developments. The election results have made the official budget forecasts obsolete, while there is as yet only limited information available on the new budget. (As I am writing this I do not yet have a copy of President Carter's new budget recommendations, and have available only newspaper reports of it so that I am lacking considerable detail.) Furthermore, his budget proposals are likely to be amended by Congress. Hence, this report is unusually sketchy and tentative.

Previous Developments

Table 1 shows recent trends in government expenditures, revenues and deficits on an NIA basis. While revenues (in current dollars) have increased by 15 percent since 1974, total expenditures have increased by 30 percent so that the deficit rose from \$11.5 billion in 1974 to \$58.3 billion in 1976. The increase in government expenditures has been substantially larger for transfer payments to persons (which rose in this period by 39.1 percent) than for expenditures on goods and services which rose by 19.5 percent. In real

terms the latter increased hardly at all, only 1.5 percent. The rapid rise in transfers and the very much slower rise in real expenditures on goods and services is a continuation of a trend commented on in previous reports by Bob Rasche and myself. However, it is worth noting that transfers to state and local governments have increase by \$16.3 billion in this period (37 percent). These grant-in-aid payments should not be thought of as pure transfer payments, since at least to some extent they represent increases in federally induced expenditures on goods and services by state and local governments, and hence lead to a federally induced decline in the proportion of GNP available for private expenditures. To some extent at least they are a substitute for direct federal expenditures on goods and services. It may therefore be useful to look also at the total of federal expenditures on goods and services plus transfers to state and local governments. For 1976 this total is 8.3 percent above its 1975 level and 24.5 percent above its 1974 level.

Table 2 shows the financing problems associated with the Federal deficit in calendar 1975 and 1976. (The deficit figures differ from those shown in Table 1 since Table 2 is not on an NIA basis.) As Table 2 shows, except in the last quarter of 1976, the off-budget agencies plus the Federal Financing Bank added to the deficit to be financed, as did, over the period as a whole the Treasury's need to build up cash balances. In the last three quarters of 1976, a number of minor miscellaneous items also added to the volume of

financing needed. As a result the Federal Government borrowed from the public (including the Federal Reserve) \$68.9 billion compared to \$85.5 in 1975.

Fiscal 1977

Table 3 compares the forecasts for the current fiscal year of the Ford budget, the CBO and the Carter budget. Assuming the continuation of current tax rates the difference in the deficit forecast by the Ford budget and the CBO is trivial, while the Carter budget shows a considerably larger deficit due both to a proposed tax cut and an expenditure increase. Moreover, the Carter budget makes a somewhat different assumption about the growth of the tax base.

It is, however, quite possible that the deficit will differ substantially from that proposed in the Carter budget. On the one hand Congress is likely to add additional expenditures and perhaps cut taxes further.

But, on the other hand, not all the increase in expenditures proposed either by the Administration or by Congress may actually occur. The Administration may simply not be able to gear up expenditures fast enough. (This is particularly so if Congress adds some unwanted expenditure programs about which the Administration is unenthusiastic.) We have had one recent experience of how unreliable a guide the outlay projections of the budget can be; in the first nine months of 1976 net outlays were \$11.4 billion below estimates.

Furthermore, the Carter estimate may, of course, be in error due to mistakes in predicting the even future path of income and prices - there are, after all, about seven more months remaining in this fiscal year. Currently it is particularly difficult to project income and prices because of the difficulty of assessing the impact of the recent cold wave in the east, the spring floods which will probably occur in the east and the western drought. I have, of course, no way of knowing in which direction the inevitable errors will go. Hence the predicted deficit for the current fiscal year has to be treated as an unusually unreliable figure. In this connection it may be useful to repeat my warning from our last meeting that if one assumes that the Fed picks up at the margin a quarter of any deficit and also, a money multiplier of 2, then an \$8 billion increase in the deficit implies a one percent increase in the M_1 growth rate.

Longer Run Projections

Table 4 shows the economic assumptions underlying the fiscal 1977 as well as the longer run budget projections. There are two CBO projections. One represents the CBO's longer run estimate, and the other the most recent revision of the 1977 estimates. It is very hard to make a choice among the various projections of Table 4. It seems to me, however, that the long run CBO projections of unemployment decreasing below 6 percent in calendar 1978 and to 4.1 percent in 1982 is much too optimistic. The various projections of the inflation

rate are almost impossible to evaluate. The inflation rate experienced in 1982 will depend largely upon what monetary policy is followed until then, and, given the Federal Reserve's willingness to tolerate wide fluctuations in the monetary growth rate it is hard to see how one can project with any degree of assurance, particularly at a time when it seems that the Federal Reserve is returning part of the way to a money market conditions approach.

Table 5 shows the projected budget trends which, for the Carter budget are unfortunately available only for fiscal 1977 and 1978. For these two years it shows very substantial deficits totalling \$125.7 billion compared to a combined deficit of \$109.2 billion in fiscal 1975 and 1976. For the four fiscal years 1975-1979 the total deficit is therefore projected at \$235 billion! It is also worth noting that the projected deficit in the Carter budget for fiscal 1977 is practically the same as for fiscal 1976 which was considered an extraordinarily large deficit.

For the subsequent years the budgets show surpluses. But these surplus projections for the far out years indeed are "far out." They are meant merely to indicate the amount of fiscal slack, and nobody imagines that the federal government will actually run a surplus of \$70 billion or more in 1982. Our past experience suggests that fiscal slack is spoken for before it appears, and hence the special needs that will arise in 1982 may well result in a deficit in that year.

Other Federal Financing

In addition to the unified budget, the deficits of a number of off-budget agencies have to be financed. Moreover, if one wants to measure the impact of federally induced financing one should also look at the deficits of the government sponsored agencies and at the lending activities of government credit agencies. I do not have any estimates of these financing requirements in the Carter budget available, not yet having an actual copy of the budget. But, the Ford budgets lists these totals as follows:

Fiscal Year	Off-Budget Federal Entities (billions of dollars)	Government Sponsored Enterprises (billions of dollars)	Net Loans Guarenteed (billions of dollars)
1976	7.2	4.6	10.3
TQ	1.8	2.3	- .1
1977 (est.)	10.8	11.0	11.3
1978 (est.)	9.2	13.2	21.2
1979 (est.)	10.9	N.A.	N.A.

Source: OMB, The Budget of the United States Government Fiscal Year 1978, pp. 26 & 33.

In the Carter budget the deficit of the off-budget agencies in 1978 is estimated at slightly less \$8.5 billion. These figures while well below the deficit of the unified budget of the last two years, are by no means small when compared to the more usual level of deficits. The unified

budget therefore is not a sufficient guide to the amount of crowding out of totally private financing that can occur.

Moreover, the deficits of off-budget federal entities, and government sponsored enterprises as well as net loan guarantees have all grown very rapidly since 1976. And there is a danger that they will continue to do so. With political pressures, both to balance the budget and to increase employment-generating expenditures while keeping taxes down, there is an obvious temptation to use such backdoor financing. And programs such as developing new sources of energy are likely to provide a "justification" for extensive financing of this sort.

Financing the Deficit

The total borrowing from the public (including the Federal Reserve) that will be required to finance the deficit in the Carter budget plus the off-budget outlays is substantial. Here are the estimates:

	FY 1976	Transition Quarter	FY 1977 (est.)	FY 1978 (est.)
	(Billions of dollars)			
Total borrowing from the public	82.9	18.0	73.0	65.8

Sources: OMB, Special Analyses Budget of the United States, Fiscal Year 1978, p.42.
Wall Street Journal, February 23, 1977.

Thus the federal government will impose a substantial burden on the capital and money markets. To be sure, this burden is less than that imposed in fiscal 1976, but from now on it is likely to coincide with increased private demands for credit, and hence will act more as a burden. Will it be enough to produce a credit "crunch," and to induce the Federal Reserve to increase the growth rate of the money stock? This is obviously a major issue for us, but to answer this question would require estimating the private demand for credit, something I am ill equipped to do.

Moreover, it is worth noting that there exist two factors that might change the burden on the credit markets. One is the possibility that foreigners will pick up a significant proportion of the new debt. As Table 6 shows this source of financing has been far from trivial in the past. But it is very hard to forecast since it depends on the future course of relative interest rates in the United States and abroad.

The second factor is that the Carter budget is only the Administration's forecast. This forecast may well be off by several billions. As discussed above, Congress is likely to add to expenditure programs, but on the other hand there may well be delays in actually getting expenditures going, and also the economic forecast underlying the revenue and outlay projections may be in error.

All in all, the fiscal outlook is even harder to pin down this time than it usually is.

Table 1
Federal Government
Receipts and Expenditures

	<u>Calendar Year</u>		
	<u>1974</u>	<u>1975</u>	<u>1976</u>
Revenues	288.2	286.5	330.6
Total Outlays	299.7	357.8	388.9
Purchases of Goods and Services	111.6	124.4	133.4
Transfer Payments to Persons	114.3	145.8	159.0
Transfer Payments to Foreigners	3.2	3.1	3.2
Grants-In-Aid: S and L, Gov.	43.9	54.4	60.2
Net Interest Paid	20.9	23.5	27.5
Subsidies - Surpluses of Gov. Enterp.	5.2	6.5	5.6
Surplus or Deficit (-)	-11.5	-71.2	-58.3
Federal Gov. Purchases of Goods and Services in 1972 \$	95.3	95.7	96.7

Source: 1977 Economic Report of the President, pp. 189 & 271.

Table 2
Financial Flows of the
Federal Government 1975-1976
(Calendar Years)

	<u>1975</u>		<u>1976</u>			
	1st Half	2nd Half	Q1	Q2	Q3	Q4
	(billions of dollars)					
U.S. Budget:						
Receipts	141.4	139.5	66.9	43.6	81.8	76.2
Outlays	171.5	184.5	89.6	91.5	94.5	99.0
Surplus or Deficit (-)	-30.1	-45.1	-22.7	2.2	-12.7	-22.8
Off-Budget Agencies						
Surplus or Deficit (-)	-4.7	- .8	- .5	- .8	.6	3.0
Fed Financing Bank						
Net Outlays	-3.4	-2.7	-3.3	.1	-2.6	-2.6
Budget Deficit and Off-Budget						
Agencies Deficit and Fed. Fin. Bank	-38.1	-48.6	-26.5	1.5	-14.7	-22.4
Financed By:						
Borrowing from Public	36.2	49.3	24.1	9.4	18.0	17.4
Cash and Monetary Assets Decrease or Increase (-)	-3.0	.1	.7	-8.6	-2.9	5.1
Other ¹	5.0	- .9	1.7	-2.2	- .4	- .1

Source: Federal Reserve Bulletin, Jan., 1977, p. A30, and
 Unpublished data provided thorough the courtesy of
 the Federal Reserve System.

- ¹. Includes public debt accrued interest, payable to the public, deposit funds, miscellaneous liabilities (including checks outstanding) and asset accounts, Special Drawing Rights, etc.

Table 3

Estimated Receipts, Outlays and Deficits FY 1977

	Ford Budget- Current Tax Law	Ford Budget Including Recommended Tax Cut	CBO. Projections ^a	Carter Budget
<u>(Billions of Dollars)</u>				
(1) Receipts	360.9	354.0	356.5	349.4
(2) Outlays	411.2	411.2	407.1	417.4
(3) Deficit (-)	-50.3	-57.2	-50.6	-68.0
(4) Deficit of Off-Budget Federal Entities	-10.8	-10.8	N.A.	N.A.
(5) (3)+(4)	-61.1	-68.0	-61.4 ^b	N.A.

Sources: OMB, The Budget of the United States Government, Fiscal 1978, pp. 3, 9 & 26.
 CBO, Five Year Budget Projections, Fiscal Years 1978-1982, p. 7.
1977 Congressional Budget Scorekeeping Report #5, pp. 3 & 10.
Wall Street Journal, February 23, 1977.
New York Times, February 23, 1977.

a. Second concurrent resolution on the budget.

b. Deficit of Off-Budget agencies taken as \$10.8 billion.

Table 4
Assumptions Underlying Budget Projections

	<u>1976</u>	<u>1977</u>	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>
	(calendar years)						
GNP Current \$ (billion)							
Ford Budget	1693	1880	2092	2334	2579	2784	2963
CBO ^a	1698	1884	2085	2304	2547	2809	3103
CBO ^b	1692	1854	N.A.	N.A.	N.A.	N.A.	N.A.
Growth Rate of Real GNP (%)							
Ford Budget	6.2	5.2	5.1	5.9	5.5	3.9	3.5
CBO ^a	6.4	5.4	5.6	5.5	5.3	4.7	4.5
CBO ^b	6.4	4.3	N.A.	N.A.	N.A.	N.A.	N.A.
Carter Budget	6.1	5.4	5.4	N.A.	N.A.	N.A.	N.A.
Unemployment Rate (%)							
Ford Budget	7.7	7.3	6.6	5.7	4.9	4.8	4.7
CBO ^a	7.6	6.8	5.9	5.3	4.8	4.4	4.1
CBO ^b	7.7	7.7	N.A.	N.A.	N.A.	N.A.	N.A.
Carter Budget	7.6	7.1	6.3	N.A.	N.A.	N.A.	N.A.
C.P.I. Increase (%)							
Ford Budget	5.7	5.1	5.4	5.0	4.6	3.8	2.9
CBO ^a	5.7	5.0	4.8	4.8	5.0	5.3	5.8
CBO ^b	5.7	5.0	N.A.	N.A.	N.A.	N.A.	N.A.
Carter Budget	5.7	5.1	5.4	N.A.	N.A.	N.A.	N.A.

^a. baseline assumption

^b. February 10 Revision of estimates

^c. Year over year

Table 4 (cont.)

Sources: OMB, The Budget of the United States Government, Fiscal Year 1978, pp. 41-42.
CBO, Five Year Budget Projections: Fiscal Years 1978-1982, p.4.
1977 Congressional Budget Scorekeeping Report #5, p.2.
Wall Street Journal, February 23, 1977.

Table 5
Projections of Federal Budget Totals

	<u>1977</u>	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>
	(Fiscal years)					
	(billions of dollars)					
Receipts						
Ford Budget ^a	360.9	407.6	465.0	526.4	584.6	634.8
CBO ^b	356.5	407.0	464.0	526.0	594.0	668.0
Carter Budget	349.4	401.7	N.A.	N.A.	N.A.	N.A.
Outlays						
Ford Budget ^a	411.2	445.4	427.7	502.1	531.5	564.8
CBO	413.1	445.0	467.0	491.0	516.0	542.0
CBO ^b	407.1	451.0	480.0	514.0	548.0	586.0
Carter Budget	417.4	459.4	N.A.	N.A.	N.A.	N.A.
Surplus or Deficit (-)						
Ford Budget ^a	-50.3	-37.8	-7.7	24.3	53.0	70.0
CBO	-50.6	-38.0	-3.0	35.0	78.0	126.0
CBO ^b	-50.6	-44.0	-16.0	12.0	46.0	82.0
Carter Budget	-68.0	-57.7	N.A.	N.A.	N.A.	N.A.

a. assumes rejection of proposed tax and expenditure changes

b. assumes further adjustments for inflation

Sources: OMB, The Budget of the United States Government Fiscal Year 1978, p. 9.
 CBO, Five Year Budget Projections Fiscal Years 1978-1982, p.7.
1977 Congressional Budget Scorekeeping Report #5, pp. 3 & 10.
Wall Street Journal, Feb. 23, 1977.

Table 6

Borrowing From Foreign and International Sources

Fiscal Years	Total Borrowing from Public ^a (billions of \$)	Borrowing From from Foreign & International Sources (billions of \$)	Foreign Borrowing (percent of total)
1971	11.6	17.9	154.3
1972	13.5	17.3	128.1
1973	15.5	10.2	65.8
1974	-2.5	-2.5	100.0
1975	46.5	9.1	19.6
1976	73.2	3.8	5.2
TQ	16.0	4.8	30.0

a. includes foreign sources but excludes Federal Reserve

Source: OMB, Special Analyses Budget of the United States
Government Fiscal Year 1978, p.43.

Economic Policy in the Carter Administration

Testimony prepared for the House Budget Committee

Washington, D. C.

March 3, 1977

by

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Economic Policy in the Carter Administration,

by

Allan H. Meltzer

A new administration, a new Congress and a new corps of economic advisers is commonly the occasion to reconsider the strategy for the future, the successes and failures of the past, and the long-term consequences of current actions. Early impressions are subject to revision, in much the same way that economic statistics are revised, and I hope that my early impression of Carter administration policies will be as incorrect as the forecasts of those who found real meaning in the so-called "pause" last fall.

The first signs are disquieting, however, to anyone who believes that the proper goals of policy for the United States are to return to full employment, eliminate inflation, improve efficiency in the use of resources, and increase freedom. These goals cannot be achieved by programs that place one objective -- employment -- above all others or that strive to achieve more employment now and reduce inflation "later." Freedom and efficiency are reduced, and sustained inflation is unaffected by guidelines for price and wage increases. Whether these guidelines are mandatory or whether they are called "voluntary," their principal result is to divert the attention of the public by offering a comic opera for their leisure and a waste of the time of those who enforce controls and those who respond to the enforcers.

Guidelines and controls are not the only restriction on freedom and efficiency. The emergency energy program, the first economic legislation passed this year, is heavy with the suggestion that it is more important to investigate the ownership of natural gas inventories than to encourage

efficient production of additional supply. Once again, we have acted in crisis to increase the authority and power of the government over economic activity, exchanging freedom and an efficient solution for some temporary relief from the cold.

Government controls and regulations created a shortage of natural gas and prevented a rational solution to the shortage. The government uses the crisis to justify an increase in its power and authority to allocate supply and coerce suppliers. The fact that the grant of power is temporary justifies neither the grant of authority nor the failure to choose a rational solution.

The administration's fiscal program also developed in disregard of freedom and efficiency. The presumption underlying the program is the simple Keynesian view that neglects all effects on incentives, prices and anticipations. What matters for consumption is the amount consumers receive; what matters for investment is the additional amount consumers spend. Thoughtful investors and consumers who project after tax rates of return before deciding to invest could be encouraged by permanent tax reduction, or in other ways, but they are not. Indeed, they cannot for long be encouraged by the fiscal prospects that we face.

The fiscal program neglects freedom and efficiency, also, by protecting the bureaucracy and future budgets from reductions that would increase the efficiency with which society uses resources and the freedom of individuals to decide on how they wish to spend their incomes. The long-run thrust of the Carter program is to balance the government budget only, if at all, by increasing tax rates through inflation, not by reducing the growth of public outlays or the relative size of government.

In three respects, the fiscal program is a strong reminder of some past policies. First, once again, we are to know the arrogance of fine tuning. Second, we are offered another piece of legislation designed by the Association for the Protection of the Civil Service. Third, we return to the failed policy of "priorities" that promises lower unemployment now and less inflation later but produces instead a temporary gain in employment followed by more inflation and more unemployment later. I propose to discuss the short- and long-term effects of the administration's program in turn and to offer an alternative.

The Short-Term Problem

The fiscal program is based on two errors. One is judgmental; the other is a conceptual error with several facets. Let me dispose of the judgmental issue quickly since it is rapidly becoming clear that the much discussed slowdown in the economy was misinterpreted by Keynesians eager to believe that, because government spending in the third quarter fell below projections, the economy paused.

If we look at the quarterly rates of change of gross national product in 1976, the expansion reaches a peak rate of change in the first quarter, then slows for the rest of the year. The growth of final sales shows exactly the opposite pattern. Rates of change of final sales in dollars of constant purchasing power are lowest in the first quarter and highest at the end of the year. The difference between the two series is entirely the result of business decisions to first build and then reduce inventories.

There is a simple, plausible explanation of the pattern of inventory change. At the beginning of 1976, the belief was widespread that the

administration and the Federal Reserve would produce enough stimulus to assist in the election of Gerald Ford. Excessive fiscal or monetary stimulus in election years is part of the pattern known as the political business cycle. Election year 1964 brought a tax cut. Elections in 1968 and 1972 brought a mixture of expansive fiscal and monetary policies. Election year 1976 was widely expected to bring more of the same.

In the first months of 1976, businesses built inventories in anticipation of rapidly rising sales and the higher rates of inflation they expected to follow. By the end of the first quarter, anticipations of another political business cycle were confirmed. The time for stimulus that would benefit the incumbents passed. Vetos of spending programs made the headlines. Inventories were brought into closer relation to sales.

This interpretation of 1976 suggests that additional stimulus is neither required nor desirable. The economy does not require a fiscal program to stimulate spending and create jobs. The weakness of the economy was overstated during the election campaign; current strength is misjudged.

Errors in forecasting are not so rare that we should dwell on them. Two percentage points or more is about the average error in quarterly forecasts of the rate of change of real GNP and the price level in recent years.

The more serious problem arises from the type of action proposed. The fiscal program appears to be based on a belief that economists can achieve more output now without increasing the rate of inflation. This is to be done by timing the injections of stimulus and restraint so as to bring idle resources into use. The critical underlying assumption is

that, bottlenecks aside, larger supplies of output can be produced without raising the rate of price change. Even avid proponents of additional stimulus recognize that the stimulus must be reduced when the economy approaches full employment. We have returned to fine tuning.

Instead of general policies that provide relatively clear indications of the thrust to be exerted by government programs, private decision makers face increased uncertainty. To make plans, they must guess at the type of tax structure and the length of time reductions in unemployment insurance taxes or increases in investment tax credits will remain in effect. To estimate future sales, they must guess at the size and duration of the effect of the rebate.

Behind the fiscal package lies the belief that economists can predict the effect of various mixes of stimuli with sufficient accuracy to provide a choice to policymakers. The alternative of providing a more stable fiscal environment is rejected. This, too, is a return to fine tuning. I do not know any evidence to support the belief that economists can predict the short-term aggregate effects of specific tax cuts with sufficient accuracy to justify the policies that are now proposed.

Long-Term Effects

Choice of a one-time rebate instead of general tax reduction is a way of maintaining future tax collections. President Carter has promised a balanced budget for fiscal year 1981, and permanent tax reduction would permit that promise to be kept only if the growth of government falls or the rate of inflation rises. Speculation on whether the administration can achieve a balanced budget for fiscal 1981 generally ignores the effects of

inflation. Since the tax system is not indexed, a balanced budget can be achieved by allowing inflation to rise.

In Five Year Budget Projections: Fiscal Years 1978-82, the Congressional Budget Office shows the extent to which inflation is required to balance the budget in 1981 or 1982. Much of their analysis is based on an explicit assumption that the unemployment rate can be brought to 4% by 1982 if real growth is maintained in the neighborhood of 5-1/2% for the next four years. The policy of vigorous expansion adds to inflation so that by 1982, the inflation rate is back to the 1976 level.

Many economists in and out of government regard the projected 4% unemployment rate as achievable only temporarily and at the cost of rising inflation. Several careful studies of the labor force show that after adjustment for demographic changes, the full employment rate of unemployment is now about 5.5% to 6%. The Congressional Budget Office developed a set of projections based on a less vigorous expansion that reduces inflation. On the less vigorous expansion path, unemployment and inflation fall to 5.5% and 4.6% respectively in 1982. All of my estimates start from these budget data.

The presumed expansion produces 10.4% nominal GNP growth in 1977 and 9.8% in 1978. Subsequently, nominal growth is steady at 8.6%, with 4.0% real growth and inflation of 4.6%. No effort is made to reduce inflation after 1979, so inflation raises government revenue by pushing households into higher tax brackets. Moreover, owners of business firms are taxed because depreciation of capital is tied to historic cost. The replacement cost of capital rises with inflation, but depreciation does not, so reported profits are overstated by the difference between replacement cost and the book value of capital. Corporate taxes are increased in this way.

As one of my former students Hai Hong points out, the government continues to collect tax revenues from firms even if inflation ends tomorrow. Of course, owners of capital have taken the loss in the stock market, and new owners of capital intensive firms pay a price that reflects the estimated after tax revenues.

The effects of inflation on tax payers remain in a fully anticipated inflation. To these, we must add the effects of unanticipated inflation. Unanticipated inflation taxes owners nominal wealth. These effects are more frequently discussed by economists, but they are much smaller than the effects of anticipated inflation on tax payments.

The 4.7% inflation assumed by the Congressional Budget Office adds \$24 billion to Federal tax revenues in 1978 and transfers \$150 billion in 1982. For the five year period 1977-82 the cumulative increase in tax payments from inflation is \$408 billion. These sums are obtained using an average marginal tax rate of 25% and the estimated change in real income, obtained from the CBO, to compute the tax revenues that would be collected if inflation ended in 1977.

The \$408 billion tax revenue from inflation is 16% of total tax collections in the five year period. The tax revenues from inflation permit the government to balance the budget and to increase the share of GNP collected in taxes. On the CBO assumptions, Federal tax collections as a percentage of GNP increase by more than two percentage points as we move toward full employment in 1982.

An estimate of the contribution of inflation to reducing the budget deficit requires an adjustment of government outlays. Outlays increase

with inflation by less than taxes. The response of outlays to inflation computed from CBO projections, is more variable from year to year than the response of taxes, so I used the computed response for each year instead of the average response for the five year period.

The cumulated deficit for the five years 1978 to 1982 is \$162 billion at zero rate of inflation and \$45 billion on the CBO assumptions. Inflation reduces the budget deficit by more than \$100 billion in five years. This is a crude but, I believe, useful measure of the net transfer from private to public uses resulting from the effects of inflation on tax payments.

The calculations leave out many adjustments. Interest on the public debt would be changed by the larger deficits and by the lower interest rates resulting from an end to inflation. My calculations have used average effects instead of the more accurate calculations that recognize the different effects on social security taxes, excises, and personal and corporate taxes. Lower inflation would also change the real returns to capital by reducing the tax on existing capital, thereby changing the composition of output, the size of capital gains and capital gains taxes, and the like. Adjustments to steady inflation by investors and consumers would undo many of the adjustments that have been made, for example reducing investment in land or gold stocks relative to investment in depreciable capital. All of these, and many other, effects on taxes, spending and output are ignored.

We cannot hope to end inflation by 1978 and remain on a path toward full employment. The first effects of the sharp reduction in the rate of monetary expansion will cause revision of plans. Those who accumulated inventories or planned production or spending on the assumption of sustained

inflation must adjust planning to the new environment. Unemployment will increase and the growth of output and perhaps output will at first fall. Gradually, it will return to its growth path at a lower average rate of inflation, but government payments for welfare and unemployment compensation will be larger and tax collections smaller. The actual deficit would be much larger than the \$162 billion if there is an attempt to end inflation suddenly. The \$162 billion is an estimate of the effect of inflation on government revenues and outlays, not a projection of the effect on the deficit of an end to inflation.

In the past several years, we have seen that the economy can recover while inflation is ended gradually. A policy of reducing the growth rate of money by stages has brought a recovery from recession, expansion, reduction in unemployment and in inflation. Continuation of gradualism, I believe, can bring inflation to an end by the early 1980's. Despite growing evidence that the policy of reducing inflation has ended, I assume the policy continues, specifically that rates of inflation fall by approximately 1% per year to reach zero in 1982. Real growth is kept at the CBO's less vigorous expansion path. The gradual reduction of inflation may change the yearly numbers, but any early reductions would be offset by later increases.

The projected budget deficit falls for \$46 billion in 1978 to \$5 billion in 1982. Tax collections in 1982 are \$518 billion, about \$100 billion lower than under CBO projections, and outlays are lower by \$65 billion. The budget is near balance with full employment and no inflation. The table below compares the budget position and GNP resulting from my assumptions to the CBO estimates.

Inflation, Taxes and the Deficit

Year	Growth of GNP (in percent)	My Assumptions			CBO Assumptions		
		GNP (in current dollars)	Taxes	Deficit	GNP (in current dollars)	Taxes	Deficit
1977	10.4	1884	362	-50.6	1884	362	-50.6
1978	8.8	2050	400	-46	2075	405	-46
1979	6.6	2186	436	-34	2259	454	-29
1980	5.6	2308	466	-26	2457	505	-14
1981	4.6	2414	494	-14	2673	562	+10
1982	4.0	2511	518	- 5	2909	621	+34

My proposed budget has very different consequences from the CBO budget. The share of GNP taken in taxes by the Federal government is reduced from 21.4% to 20.6%. Much of the reduction is the result of a small deficit instead of a budget surplus, but this is misleading. I have made no provision for the reduction in interest payments on the Federal debt that would result from the removal of inflation premiums in interest rates. Average interest rates on the outstanding debt in 1982 would fall from the 7% projected by the CBO to 3 or 3-1/2%, so after allowing for the larger deficits, there is a reduction of \$15 billion or more in outlays.

It would be a mistake to attach too much reliance to any of the estimates or projections five or six years ahead. The estimates show that a balanced budget, a smaller share of GNP absorbed by government and an end to inflation are feasible and compatible goals. By 1978, the projected budget deficits can be financed with a rate of increase in the monetary base that is consistent with slower inflation and no further increase in the ratio of government debt to base money. No later

than 1980, the financing of the deficit permits the Federal Reserve to slow money growth and reduce outstanding public debt to make room for additional financing of housing and private capital formation.

An Alternative Program

The difficulties I find in the administration's program do not lie as much with the inaccuracies of the projections as in the requirements on government. All of the projections assume that Congress holds spending to levels no higher than the projections. These allow for expansion of existing programs, but permit no additions. Every new program must be matched by a reduction in an existing program.

Does anyone believe that Congress or the administration will behave in this way? The \$50 billion deficit for fiscal 1977 had been increased to \$70 billion by January and will be increased further. A deficit of more than \$75 billion for fiscal 1977 seems likely, and the new administration and the new Congress have only begun to search out new ways of spending. The increase in fuel costs is seen as an opportunity to grant additional relief to families that pay more for heating. At the same time, there are proposals for additional stimulus for the economy on the grounds that higher spending on utilities must be offset to cushion the shock to employment. Apparently, those who receive the additional payment for food or fuel are expected to withhold their receipts from the spending stream, so government must correct their behavior.

I will not dwell on the obvious reasons why this argument is wrong. Even if it were correct, it is fine tuning with a vengeance. Every shift in spending

brings a new program or an addition to an old program. The government takes responsibility for smoothing out the ripples in economic life disregarding that their forecasts of the ripples are subject to large errors and that their actions create uncertainties about the future that are at times as disturbing and unsettling to the economy as the ripples they attempt to smooth.

We need not continue to restrict freedom and reduce efficiency in the interests of full employment. There is an alternative path to full employment that uses our resources, increases freedom and encourages efficiency.

Inflation, restrictions, prohibitions and regulations not only reduce the return to capital and labor and discourage investment, but they transfer resources to less productive uses. If we reduce the army of regulators to a brigade or platoon, we raise productivity by transferring resources from less efficient to more efficient activities. Those engaged in negotiation over the rules and their application are directed to more productive tasks. Productivity increases and saving is attracted from the many other places in the world where restrictions, disincenives, and regulations lower the rate of investment in new and more productive facilities.

Many countries have followed the path we have followed. They, too, restrict freedom and efficiency in the use of resources, limit returns to investment, and create uncertainty about the future. By increasing freedom and encouraging efficiency, we can raise our standard of living and develop opportunities for employment at higher real earnings and with more freedom to decide how we spend our incomes.

This is a long-term program, for improving the efficiency with which we use resources and improving the performance of the economy. Unemployment is generally regarded as a current problem that we must solve sooner than my proposals permit. If this is correct, we must recognize that much of our long-term unemployment is the result of past policies particularly the minimum wage law and restrictions on entry into professions and occupations written into local and national laws. Few actions would have more effect on long-term unemployment of teenagers than the removal of minimum wage laws and other barriers to entering the labor market.

Ending inflation, increasing employment, reducing the burden of a large government, increasing efficiency and encouraging freedom are compatible goals that can be achieved by this administration, if they avoid three temptations: to fine tune the economy, to preserve and nurture the growth of bureaucracy, and to believe that they can choose to increase employment now and reduce inflation later.

INTERNATIONAL ECONOMIC POLICY

A Briefing of the Shadow Open Market Committee

March 7, 1977

By Wilson Schmidt*

I. What's New?

President Carter may have tried to take the limousines away from the staff, but he certainly hasn't cut out their international travel.

The Secretary of the Treasury, Mr. Blumenthal, in presenting the President's domestic economic recovery program to the House Appropriations Committee highlighted the international economy (February 1, 1977).

The international aspect of the domestic program was two pronged and simple. American economic health depends importantly on our export markets. Slow-downs are foreseen in industrial countries. In addition, there is growing concern about the ability of a number of countries, both industrial and developing, to finance their continued current account deficits, that is, excess payments for imports of goods, services, and gifts over receipts from the same sources; in turn, this raises doubts about their capacity to sustain their growth, reduce unemployment, and control inflation.

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The solution to both problems according to the Secretary lies in the expansion of the financially and economically strong countries who must run current account deficits.

Underlying both problems, according to Secretary Blumenthal, is the persistent external surplus of the oil-producing countries. (The Organization for Economic Cooperation and Development, the OECD, which is the rich countries' club, projects these to continue in 1977 at about \$37 billion compared with \$42 billion in 1976; see its Economic Outlook, December, 1976, page 10.) The weak countries must reduce their deficits to preserve their credit worthiness and must "depend on us for export-led growth," according to Secretary Blumenthal. The strong countries must therefore reduce their current account surpluses.

The arguments were sharpened three days later, upon the return of the Vice President, Mr. Mondale, from ten days abroad. The Undersecretary of State for Economic Affairs-Designate, Mr. Richard Cooper, was reported to have estimated that the world was losing \$300 billion in unused resources because of sluggish economic growth. The Assistant Secretary of the Treasury-Designate, Mr. Fred Bergsten, was cited, saying that the United States was seeking to induce Japan and Germany to move from a "small to big country psychology." They should think of themselves as "engines of the world economy." (Journal of Commerce, February 3, 1977).

As Mr. Blumenthal put it, ". . . the United States is asserting leadership and encouraging the stronger countries abroad to follow suit. We are implicitly and explicitly asking them to follow a course of stimulating their economies much as we are proposing for the United States . . ."

Though the Administration did not specify its criteria, it is easy to see why the Federal Republic of Germany (FRG) and Japan were singled out. Of the seven largest countries, all ran current account deficits in 1976 except Japan and the FRG. And they also enjoyed the largest holdings of official international reserves, after the United States.

And one would not expect the Administration to name the particular countries where current account deficits might be hard to finance. But the numbers do not deny the possibility of the problem. For example, between 1973 and 1975, the external debt of the LDCs almost doubled and the ratio of debt service payments to merchandise exports rose from 15% to 20%. (International Economic Report of the President, January 1977, p. 30f.). The members of OECD accumulated net current account deficits of \$60 billion since 1974, but \$70 billion was accounted for by countries having only 30% of the combined gross product of the OECD nations. (OECD, Economic Outlook, December 1976, p. 10.)

Mixed in with this picture are estimates that commercial banks raised their share of the new external financing of the LDCs from

20% in 1971-73 to over 40% in 1974-76. The official multilateral sources seem to be running out of resources to lend, for example the International Monetary Fund had to turn to the General Arrangements to Borrow to finance the British loan and the IMF's Oil Facility ended in March 1976. (Morgan Guaranty Trust, World Financial Markets, January, 1977). With commercial banks holding \$75 billion of the estimated external debt of \$180 billion of the LDCs, concern over the willingness of the private sources to continue their support of current account deficits arises.

II. A Lone Ranger?

The Administration's diagnosis and proposed solution had support on the Hill. Worried about large U. S. budget deficits being "politically unattractive," the Senate Budget Committee wrote "There is no reason why," the U. S. alone must bear the responsibility for stimulating the world economy . . . "Other strong industrial economies - notably Germany and Japan - must share the responsibility to provide the fiscal and monetary stimulus that world economic recovery requires." (Wall Street Journal, December 17, 1976.)

The OECD in its December report on the economic outlook pressed Japan, the FRG, and the United States for expansion. It forecast a slower rise in the real gross product of the OECD countries from 5% in 1976 to 3.75% in 1977. Compared with its report six months earlier, the latest was notably more pessimistic. It also expressed concern about the ability of some of its member nations to finance their expected current account deficits and added that some of the non-oil developing countries might be in trouble as well.

The Ford Administration raised the same problems that could have led to the same diagnoses as those of the Secretary but without coming down on policy prescriptions. (Economic Report of the President, January, 1977, Chapter 3.) Perhaps the major discernible difference between the present and previous Administrations

is that the shoe is on the other foot. The Ford Administration resisted entreaties from other nations including Japan and Germany to expand in 1975 and early 1976; this Administration is inviting selected, cooperative expansion.

III. Some Questions (and Answers?)

Is the world headed for a slow-down? Is the financing for expected current account deficits inadequate? If so, will the Federal Republic and Japan comply with the Administration's request? And if they do will it turn the trick?

Obviously, these are not easy questions to answer.

A. Prospects for a Slow-Down

As for the OECD area, leaving aside the United States, there was an unmistakable decline in the rate of growth of the combined industrial production of the six other major members (Canada, France, Germany, Italy, Japan, and the United Kingdom) in the last quarter of 1976 over the year as a whole, supporting the notion of a slow-down in 1977. (CIA, Economic Indicators, February 16, 1977; I used 1974-75 shares of their combined gross product as weights.)

Furthermore, there was also a sharp decline in the rate of growth (it actually became negative) in the real money balances of those same members in the last quarter of 1976 over 1976 as a whole, further supporting the notion of a decline in economic activity in 1977. (Ibid.)

But this evidence is not decisive. For example, excluding the U. S., the OECD projects a decline in the rate of increase of the gross product from 3.8% to 3.3% between 1976 and 1977, well

within the possible range of forecasting error. More importantly, perhaps, the sharp decline in real money balances noted above is almost entirely attributable to developments in Italy and the United Kingdom. These are the only two of the seven to show an increase in their rates of price inflation in the last three months of 1976 over the year as a whole. And, in comparison with their average rates of inflation since 1970, they are also the only two to display faster inflation in the last three months or, except for France by a small margin, over the year as a whole. By creating uncertainty, inflation in Italy and the United Kingdom may have been the chief cause of their unemployment and recessions. Declining real balances may slow price inflation, create more certainty, and thereby stimulate their growth and employment.

And for those who like large-scale econometric models, Professor Lawrence Klein projects a rise in the OECD real output from 3.15% to 5.5% between 1976 and 1977. (International Financial News Survey, January 10, 1977)

It is hard to know that the Administration is wrong, but it is also difficult to be confident that it is right.

B. Current Account Financing

The Administration's concern about the ability of countries to finance their current account deficits is extremely difficult to assess.

The reasons are obvious.

The assessment of a country's ability to carry present or added debt is a judgement call, where the answer depends upon a wide range of political and economic variables, including whether or not those variables would permit a policy-directed reduction in the deficit to be financed.

The easiest argument in support of the Administration is that if its proposals and pressures would induce inflation in the creditor countries (which it explicitly does not desire), the real burden on foreign debtors would fall. But in a world where nominal rates of interest seem to adjust quickly to expected rates of inflation, so that inflation would raise debt service payments, this line of reasoning is far from persuasive.

Another argument which would support the Administration would be that the problem of current account deficits and their financing is so general that a series of defaults, world-wide, would ensue that might break the fabric of the financial system.

But the problem seems to be more localized than general. Without mentioning their names, the OECD seems to be worried about the U.K., France, and Italy. (See the countries not mentioned by the OECD, Economic Outlook, December, 1976, p. 10.) But since these countries have floating exchange rates, there is no reason to assume that the current account deficits are intractable; after all, capital and current transactions adjust to one another to equate total

inflows and outflows of foreign exchange. (The OECD forecasts assume no change in exchange rates.)

As for the LDCs, in the eye of one keen observer, "The judgement of the United States Government, the World Bank, and most private bankers is that there is no global problem, no serious threat of massive defaults or debt repudiation. (Edwin L. Dale, Jr., The New York Times, January 30, 1977.)

Again, it is difficult to show that the Administration is wrong, but it is hard to be confident that it is right.

C. Will Japan and the FRG Respond?

Who knows?

The Vice President, upon his return, stated that the three countries are in "substantial agreement" on the need to help "stimulate" world recovery. But he acknowledged that the three governments may differ on the "size" of the necessary stimulus. (Journal of Commerce, February 3, 1977.) While reports emanating from abroad suggested that Japan and Germany reacted to the Administration's recommendations less favorably than that, it is difficult to tell how much of this was for domestic consumption and how much was for real.

D. Will It Turn the Trick?

Obviously the Administration, by its own words, is not sure. Secretary Blumenthal testified on January 27 that " . . . it is easy

to overestimate the magnitude of the contribution that faster growth in Japan, Germany, and the United States can make in fostering the needed adjustments in the weaker countries. A one percent rise in the real GNP of the "big three" would result in an increase in their combined import demand on the order of \$4 billion in 1977, of which only 60% or about \$2.4 billion, could directly benefit the financially weaker countries." (House Budget Committee, p. 6) For ball-park comparison, the world GNP excluding those three countries and the Soviet Union and China is probably around \$5,000 billion. (International Economic Report of the President, op.cit. Table 2.)

The Secretary's scenario depends upon some "ifs" which could deny him his objectives. More fundamentally, can prosperity be transmitted from one country to another or is prosperity chiefly made at home?

First, look at the issue from the Keynesian point of view, a view which focuses on the effects of changes in the current account on aggregate demand.

Suppose that the FRG expands its internal demand. Germany's imports increase. And, by definition, exports to Germany also rise, adding, at least potentially, to aggregate demand in the rest of the world.

When Germany's imports rise, this increases the supply of marks on the foreign exchange market. If the German central bank does not buy up those marks, the value of the German mark on the foreign exchange market must fall. This makes German goods more

competitive. Other countries will divert their purchases toward German products and away from their own goods. This reduces aggregate demand in the rest of the world. If nothing else happens, German exports must rise by an amount equal to the increase in its imports, causing no net decrease in Germany's current account surplus and thus no decline in the current account deficits of other countries. In short, there is no net transmission of demand from Germany to the outside world. In fact, the transmission might work perversely. If the expansion of demand in Germany is achieved through lower interest rates, capital will flow out of the FRG, further increasing the supply of marks on the foreign exchange market. This depresses the mark even more against foreign currencies. In the end, the mark will fall in value until the extra imports by the FRG plus the flow of capital from the FRG just matches the increase in German exports. The German current account surplus rises to finance the extra capital exports, exactly the opposite of the desired result.

From the monetarist point of view, the exercise also fails. As German imports rise, foreign exporters receive additional marks which they sell on the foreign exchange market for their own currency. If the foreign central bank does not buy and hold those extra marks, it does not issue newly-created money to buy those marks; the stock of money outside of Germany does not rise, and aggregate demand abroad therefore cannot increase despite the rise

in exports. The currency simply appreciates until the inflow of marks and the outflow of marks are equal.

For the scheme to work, on the Keynesian analysis, the German central bank must buy up the extra marks when Germany's imports and capital exports increase. This prevents the decline in the value of the mark on the foreign exchange market. As a consequence, German exports won't rise, and the German current account surplus must diminish. If the German expansion brings internal inflation, this result is strengthened as German goods become less competitive while the exchange rate stays constant.

Alternatively, in the monetarist framework, if the foreign central banks buy the marks to hold, they will issue their own new local money to buy those marks from those who export to Germany; this expands the stock of money at home and stimulates internal demand as exports rise.

The central problem is now apparent. Fine tuning with an international orchestra requires a strong conductor--fixed exchange rates. But Germany, Japan, and the United States do not automatically fix their rates of exchange or, in our example, buy up their currencies as their imports of goods or capital exports rise. Much of the rest of the industrial world is floating so that it cannot receive the German transmission. Some of the developing countries tie their currencies to one of the major currencies, chiefly the dollar, but then their currencies float automatically against non-dollar currencies.

This is not to say that the Secretary is wrong. It is just to say that the process is complicated and the results are therefore problematical.