

**SHADOW OPEN MARKET COMMITTEE
(SOMC)**

Policy Statement and Position Papers

September 12-13, 1993

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SHADOW OPEN MARKET COMMITTEE

The Shadow Open Market Committee met on Sunday, September 12, 1993 from 2:00 PM to 6:30 PM in Washington, D.C.

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SOMC POLICY STATEMENT SUMMARY

Washington, September 13—The Shadow Open Market Committee warned today that Federal Reserve's "highly expansive" monetary policy cannot coexist with moderate inflation and falling interest rates. Cash balances have risen rapidly in the last three years. Nominal spending has remained between 5 and 5.5 percent.

The SOMC said that "the two trends in cash balances and nominal GDP cannot diverge permanently. Either money growth must slow or nominal GDP growth must rise, mainly through higher inflation." The committee said that "the Federal Reserve has already waited too long before acting to slow money growth. Although inflation has fallen, Federal Reserve policy has been imprudent. Policy makers failed to tie their policy actions to the objective of price stability. They have failed to respond to their own forecast of higher inflation in 1994."

The Shadow Open Market Committee is a group of academic and business economists who regularly comment on economic policy issues. The SOMC was founded by Allan H. Meltzer of Carnegie Mellon University, chairman of the committee, and the late Karl Brunner of the University of Rochester.

The SOMC charged that the Clinton Administration had made an "elementary error" in claiming that "the decline in interest rates [was] evidence of expansive policy. The market response shows that investors have not made this error. They believe the tax bill is bad for the economy. And this is true despite the impetus that the new tax rate schedule gives to reallocation of future income toward capital gains."

The committee warned that easy money was playing a major role in driving up stock and bond prices (particularly the latter), thus raising the risk of a "bubble" in security prices that eventually will burst.

The SOMC said that "a prudent monetary policy requires slower growth of the monetary base. We urge the Federal Reserve to slow the growth of the monetary base by three percentage points to an annual rate of no more than 8 percent. That is the maximum rate of base growth currently consistent with the Federal Reserve's repeated statements that it seeks to hold annual inflation to 2 percent or less."

The SOMC called on Congress to approve the North American Free Trade Agreement. The committee said that "NAFTA will shift the mix of jobs but will neither create nor destroy U.S. jobs in the aggregate. The change in the mix of jobs will substitute higher value for lower value jobs and increase productivity. The principle competitors of U.S. firms are located in high-wage countries. If this were not true, our largest bilateral trade deficits would be with countries like Bangladesh and Somalia, not Japan.

SHADOW OPEN MARKET COMMITTEE

Policy Statement

September 12, 1993

Federal Reserve policy and output are on divergent paths. Policy is highly expansive. The monetary base—consisting of bank reserves and currency supplied by the Federal Reserve—rose 11 percent in the year ending in August.

Long-term interest rates have fallen to levels not seen for 25 years. The standard explanation attributes the decline in long-term interest rates to slow growth, low inflation, and widely shared expectations that growth and inflation will remain near their recent rates of growth. In fact, real GDP has grown at about its historical average long-term rate of 2.5 to 3 percent. More than two years after the start of recovery there is no evidence of the usual cyclical spurt. Broad-based measures of inflation have remained about 2.5 percent a year during the recovery. Hence growth of nominal GDP—growth of real output plus inflation—has remained between 5 and 5.5 percent.

The divergent growth rate of base money and nominal GDP required that the public increase its money balances by 5.5 percent a year. This is a matter of arithmetic. The fall in interest rates and the rise in asset prices (stocks and bonds) have reconciled these divergent trends. If the trends in money and nominal GDP are to continue, long-term interest rates must continue to fall and asset prices must continue to rise to induce the public to continue to increase cash balances faster than output grows.

MONETARY POLICY

The two trends in cash balances and nominal GDP cannot diverge permanently. Either money growth must slow or nominal GDP growth must rise, mainly through higher inflation. The Federal Reserve has already waited too long before acting to slow money growth. Although inflation has fallen, Federal Reserve policy has been imprudent. Policy makers failed to tie their policy actions to the objective of price stability. They have failed to respond to their own forecast of higher inflation in 1994.

A prudent monetary policy requires slower growth of the monetary base. We urge the Federal Reserve to slow the growth of the monetary base by three percentage points to an annual rate of no more than 8 percent. That is the maximum rate of base growth currently consistent with the Federal Reserve's repeated statements that it seeks to hold annual inflation to 2 percent or less.

Chart 1 shows the basis for our recommended policy. The dark line is the three year moving average rate of change of real GDP minus the three year moving average of base velocity. The moving average of velocity growth adjusts gradually for changes in foreigners' holdings of U.S. currency, changes in financial practices or intermediation, and in growth of productivity and output. The lighter line is the annual growth rate of the monetary base, a measure of Federal Reserve monetary policy. The wider the gap between the two lines, the higher is predicted future inflation. For zero inflation, the two lines must persistently move together. For two percent inflation, they must differ persistently by 2 percent. Inflation slowed in 1983 when the distance between the two lines narrowed. Inflation rose after the distance between the two lines widened.

The average difference between the two lines for the past six quarters is 4 3/4 percent. To get to 2 percent inflation, monetary policy must reduce the difference to 2 percent by lowering the growth rate of the base and keeping the growth of the base within 2 percent of the moving averages shown by the dark line.

In its mid-year report to Congress, the Federal Reserve dismissed M2 as a guide to monetary policy and highlighted the real interest rate. Neither M2 nor any other monetary aggregate has influenced the direction of Federal Reserve policy in recent years, so we regard the statement about M2 as no more than recognition of what has long been true.

Chart 2 shows (ex post) real interest rates for the past one hundred years. The real interest rate is computed by subtracting the annual CPI inflation from the interest rate on 6-month commercial paper. Currently, real interest rates are low relative to most past experience. There are only four periods with lower real interest rates. One is the Great Depression of the 1930s. The other three are periods in which rising inflation was unanticipated, either during wartime or in the 1970s.

The emphasis given to real interest rates has been criticized by many observers. Analysts have no reliable way to estimate the equilibrium real interest rate, and they cannot measure accurately or in a timely way changes in real interest rates or changes in anticipated inflation. Hence they cannot be certain whether real interest rates are moving toward or away from the equilibrium real interest rate. Given these well-known problems, we doubt that the Federal Reserve will highlight real interest rates very long.

Recent emphasis on real interest rates and the recent decision process show the hesitancy and uncertainty that now prevails. The Federal Reserve is groping for some measure or measures to guide its actions and explain them to Congress and the public. The Federal Open Market Committee appears to be so uncertain about the proper direction for policy action that it substitutes grants of limited discretion by the Chairman for the decisions that it is charged to make. Several members of the Committee substitute strong statements about controlling inflation for actions to control excessive money growth. Actual policy remains on an inflationary path.

FISCAL POLICY

The administration's fiscal policy is a triumph of the politics of redistribution over a rational policy for economic growth. The architects of this policy have not learned that just as you cannot penalize luxury boat buyers without hurting luxury boat builders, you cannot tax the "rich" without reducing economic activity.

High marginal tax rates reduce the taxed activity. In this case, the taxed activities are income, saving, and investment. Growth of income will be slower and private sector saving lower. Conventional analysis estimates the loss at 1/2 percent of GDP in the first year, or approximately \$30 billion dollars.

Market data appear to be more pessimistic. The rapid decline in interest rates and the modest increase in stock prices imply that expected growth of corporate earnings will decline substantially. This is arithmetic; the rate of change of stock prices equals the rate of change of expected corporate earnings minus the rate of change of interest rates. From early January to Labor Day, the Standard & Poor's 500 stock index rose 8 percent and the Dow Jones Industrials rose about 10 percent; interest rates on 5 year or 30 year bonds declined 20 percent or more; therefore expected nominal earnings have fallen at least 10 to 12 percent. Although the magnitudes depend on the choice of time period and the division between real earnings and price increases, the direction of change in expected profits or earnings this year does not depend on the particular choice of time period. A calculation of the relative changes since the election or since the passage of the budget bill on August 6 would have the same general implication.

The administration laid great stress on the decline in interest rates as evidence of expansive policy. This interpretation of the decline was based on elementary error. The market response

shows that investors have not made this error. They believe the tax bill is bad for the economy. And this is true despite the impetus that the new tax rate schedule gives to reallocation of future income toward capital gains.

The major issues of fiscal policy are incentives and resource use. The new tax law will reduce incentives for investment and work. Congress achieved the principal reductions in net outlays by raising taxes on entitlements and counting the increase in revenues as spending cuts. The budget failed to shift spending from consumption to investment or control the growth of entitlements.

The chief fiscal issues for the United States remain (1) removing disincentives to save, (2) eliminating the bias in favor of consumption, and (3) controlling the growth of spending. The government has promised more spending for entitlements than the public is willing to pay for. The right solution is to cut back on the spending. Alas, other than defense cuts, the largest spending reduction is a \$108 billion magic asterisk "to be named later." This is required to meet the caps on discretionary spending imposed by the 1990 budget agreement. Congress did not include an additional \$10 to \$15 billion spending for flood relief and national service in the budget.

JOBS, JOBS, JOBS

The rhetoric is jobs, jobs, jobs, but many of the administration's policies are anti-job creation. Rising taxes on the use of labor, and rising costs of employment encourage substitution of capital for labor and of leisure for work. Tax increases slow economic activity. Talk of higher minimum wages and increase marginal costs of health care discourage employment.

Slow growth of employment relative to output did not start with the Clinton administration. For several years restructuring by employers has reduced employment by large firms and shifted employment toward smaller companies and personnel suppliers. The use of part-time workers has increased as a way of reducing labor costs and costs of production. Greater use of overtime avoids hiring and firing costs and reduces the burden of health care and other non-wage costs of labor. Defense cutbacks contribute to the decline in manufacturing jobs.

The only way to create more jobs at rising pay is to increase productivity. The principal reason for slow growth in private sector employment in the 1990s is that it is not profitable to hire more labor. Profitability can only increase if output increases, productivity rises or employment costs fall.

Chart 3 shows recent productivity changes based on data published last month prior to recent revisions. After an encouraging increase in 1992, productivity has fallen in 1993. Unless this movement reverses, there is no prospect for output and incomes to return to their historical average rates of increase. Both will remain below their long-term average. If productivity growth of non-farm business remains at the 0.8 percent average rate of increase experienced from 1981 to 1990, real GDP growth will fall to 1.7 percent.

An administration interested in increasing private sector employment at rising wages should seek to lower mandated costs of employment, to encourage investment and growth in productivity. This would require reversal of many administration policies but would have beneficial effects. Forthcoming health care legislation will raise employment costs and lower the demand for labor. Anticipation of this legislation is one reason that employment has grown slowly.

NAFTA AND JOBS

The statistical battle over the number of jobs created or destroyed by NAFTA is a waste of paper. NAFTA will shift the mix of jobs but will neither create nor destroy U.S. jobs in the aggregate. The change in the mix of jobs will substitute higher value for lower value jobs and increase productivity. The U.S. government should respond to the challenge from NAFTA's critics by working to encourage investment in equipment and by improving the quality of the labor force. More investment, more capital per worker and a better trained work force increase worker and total productivity. This is the only known way to raise permanently total employment and compensation.

The principal competitors of U.S. firms are located in high-wage countries. If this were not true, our largest bilateral trade deficits would be with countries like Bangladesh and Somalia, not Japan.

Congress should approve NAFTA.

Chart 1

The Thrust of Monetary Policy

September 12-13, 1993

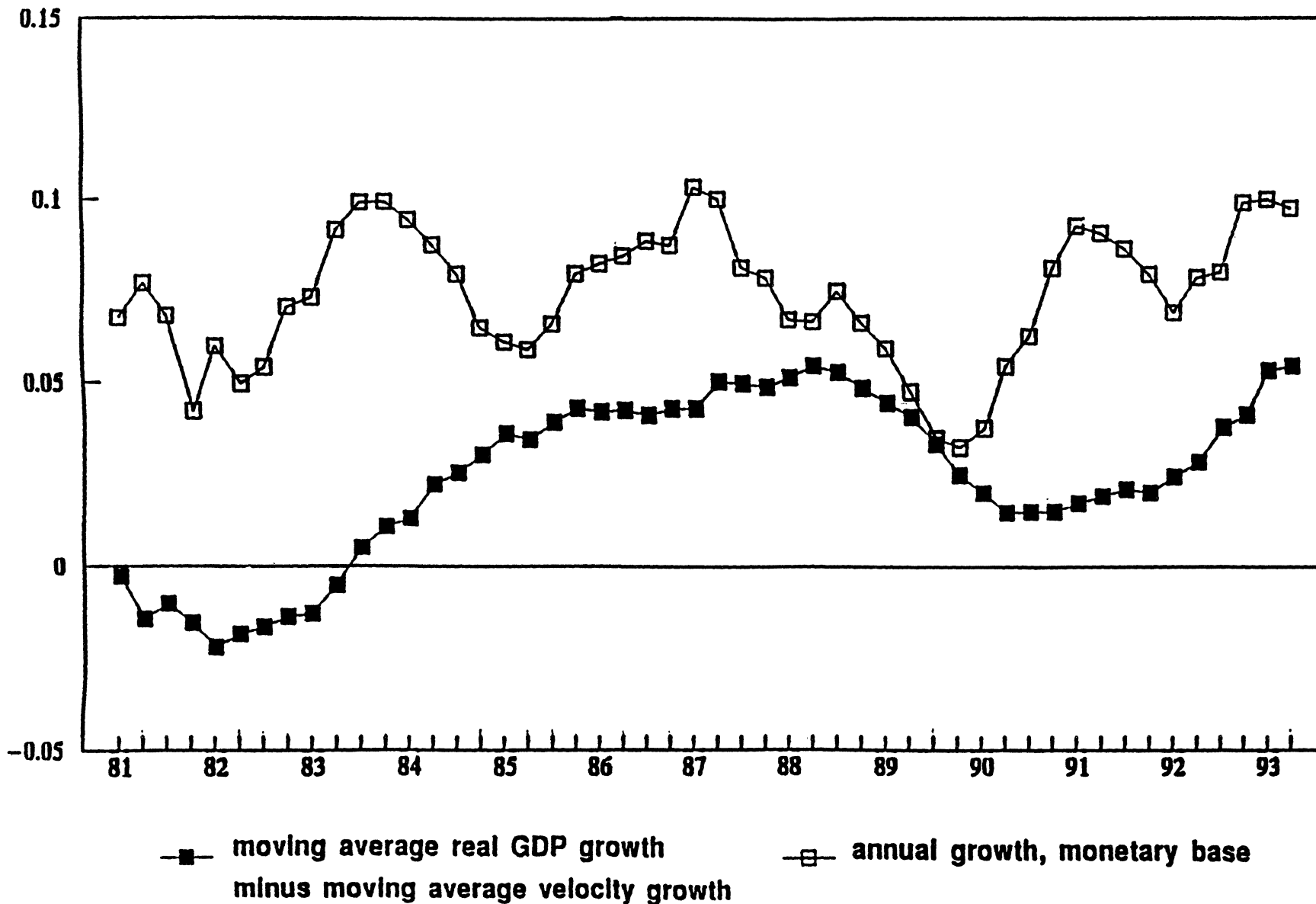
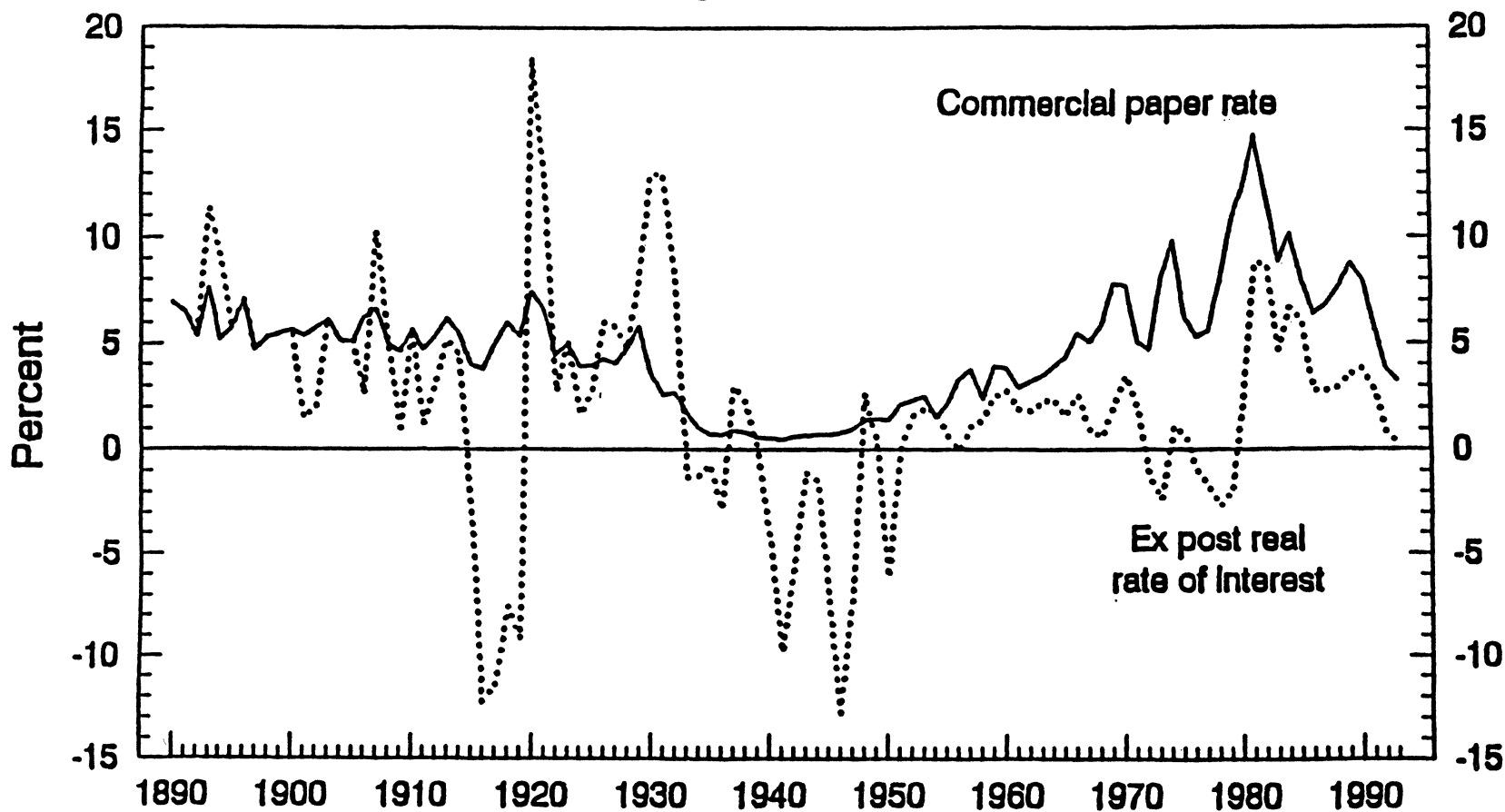


Chart 2

Nominal and Real Rates of Interest

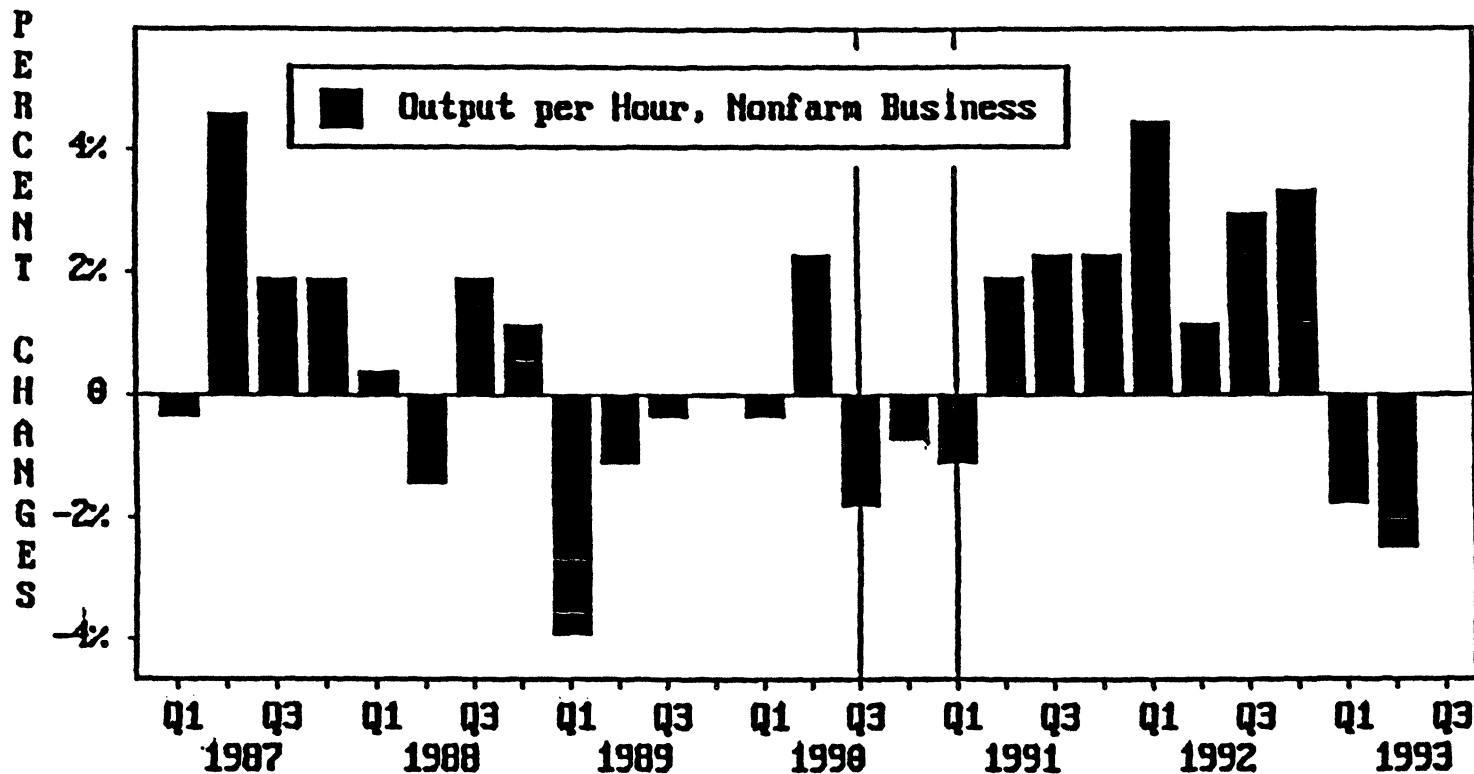
Annually, 1890-1993



1993 observation is January-June average
commercial paper rate less assumed inflation
rate of 3 percent.

Chart 3

PRODUCTIVITY HAS DECLINED IN 1993



Notes: The chart shows quarter-to-quarter percentage changes in productivity in the nonfarm business sector. Bureau of Labor Statistics Index, 1982=100. The vertical lines show the 1990-1991 recession.

Sources: Haver Analytics; Heinemann Economic Research

OBSERVATIONS ON TRENDS IN EMPLOYMENT

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There is a sudden nostalgia for the sixties—unhappy as those years were. One magazine, usually cautious with sweeping generalities, said that "high-paying, full-time manufacturing jobs were plentiful in America during the 1960s. Today, in an era of slow growth, many workers must settle for part-time positions with temporary-help agencies."

That is partly true, largely owing to government-created barriers to employment. The number of jobs in personnel supply services has gained 333,000 since July 1992. Such jobs are 1.8 percent of nonfarm payroll employment, but they accounted for more than 20 percent of the increase in nonfarm payrolls in the past year.

Even so, with the economy still limping, total employment average 61.42 percent of the adult population in the last two years, against 56.38 percent during the 1960s boom. If today's employment rate had existed in the sixties, there would have been 6.3 million more people at work.

Conversely, if the sixties rate applied today, there would be more than 9 million fewer workers. Real after-tax income per civilian worker averaged \$30,370 (in 1987 dollars) in the last two years, roughly one-third higher than the average of \$22,718 in the decade ending 1969.

Economy bashers in the fourth estate generally see job destruction whenever a well-known company (say a GM or a Procter & Gamble) says that it plans to trim its payroll by a few thousand workers. A more accurate label would be creative renewal. New businesses are continuously, unceremoniously displacing the old.

Federal Reserve chairman Alan Greenspan noted recently that "people are being hired at a pace of approximately 400,000 per week, with job losses running modestly below that figure. Such vast churning in the nation's labor markets is a normal and ultimately a productive process."

That's a gross hiring rate of more than 5 million per quarter. Jobs often disappear when firms reorganize or fail. However, on balance the U.S. has obviously created many more jobs than it has destroyed. In the last 25 years, the nation added more than 42 million jobs.

Moreover, it is a myth that the sixties were a Camelot, with lots of high-paying, low-skill manufacturing jobs (a classic oxymoron). The U.S. economy added almost 17.5 million jobs in the 1960s. Only 12 percent of those new jobs were production jobs in manufacturing.

White House political hucksters would have Americans believe that their policies will create good manufacturing jobs at good wages. This is both dishonest and silly. Two-thirds of the 67.6 million new nonfarms jobs created in the U.S. since World War II were in private services; 19.5 percent were in government; about 5 percent were non-production jobs in manufacturing (service workers employed by manufacturing concerns), and 4 percent were in construction and mining. None were on the factory floor.

MANUFACTURING UP, SERVICES FLAT

Service companies, along with federal, state and local governments, created more than 90 percent of the 68 million jobs the U.S. economy has added since World War II. By contrast, the number of production jobs in manufacturing has not changed since World War II. Yet manufacturing output has gone up 500 percent, a sensational record. Manufacturing productivity is rising so rapidly that there is no realistic increase in demand for industrial products that could lead to a sustained increase in manufacturing's share of total jobs.

Unfortunately, stagnant output per worker in services has tended to cancel the huge gains in manufacturing. As a consequence, the U.S. is suffering from a long-term slowdown in growth of productivity and real income per worker, which have been in the doldrums for about 20 years.

Efficient manufacturing firms helped to expand productivity, but the drag from an inefficient service sector is such that the growth trend in output per worker from 1970 to 1992 was half the rate from 1890 to 1970. With slow growth in productivity has come slow growth in income. Real income per worker is 30 percent higher than in the 1960s, but it is roughly 40 percent below where it would have been, had the trend of the first quarter-century after World War II continued.

The only cure for America's slow motion disease is more investment. President Clinton's senior strategists endorse this point in theory, but their actions belie their words. To get more investment, Mr. Clinton must be nice to investors. To be more precise, he must take actions which will help to lower the cost of capital.

The U.S. taxes income from investment three times. Company profits, dividends paid to stockholders and capital gains (if any) from owning stock are each subject to a separate tax. Need you ask why the U.S. suffers from chronic underinvestment?

Shifting the burden of taxation from investment to consumption would produce dramatic results: More investment, more growth, more revenue for Washington and more tax payments by the "rich." This is surely the best route to Mr. Clinton's Camelot growth with equity. Remember, Americans have to bake their pie before they can slice it.

THE GREAT DIVIDE

The U.S. economy stands at a great divide. For 20 years, roughly 1970 to 1990, America enjoyed job growth at rates well above the trend of the last century. In the 1980s, private service firms—finance, retailing, health care and transportation among others—did almost all the net hiring. Gains in government jobs offset drops in manufacturing.

Unfortunately, by the end of the decade, private service employers were in trouble. The more employment went up, the more profits declined. At the margin, companies were hiring people to produce at a loss. Firms had to stop adding people for an extended period to allow demand for their services to catch up their work forces.

Adjusted for inflation, profit before tax per private service worker fell to an average of \$2,048 from 1979 through 1992, down almost 37 percent from the average of \$3,231 from 1947 through 1978 (at 1987 prices). The fall in profitability put management under pressure. Declining profits sated the appetite for new workers. Hiring stopped, and the economy went into recession. The annual change in private service jobs went from plus 2.7 million in January 1989 to minus 633,000 in July 1991, a negative swing of 3.3 million.

Once burned, twice shy, managers have been reluctant to recreate the same problems during the subsequent recovery and expansion. Hiring has been slow. Thus, in the 1990s, the great American job machine seems to be stalled. What, if anything, ought government to do?

Should Washington seek a return to rapid job creation? Alternately, should it foster opportunities for a more stable (possibly a smaller) work force to create more wealth? These aims are not mutually exclusive, but policy choices will be different depending which goal you prefer.

On average, more than 62 percent of civilian adults in the U.S. were at work during George Bush's four years in the White House. Even with the recession, that was a record for any President in the 20th Century, and probably the 19th as well. An average of 1.8 million people found work each year from 1960 through 1989, a total gain of about 53 million.

By contrast, total employment went up less than 1 million from 1990 through mid-1993, an annual increase of 270,000. Obviously, most of that slump in growth was due to the recession. Even so, some folk are worried that forces leading to a long-term slowdown in jobs may be at work.

Bill Clinton went to Washington to create "good jobs at good wages." Sadly, he seems to have lost whatever sense of strategy he brought to the White House. His budget squeaked through Congress last month. But the final bill was a patchwork of political accommodation, not a program of incentives to invest and create wealth. The reverse seems more likely.

A national debate on employment policy has just begun. Voters need the facts. More workers will not necessarily equate to an increase in national wealth, which should be the objective. Employment was very high in Russia under Communism, but Russian citizens are poor today because their productivity was low. Here are four key points to keep in mind:

STRATEGIC TRENDS

First, since the early 1970s, rapid gains in employment in the U.S. have been accompanied by sluggish improvement in productivity, well below earlier trends. As a result, real income per worker has stalled. Average real incomes are not far below where they would have been, had the gains in the first 25 years after World War II continued.

Second, employment growth has been led by private firms that provide services. The list is long: Communication, entertainment, education, finance, health, insurance, real estate, trade, transportation and utilities are among the larger employers. Such firms account for over 70 percent of the job growth since World War II, and 100 percent since the early 1980s. Add in government (also a "service industry"), and services account for more than 90 percent of the jobs added since 1946.

Third, roughly two of every three net new workers in the U.S. since the late 1960s have been women. Almost 46 percent of the U.S. work force is now female compared to 37.7 percent 23 years ago. Put differently, 54 percent of women over age 16 were working outside their homes in the second quarter of 1993, against 41 percent in 1970s. The male employment rate, by contrast, fell from 83.6 percent to 69.9 percent.

Fourth, the feminization of the work force is most pronounced in the displacement of older men by younger women. Females aged 25 to 44 were 14 percent of the work force in 1970; they are 24.7 percent today. In the same period, the number of male workers aged 45 to 64 dropped from 21.7 percent of total civilian employment to 15.1 percent.

Changes in employment rates are also dramatic. The share of women aged 25-44 working outside their homes started to climb rapidly in the mid-1960s. The ratio jumped from 40 percent to 70.4 percent. Employment rates for males 45 to 64 slumped from 88 percent to 75.4 percent.

To summarize, employment growth in the United States (indeed in most advanced industrial democracies) has been dominated in recent decades by service industries. History indicates that gains in productivity have typically been difficult to achieve in these areas.

Huge gains in service employment include a large scale, systematic shift from older to younger workers; from workers who are more experienced to those that are less experienced; from those who are more expensive to those that are less expensive. Coincident with these shifts, growth in both productivity and real income slowed to a crawl.

These facts should inform the public policy choices that Americans make. No one should characterize them as good or bad. As one example, young women themselves must judge how to balance conflicting demands of family and work. They alone can decide their relative priorities.

CHICKEN AND EGG

Cause and effect are deeply intertwined. The record suggests the shock of sharply higher energy prices after the OPEC oil embargo in 1973 triggered the initial slowdown in productivity. Machinery, efficient when oil cost \$4 a barrel, was obsolete when it cost \$12. With one stroke, OPEC cut the value of the nation's capital stock. American workers had less valuable tools to produce output. In that setting, a drop in productivity was not surprising.

When productivity goes down, so must real income. In the aggregate, a society cannot pay itself more than it produces. Growth in real after tax income per worker averaged 2.8 percent annually in the 1950s and 2.4 percent in the 1960s. It fell to only eight-tenths of one percent in the seventies and has remained below 1 percent since that time.

Employers replaced expensive workers (relatively experienced older men) with cheaper ones (relatively inexperienced younger women). This was good for the bottom line. Whether it will be good for the economy is another matter. Growth in service productivity dropped at roughly the same time that women moved into the work force in large numbers.

Eventually, Americans will have to confront the social implications of economic trends that have driven the employment/population ratio among women to progressively higher levels. Mr. Clinton is right to focus on productivity and growth. He needs policies that actually achieve it.

The fall in growth of real income may have spurred women to enter the work force to sustain deep-seated expectations of gains in family living standards. In turn, an increase in the supply of women seeking work could help lower their relative real wages and speed the shift from experienced to inexperienced workers. In a vicious circle, the changing work force may reinforce the slowdown in productivity and real wages.

Many, perhaps most, of these trends lie beyond the reach of public policy. The marked drop in the growth rate of the working-age population (16 plus) from a peak of 2.8 percent in the mid-1960s to 1 percent today could limit pressure for rapid job growth. Whatever else, it is clear that a cure that simply piled on more low-productivity jobs could be worse than the disease. President Clinton is right: The U.S. needs good jobs at good wages. The question is, how to get them.

BARRIERS TO JOB GROWTH

A basic law of modern science is that two wire coat hangers, left alone in a cool, dark closet, will multiply at an exponential rate. This finding also applies to government bureaucrats and their regulations. Now that Mr. Clinton's misnamed "deficit reduction" budget is on the statute books, consumers, investors and voters must assess the consequences.

By boosting marginal tax rates on people who are most likely to start new businesses, the President's budget will suppress an activity he wants to encourage—private investment to create "good jobs at good wages." However, the budget is only the tip of the Potomac iceberg. Starting with the Family and Medical Leave Act (the first bill the President signed), the Clinton Administration and Democrats in Congress have rushed to add new spending mandates on top of old. In addition to the FMLA, the Americans with Disabilities Act and the Clean Air Act, among many others, force firms to fund a range of social and environmental programs.

Thomas D. Hopkins of the Rochester Institute of Technology pegged the cost of federal regulation this year at \$581 billion and \$662 billion in 2000 (at 1991 prices). Costs have ballooned partly because agencies issue regulations piecemeal, without a budget process that would impose spending limits and force trade-offs among competing proposals.

The Bush White House put it this way: "Regulations that provide social benefits are often issued without consumers fully realizing that they must collectively pay for them—as customers, workers or stakeholders." There is no free lunch.

Across the nation, state and local governments are in revolt against unfunded federal mandates. These rules force local politicians to take the heat for raising taxes to carry out Washington's wishes (which may or may not conform to local priorities).

In the private sector, a long list of laws and regulations add to employment costs. As a result, reluctant employers are turning to specialists in controlling job costs, the so-called temp agencies. This may be a misnomer. Many firms provide permanent as well as temporary workers. "Personnel supply service" jobs exploded 20 percent in the past year, while the overall number of nonfarm jobs went up a bare 1.5 percent.

THE BIGGEST MANDATE OF ALL

At the corporate level, federal mandates amount to implicit income taxes. During the Clinton Administration, the increase in implicit business taxes may outstrip the rise in explicit taxes. The most recent—and probably the biggest—example of this trend is the apparent decision by the White House to finance reform of the health care system largely through corporate mandates. According to *The Wall Street Journal*, the new law "would require all employers to pay a portion of each employee's health insurance premium, probably 80 percent."

Last month, the White House sent a 55 page crit sheet to Democrat members of Congress outlining the plan for changes in the health care system. While Mr. Clinton has yet to decide many details, the process is far enough along to allow disclosure in general terms.

The document says that "under the Clinton plan, every American will be guaranteed access to a comprehensive benefit package, no matter what. No one will be denied insurance because of a pre-existing medical condition, a sudden illness, a change of jobs, or for any other reason."

"All employers and employees—including those who now pay nothing—will be asked to contribute to the cost of their health care . . . The system is financed as it is today—through employer-paid premiums. The plan will not require any new broad-based tax."

WORKERS PAY FOR THEIR OWN BENEFITS

Translated from political jargon, the message is clear. Voters can get health care benefits from Uncle Sam without having to pay for them directly. This is not true. If history is a guide,

workers themselves will pay for most of their new benefits in lower wages and salaries. In addition, part of the cost of health reform will turn up in higher prices and some will be reflected in lower rates of return to investors.

By requiring employers to shoulder up to 80 percent of the cost, the Clinton plan could end up hiding the true cost of health care in millions of company budgets. That could make medical outlays almost impossible to control, despite all the White House rhetoric about cost containment.

To the extent that the Clinton health plan is a drag on corporate profits, it will be part of a long-term trend. Escalating federal mandates that require stockholders to help pay for environmental, health, safety and social programs have played a critical role in eroding the profit share of income in the U.S.

Pretax operating profits averaged 8.1 percent of national income since 1980, the low for any similar period since the 1930s, which included the Great Depression. From 1940 through 1979, this ratio averaged about 11.8 percent. The long-term erosion in the profit share of income is one symptom of the drop in the rate of return on corporate equity in the U.S.

The slide in the rate of return has been accompanied by a parallel slump in net investment as a percent of the output of goods and services. The shortfall in net investment is one of several key ingredients in the slowdown in real income growth that Mr. Clinton pledged to reverse.

The irony is that his Administration seems bent on cutting productivity, not raising it. Output per hour in the nonfarm economy rose 2.7 percent in 1992, the best showing in 20 years. The Family Leave Act will cut that record. Either employers will hire redundant workers (to cover for those at home), or they will bring in temporary help. These individuals are likely to be less well trained than those they replace.

Richard Vedder and Lowell Gallaway of Ohio University argue that government efforts to "create jobs" usually backfire. By increasing employment costs, government programs reduce demand for workers and result in more unemployment. "The state aggravated the problem of unemployment for Americans . . . The biggest losers from state intervention have been the very people that advocates of activism have claimed need the most help: namely, nonwhites, women, unskilled and inexperienced youths."

The argument may seem roundabout, but the consequences have been devastating for the average American. Whatever the merits of individual programs, financing social programs with corporate mandates makes Americans pay hidden costs for controls that often demand bigger outlays

to stop less pollution or provide fewer benefits. The nation pays twice: The first payment is fewer jobs, lower wages, higher prices and/or smaller dividends. The second payment is reduced investment, slow growth and a lower living standard.

WHAT'S WITH THE JOB MARKET?

The Wall Street Journal reported recently that "the economy generated 162,000 new jobs" in July. This report, which is typical of current comments on the employment situation, was, in a literal sense, not true. The number of nonfarm payroll jobs actually dropped 1.022 million in July. According to the Labor Department, this decline was less than normal. Therefore, seasonally adjusted, payroll jobs were up 162,000.

The point is not to impugn the data, but the journalism. News reports should not treat abstract statistical calculations as though they were actual events. Less-than-seasonal layoffs are no more job creation than-less-than seasonal hiring is job destruction.

Economic growth is indeed slow. Unemployment and involuntary part-time employment are up, reflecting lingering aftereffects of the recession. While the number of involuntary part-timers has increased, they averaged 5 percent of the labor force in the past year. That compares with a 4.7 percent norm from 1983 through 1989, a period of rapid job growth.

Moreover, voluntary part-timers are less than 12 percent of the labor force today, a ratio that has hardly changed in more than 20 years. Nonetheless, there are cautionary signs in the data. Not only has the number of part-time workers gone up in the last few months, the number of jobs has started to rise more rapidly than the number of workers. The latter indicates more people are taking second and third jobs to maintain family incomes. If these developments persist, they would be a signal of softer labor markets in the months ahead.

Thus far in 1993, the number of jobs has gone up about 1.2 million, the first relatively normal job gain in the current business expansion. Unfortunately, this modest increase in employment has been associated with back-to-back quarterly declines in productivity, increases in unit labor costs and reductions in operating profits. This is not a pretty picture. It does not bode well for job gains in the future.

GRATUITOUS BASHING

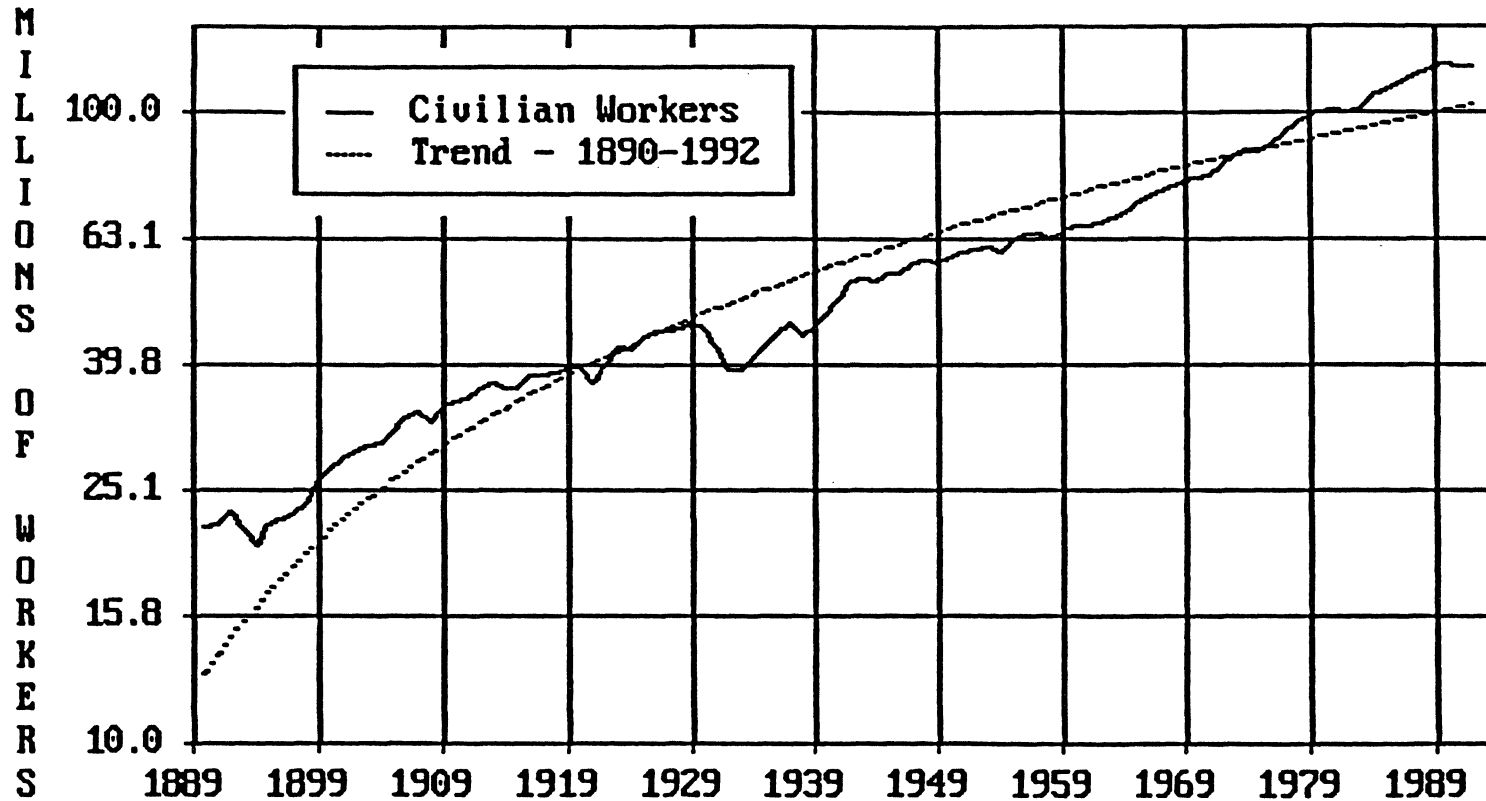
The New York Times, which has a habit of gratuitous economy bashing, published a misleading piece about the job outlook. *The Times* asserted that 60 percent of the job gains since January were part-timers. The numbers were accurate, but the conclusion was wrong. Part-timers do not dominate the current job market. We should disregard such comments.

The Times used monthly data on the number of part-time workers (not part-time jobs as it asserted) that are notoriously volatile. It then carefully selected a beginning point to make the case. Gains in workers during the last year, are mostly full-time.

Separately, *The Times* said the number of white collar workers had shown little or no growth in the current expansion. This was also false. According to the regular Labor Department definition of white and blue collar occupations, white collar jobs declined less than blue collar jobs during the recession and then recovered first.

At present, the white and blue collar employment categories are rising at about the same rate. In fact, the number of "managerial and professional specialty" workers (the highest-paid members of the labor force) went up by more than 1 million from March through July, an unusually large increase. This is a *very* volatile series; only time will tell whether such gains will last.

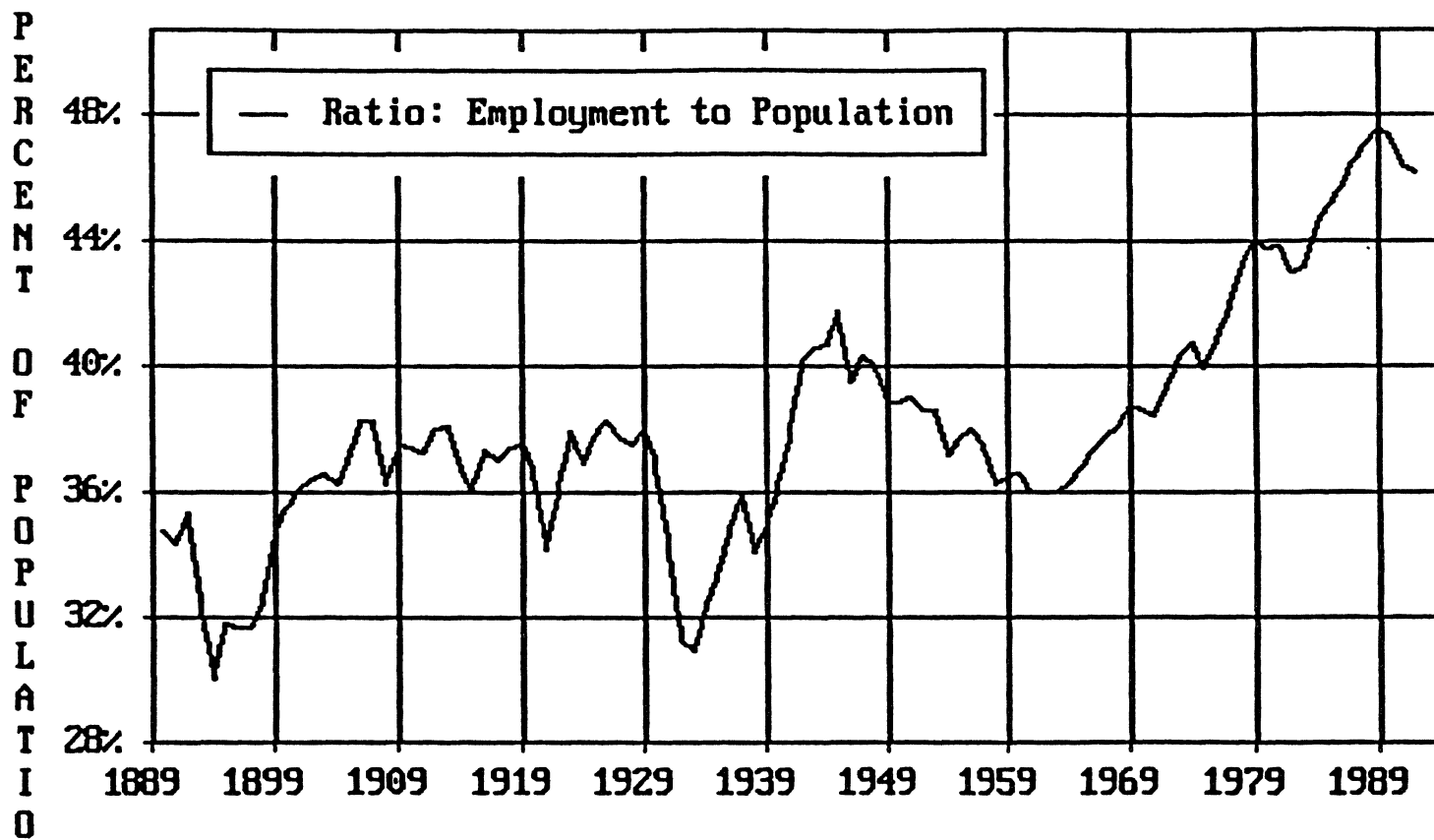
CIVILIAN EMPLOYMENT IS ABOVE ITS LONG-TERM TREND



Notes: The chart shows total civilian employment in the United States (line) and its trend from 1890 through 1992 (dot). Data are millions of workers. Since 1946, annual averages of monthly figures. Logarithmic scale.

Sources: Haver Analytics; Heinemann Economic Research

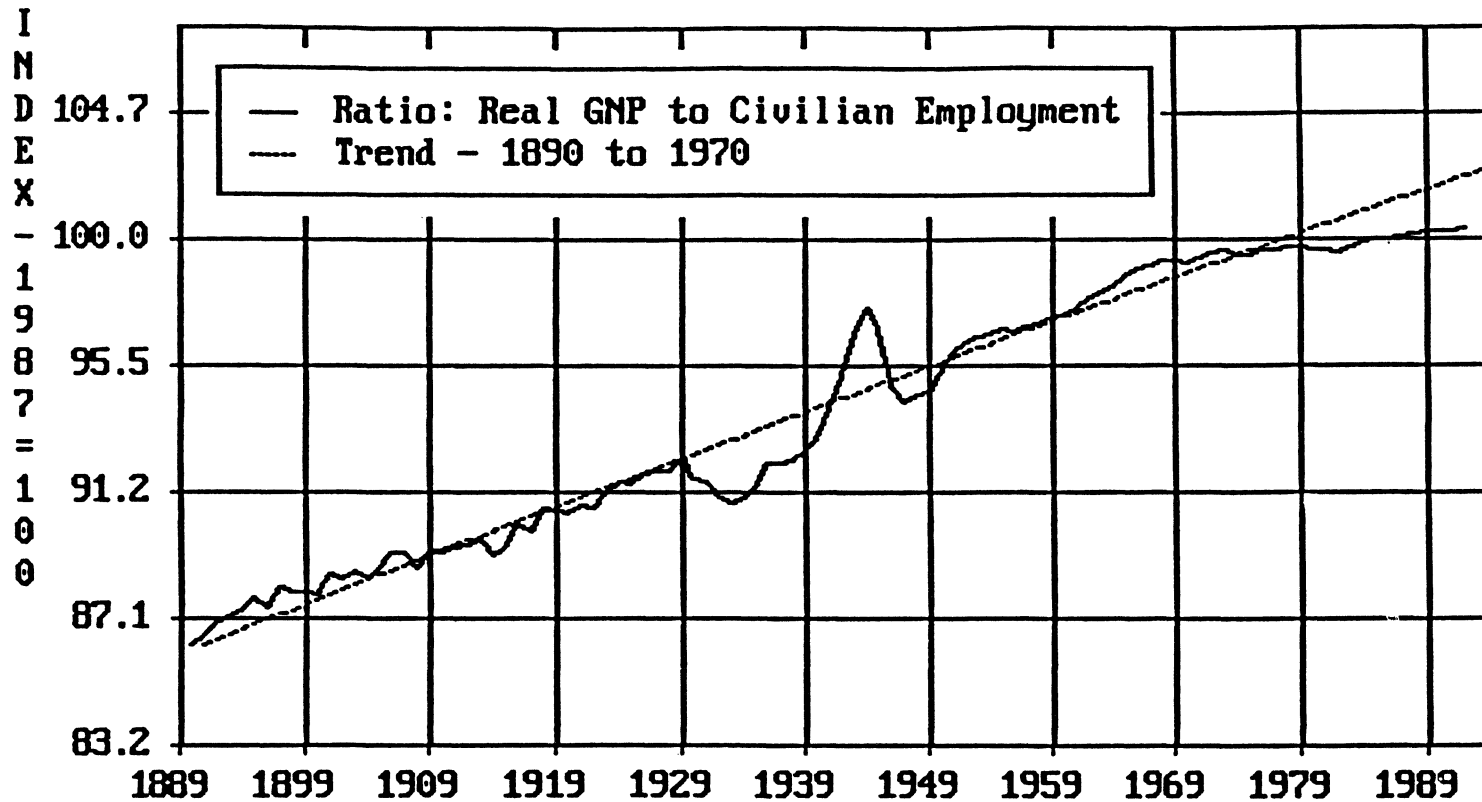
THE EMPLOYMENT RATE IS CLOSE TO ITS PEAK



Notes: The chart shows total civilian employment as a percent of the resident population. Annual data. Figures prior to 1900 are linear interpolations between census years. Underlying measures are thousands of persons/workers.

Sources: Haver Analytics; Heinemann Economic Research

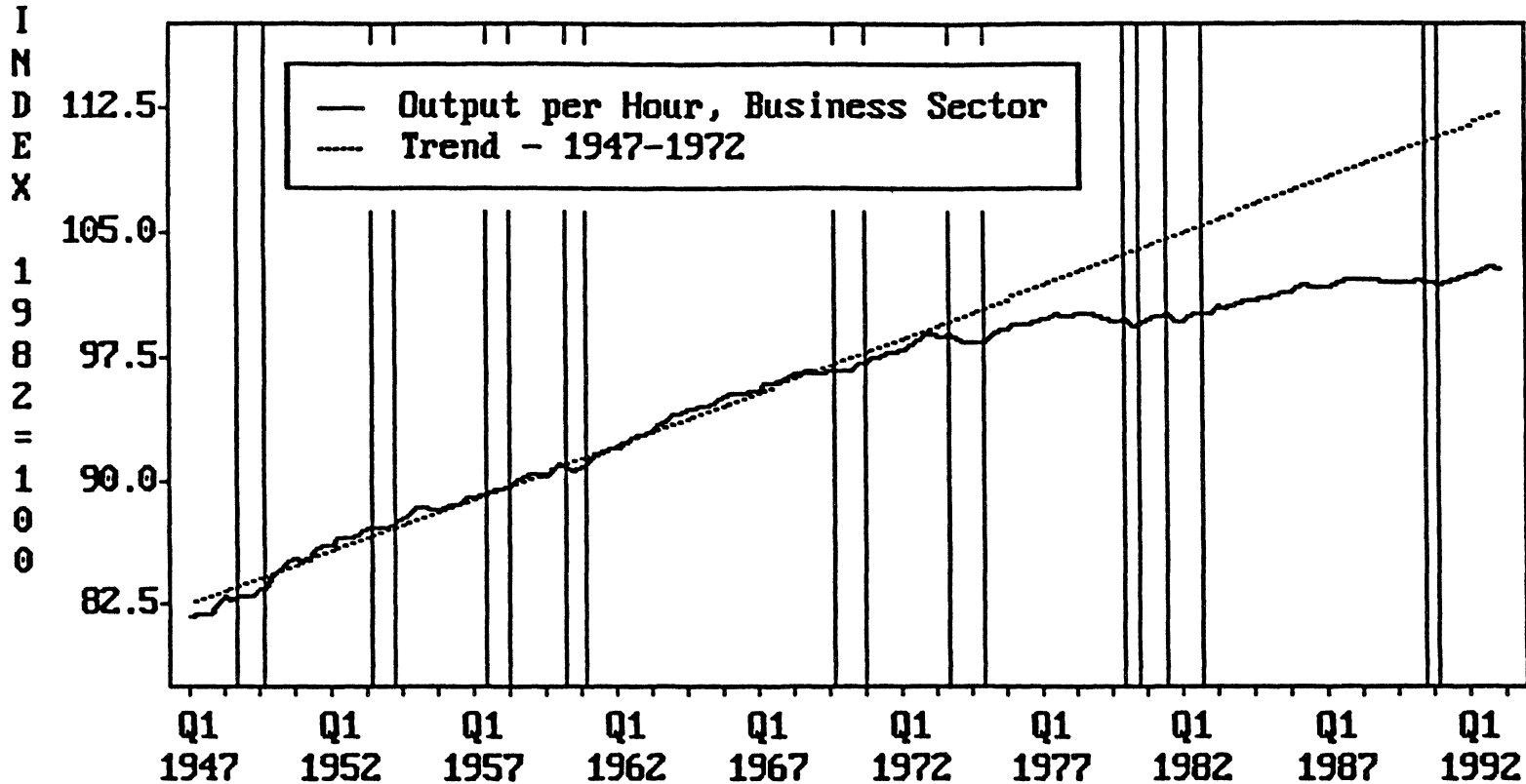
OUTPUT PER WORKER HAS INCREASED VERY SLOWLY SINCE 1970



Notes: The chart shows real gross national product per civilian worker. GNP data before 1929 are from a Bureau of Economic Analysis study of long-term growth. Data are an index of log values, 1987 = 100. Logarithmic scale.

Sources: Haver Analytics; Heinemann Economic Research

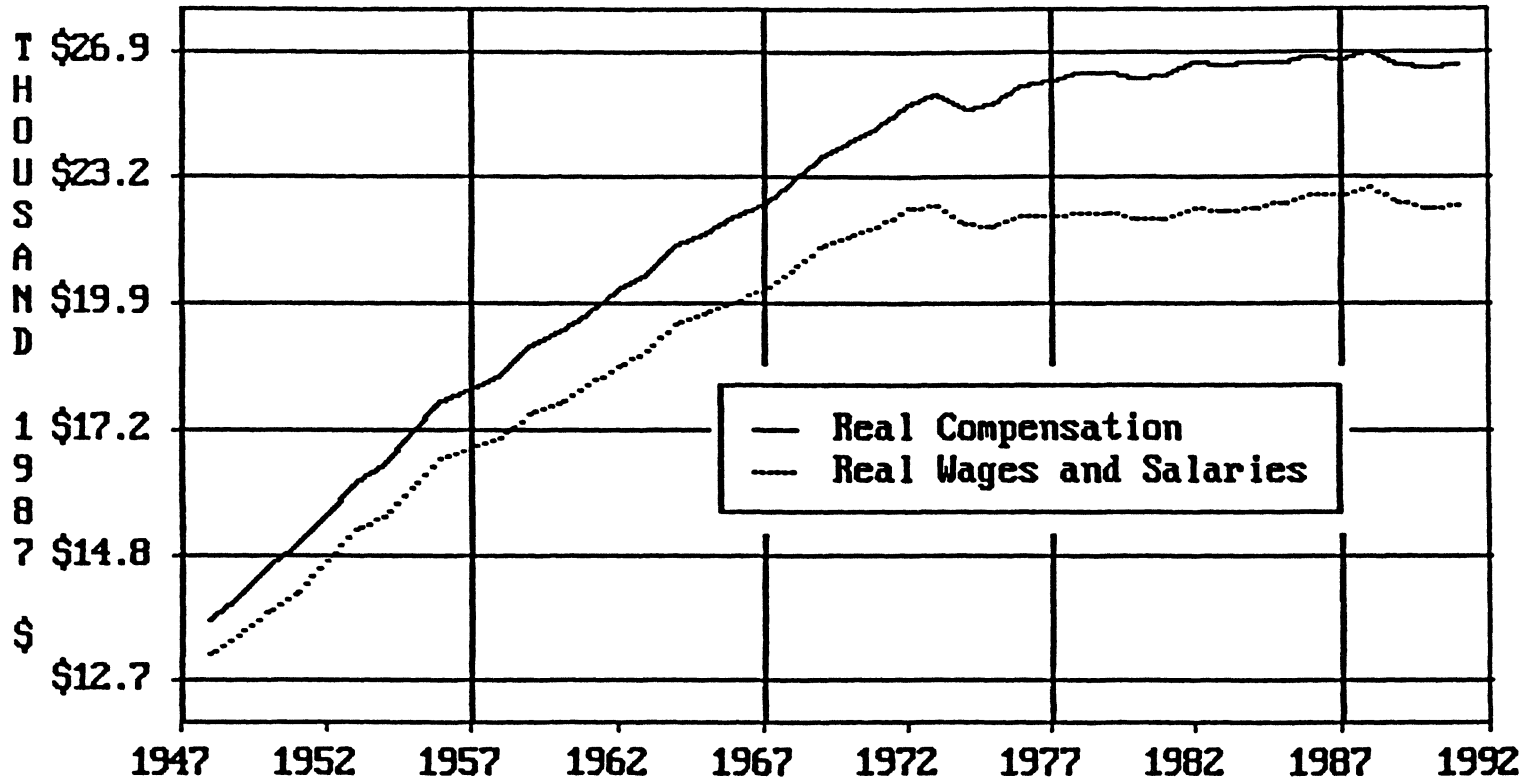
PRODUCTIVITY IS FAR BELOW THE EARLY POST-WAR TREND



Notes: The chart shows output per hour of all persons in the business sector. The data are natural logs converted to an index, 1982 = 100. The trend line is based on figures from 1947 through 1972. Vertical lines show recessions.

Sources: Haver Analytics; Heinemann Economic Research

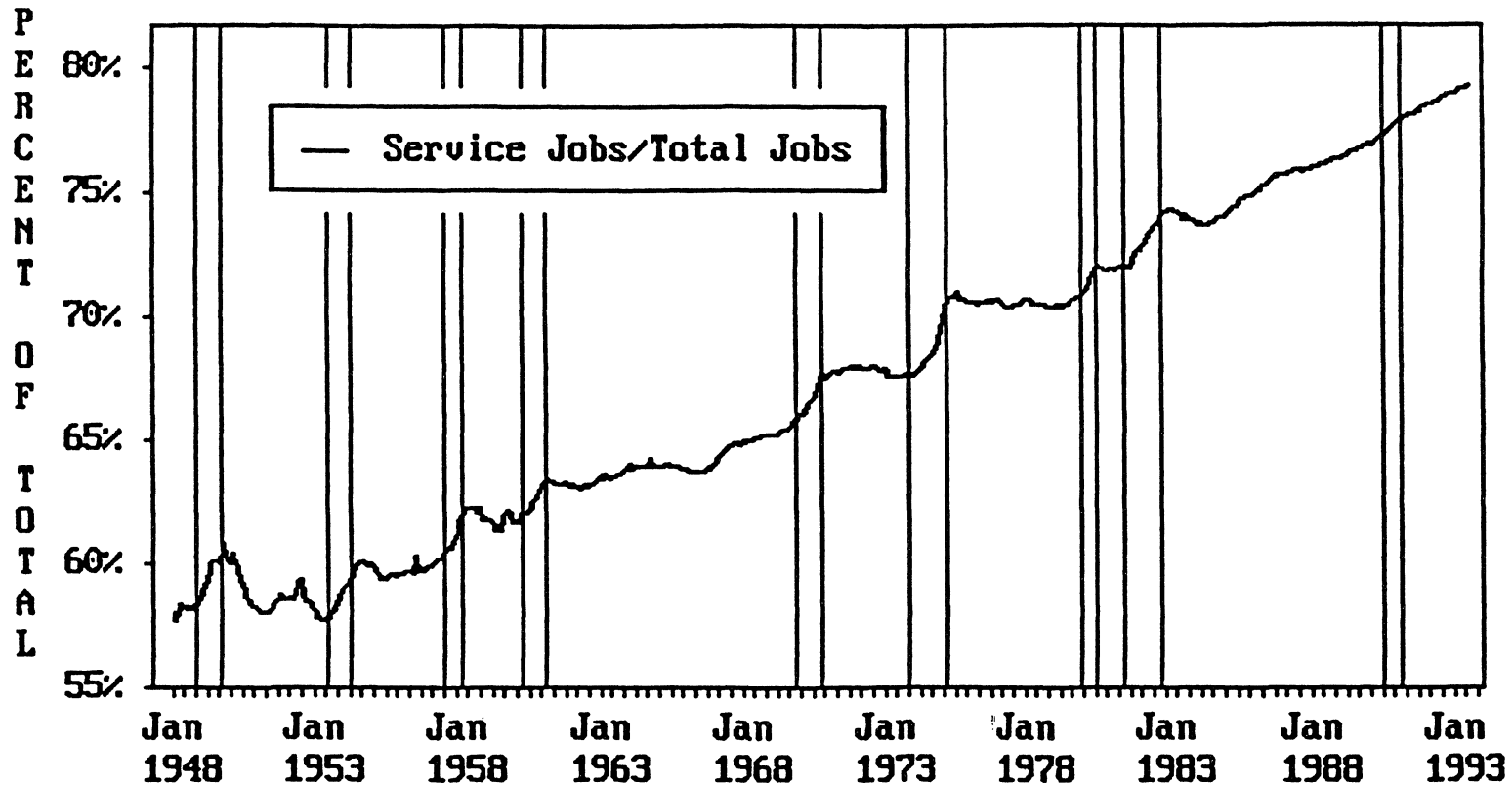
PRIVATE PAY CHECKS HAVE BEEN FLAT SINCE THE SEVENTIES



Notes: The chart shows annual real compensation per full-time equivalent private worker and real wages and salaries per full-time equivalent private worker. Natural logs converted to thousands of 1987 dollars on the vertical scale.

Sources: Haver Analytics; Heinemann Economic Research

FOUR OUT OF FIVE JOBS ARE IN THE SERVICE SECTOR

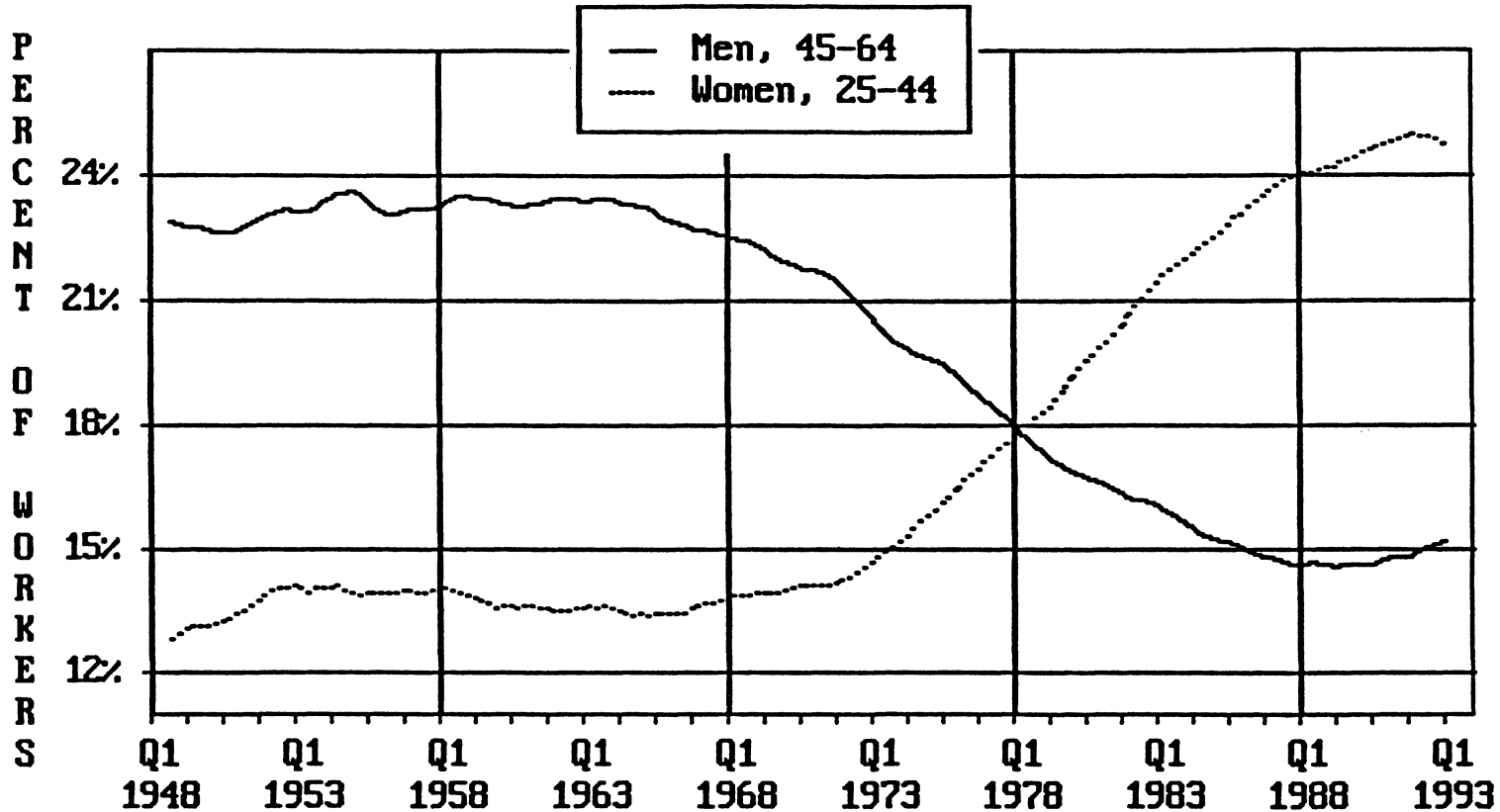


September 12-13, 1993

Notes: The chart shows nonfarm payroll jobs in service-producing sectors (including government) as a percent of total nonfarm payroll jobs. The underlying data are thousands of jobs, seasonally adjusted. The vertical lines show recessions.

Sources: Haver Analytics; Heinemann Economic Research

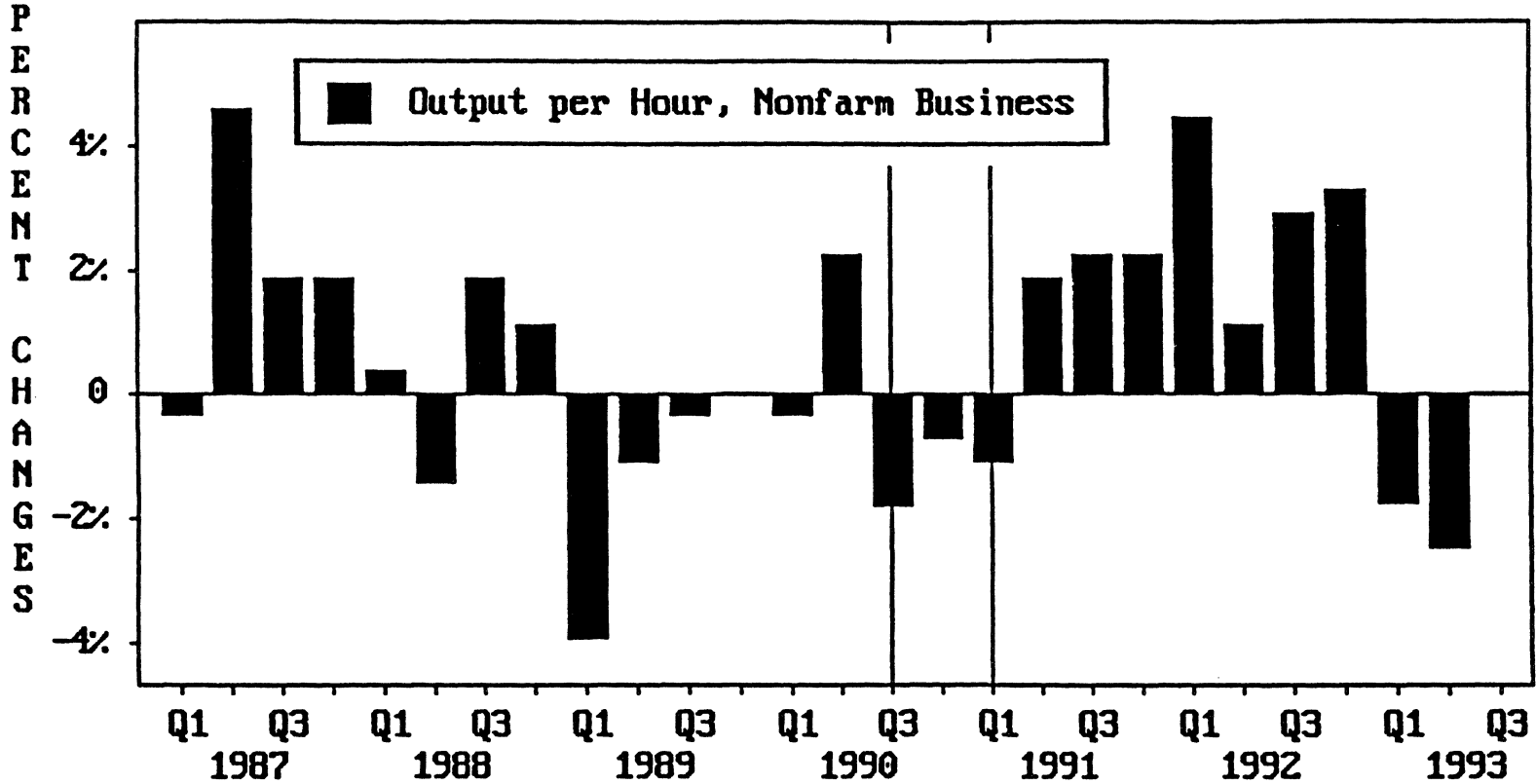
YOUNGER FEMALES HAVE DISPLACED OLDER MALES IN THE WORK FORCE



Notes: The chart shows males aged 45 to 64 (line) and females aged 25 to 44 (dot) as a percent of total civilian employment. Underlying data are thousands of workers, not seasonally adjusted. Four-quarter moving averages.

Sources: Haver Analytics; Heinemann Economic Research

PRODUCTIVITY HAS DECLINED IN 1993

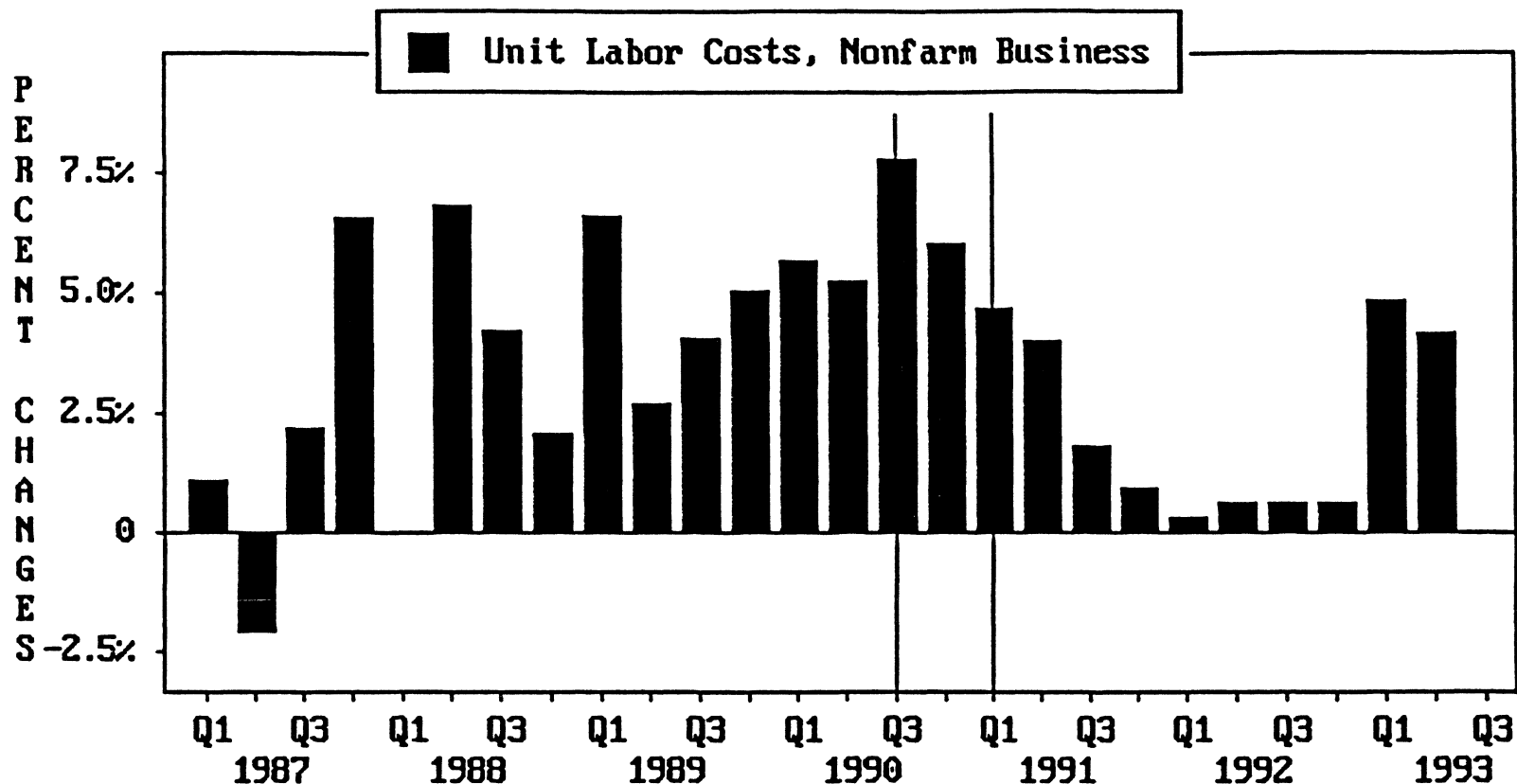


Notes: The chart shows quarter-to-quarter percentage changes in productivity in the nonfarm business sector. Bureau of Labor Statistics Index, 1982=100. The vertical lines show the 1990-1991 recession.

Sources: Haver Analytics; Heinemann Economic Research

UNIT LABOR COSTS HAVE INCREASED IN 1993

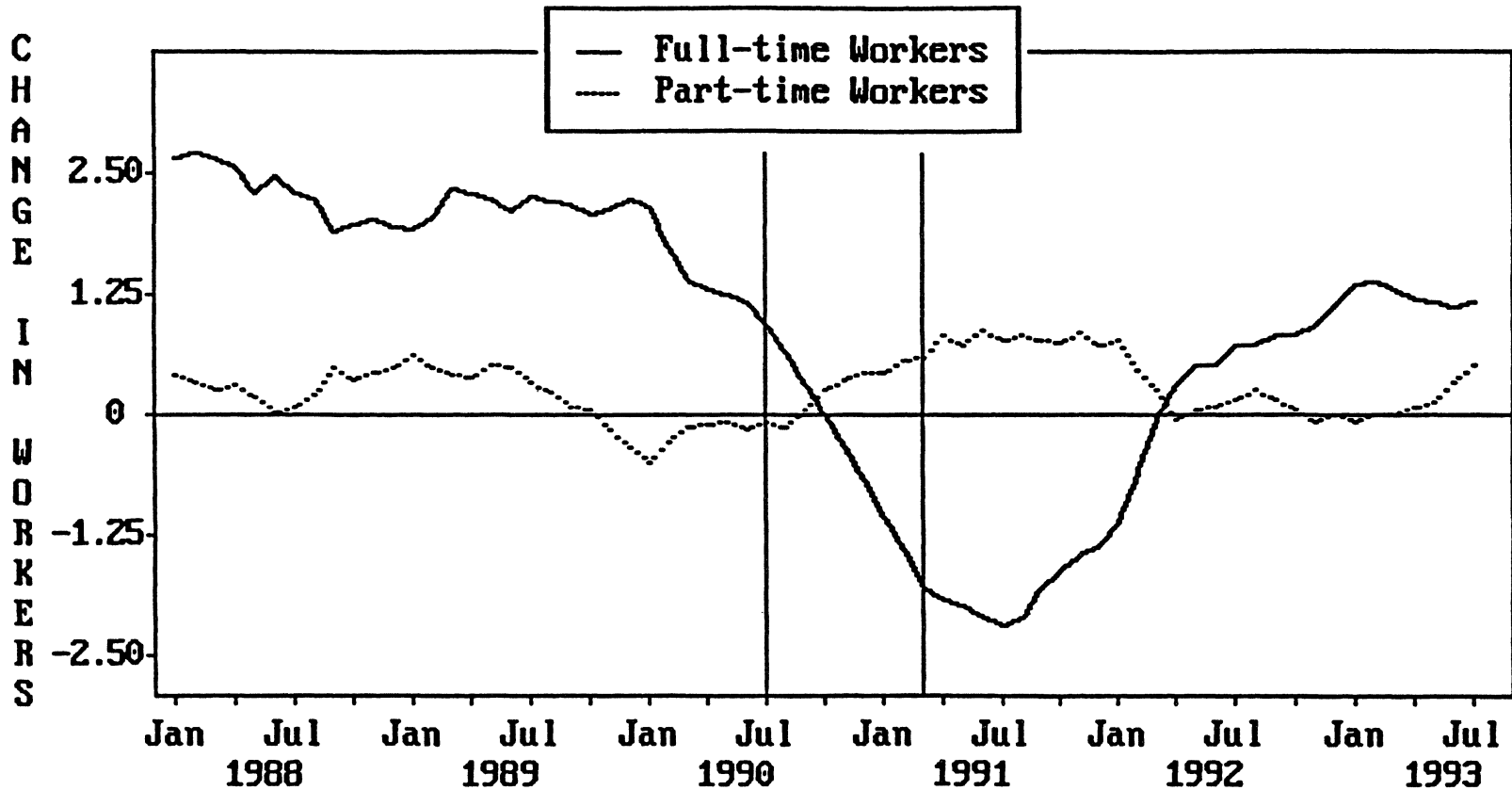
Shadow Open Market Committee



Notes: The chart shows quarter-to-quarter percentage changes in unit labor costs in the nonfarm business sector. Bureau of Labor Statistics Index, 1982=100. The vertical lines show the 1990-1991 recession.

Sources: Haver Analytics; Heinemann Economic Research

FULL- AND PART-TIME EMPLOYMENT HAVE GROWN IN THE RECOVERY



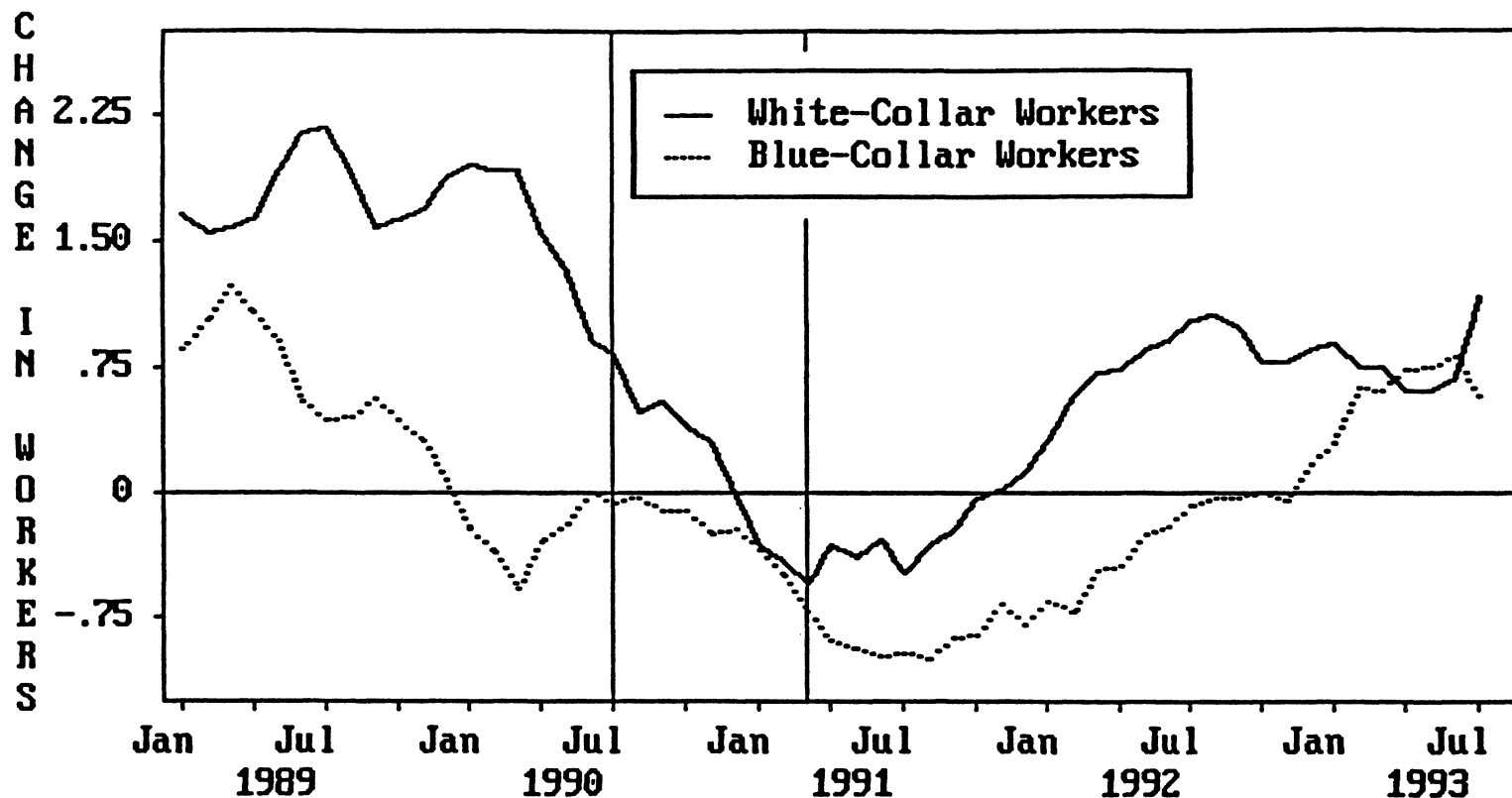
September 12-13, 1993

Notes: The chart shows year-over-year changes in the number of civilian workers — full-time (line) and part-time (dot). Data are millions of workers, seasonally adjusted. Three-month moving averages. Vertical lines show the recession.

Sources: Haver Analytics; Heinemann Economic Research

WHITE-COLLAR EMPLOYMENT RECOVERED SOONER THAN BLUE-COLLAR

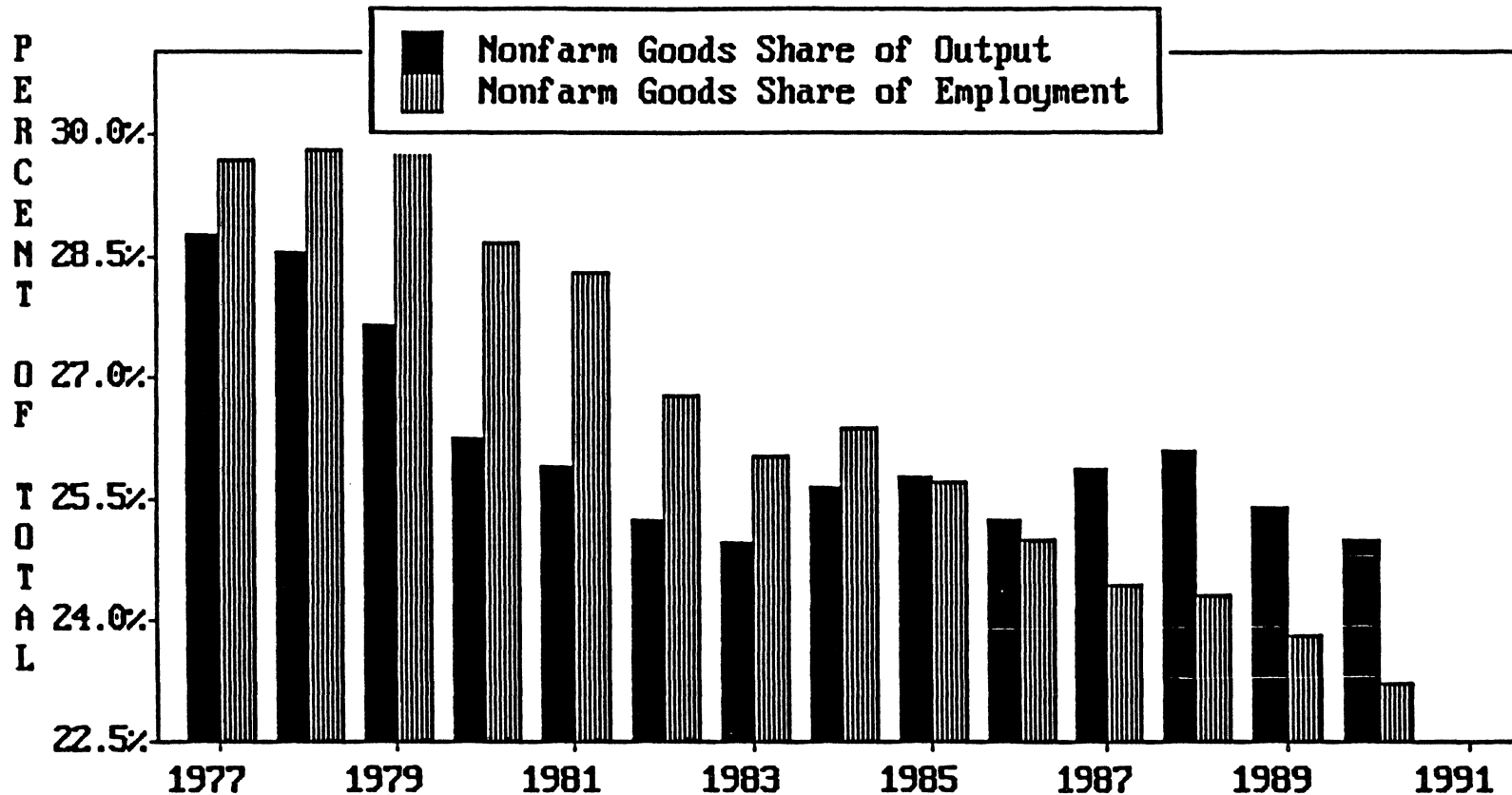
Shadow Open Market Committee



Notes: The chart shows year-over-year changes in the number of non-farm workers - white-collar (line) and blue-collar (dot). Data are millions of workers, seasonally adjusted. Three-month moving averages. Vertical lines show the recession.

Sources: Haver Analytics; Heinemann Economic Research

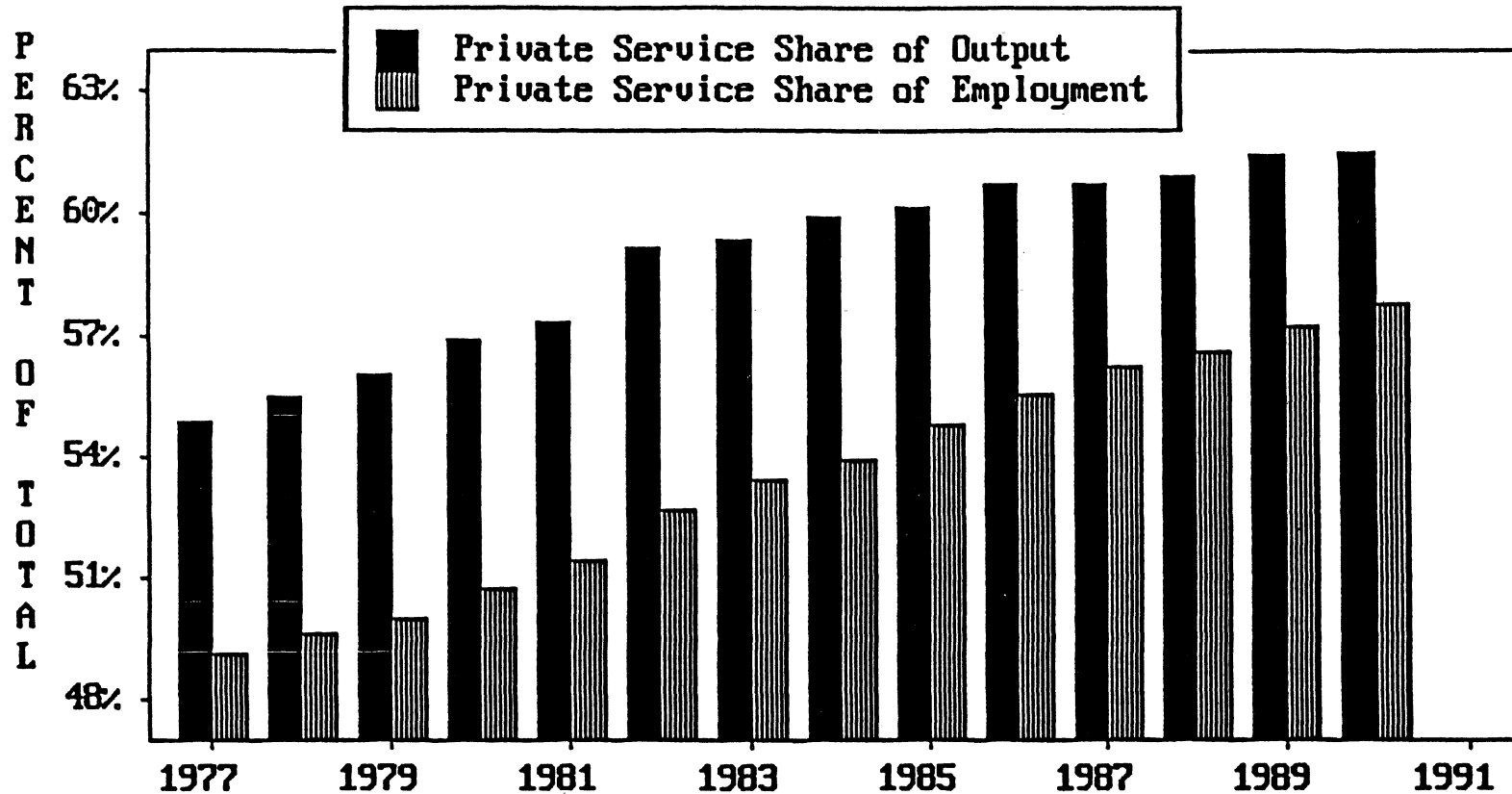
OUTPUT AND EMPLOYMENT IN NONFARM GOODS INDUSTRIES



Notes: The chart shows real output of nonfarm goods industries as a percent of GDP (solid bar) and full-time equivalent goods employment as a percent of the total (shaded bar). Data include manufacturing, mining and construction.

Sources: Haver Analytics; Heinemann Economic Research

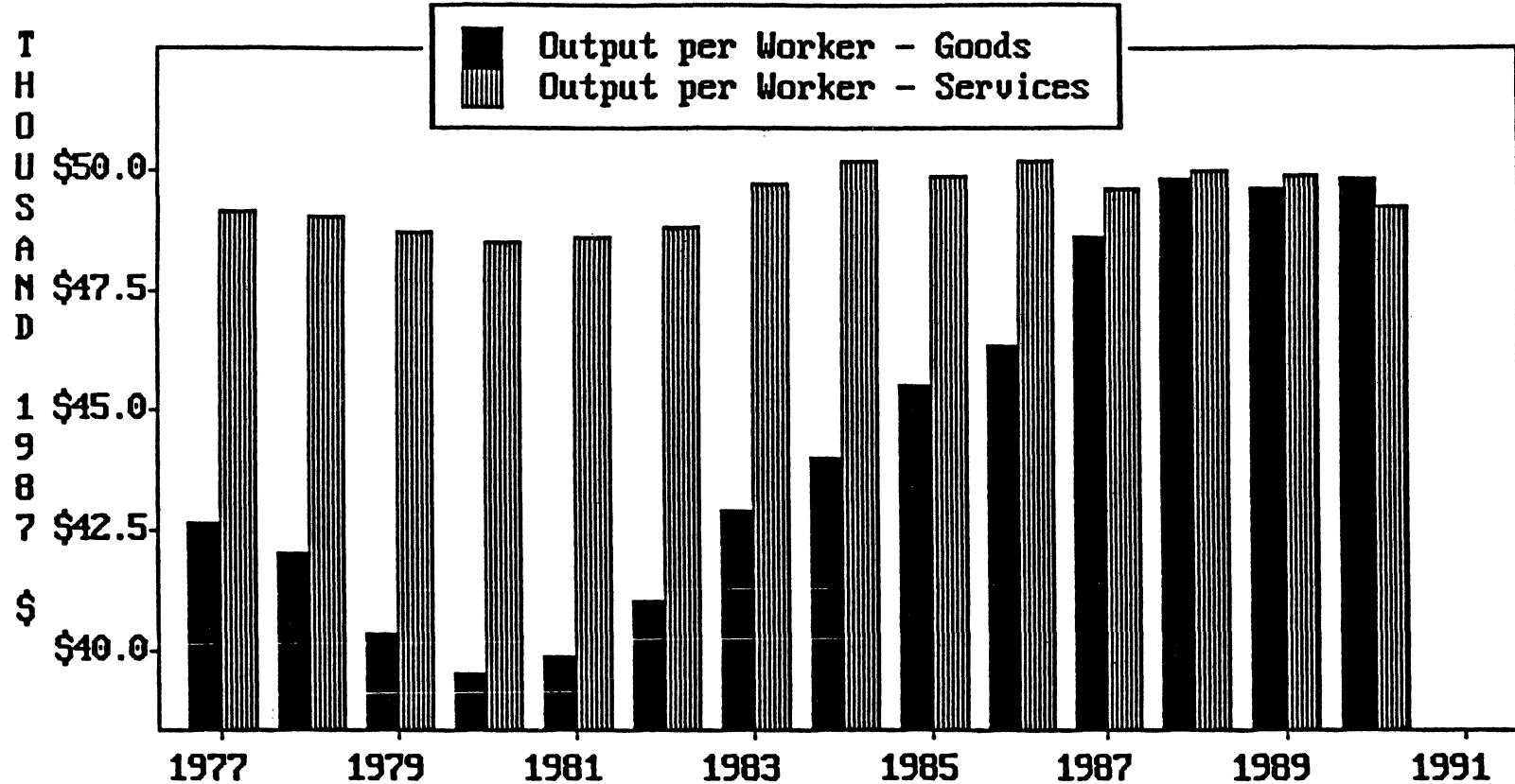
SERVICE EMPLOYMENT IS RISING FASTER THAN OUTPUT



Notes: The chart shows real output of service industries as a percent of GDP (solid bar) and full-time equivalent service employment as a percent of the total (shaded bar). Data include finance, telephone, trade, transport and utilities.

Sources: Haver Analytics; Heinemann Economic Research

REAL OUTPUT PER WORKER IN GOODS AND SERVICES

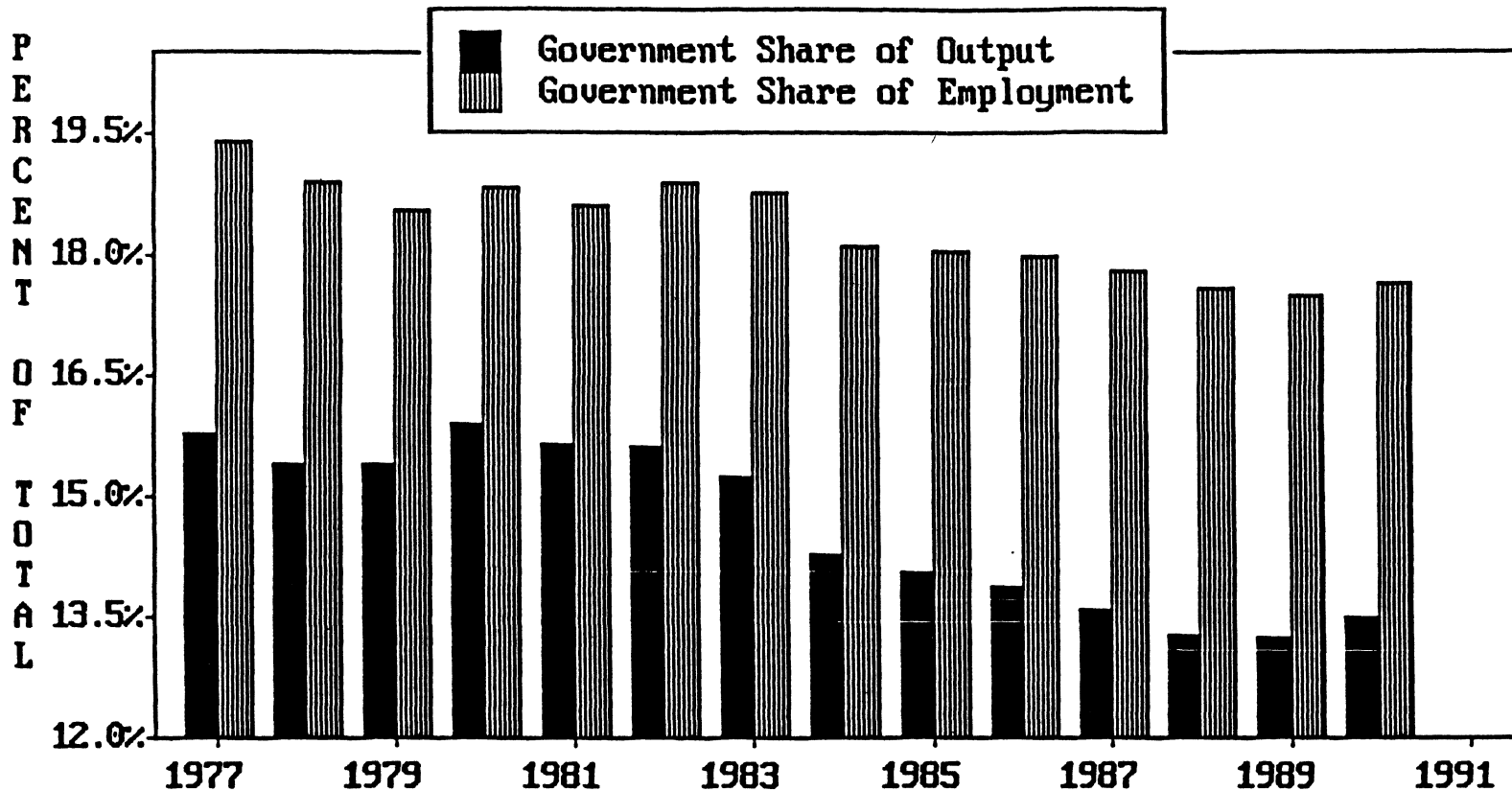


Notes: The chart shows real output of nonfarm goods industries per full-time equivalent worker (solid bar) and real output of private service industries per full-time equivalent worker (shaded bar). Data are thousand 1987 dollars.

Sources: Haver Analytics; Heinemann Economic Research

A WIDENING GAP BETWEEN EMPLOYMENT AND OUTPUT IN GOVERNMENT

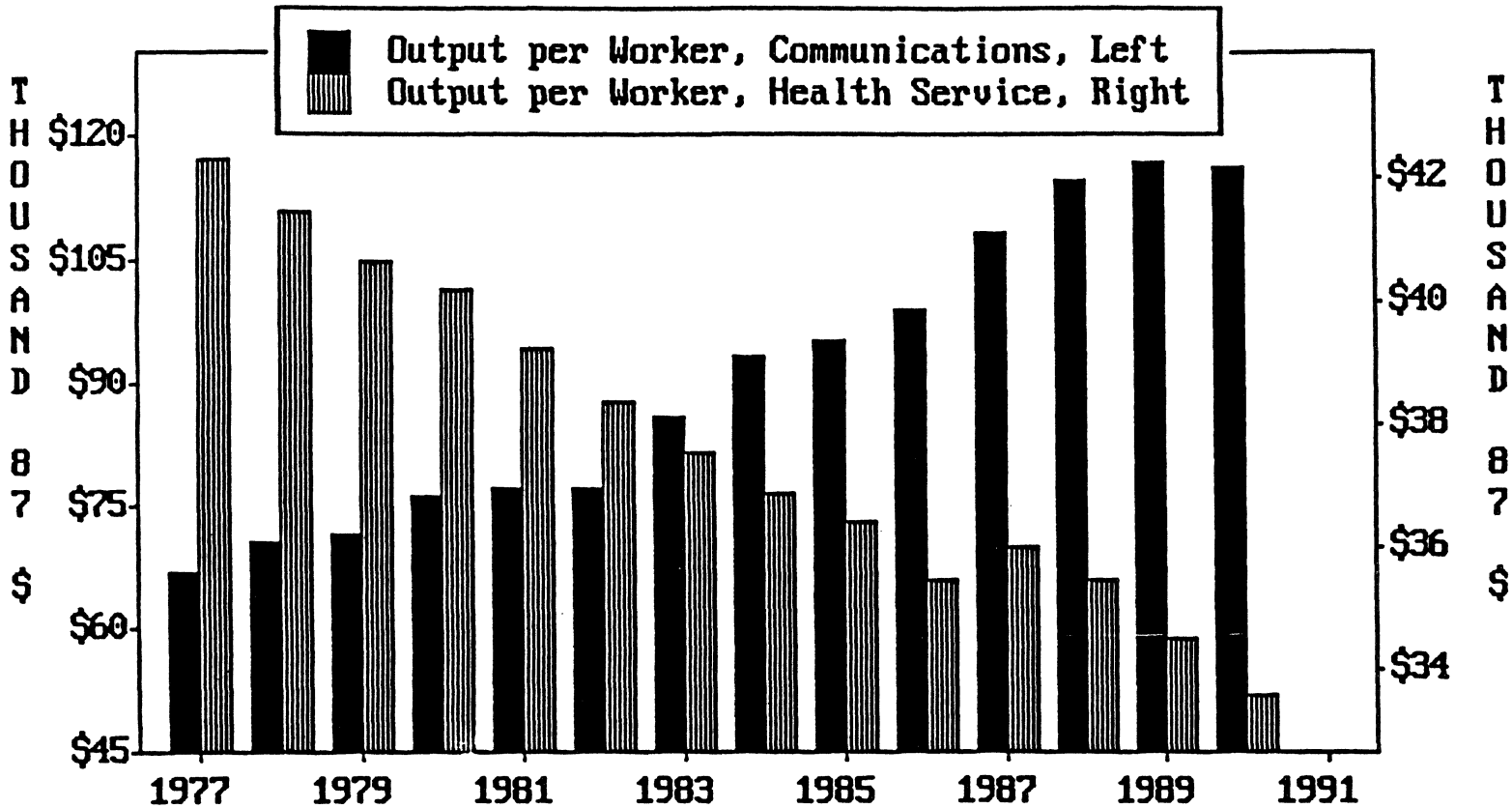
Shadow Open Market Committee



Notes: The chart shows real output of government and government enterprises as a share of GDP (solid bar) and full-time equivalent government employment as a share of the total (shaded bar). The data include the military.

Sources: Haver Analytics; Heinemann Economic Research

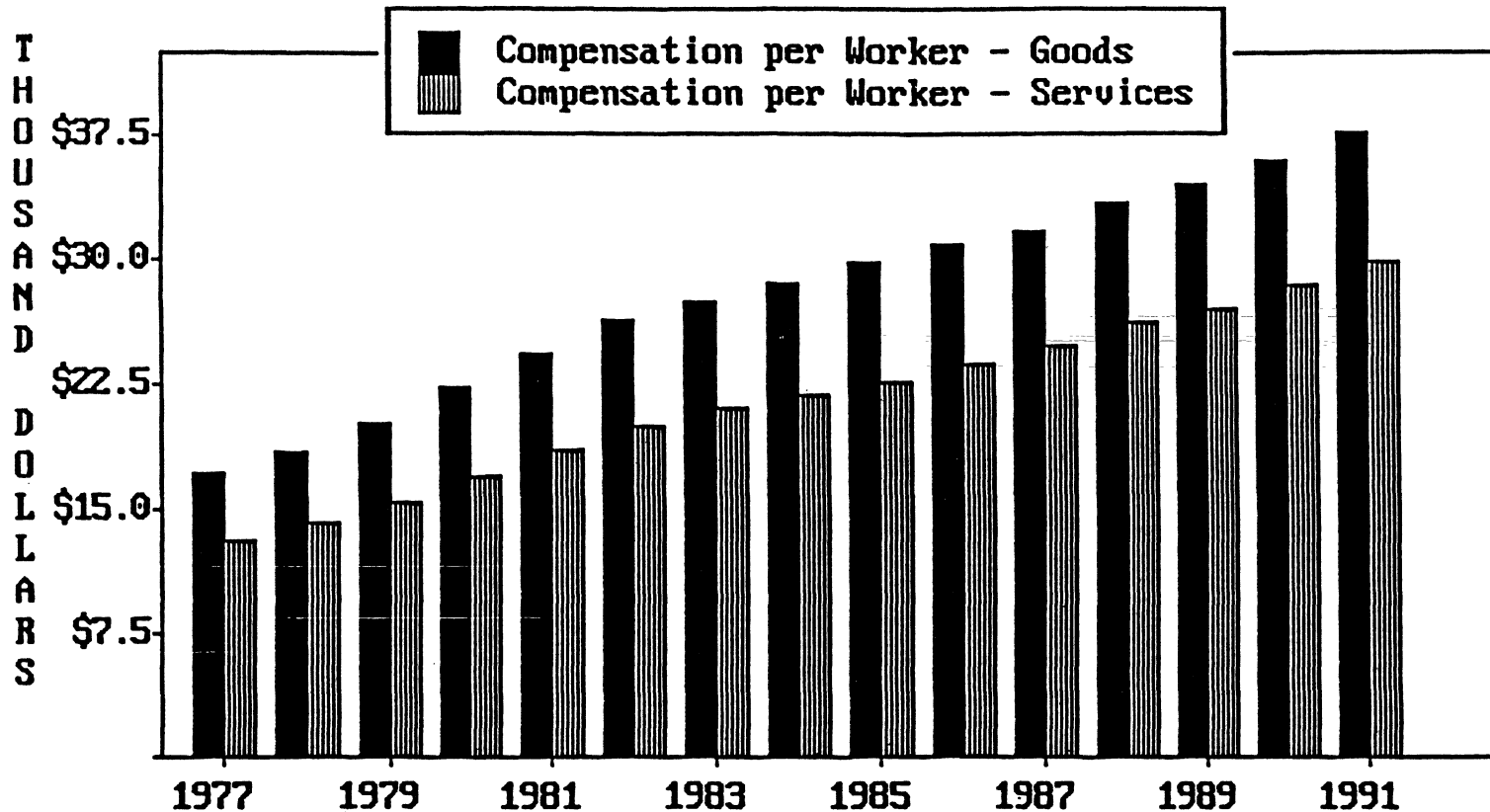
DIVERGENT TRENDS IN SERVICE PRODUCTIVITY



Notes: The chart shows real output per full-time equivalent worker in communications (solid bar, left scale) and health services (shaded bar, right scale). The data are in thousands of 1987 dollars.

Sources: Haver Analytics; Heinemann Economic Research

COMPENSATION PER WORKER IN GOODS AND SERVICES

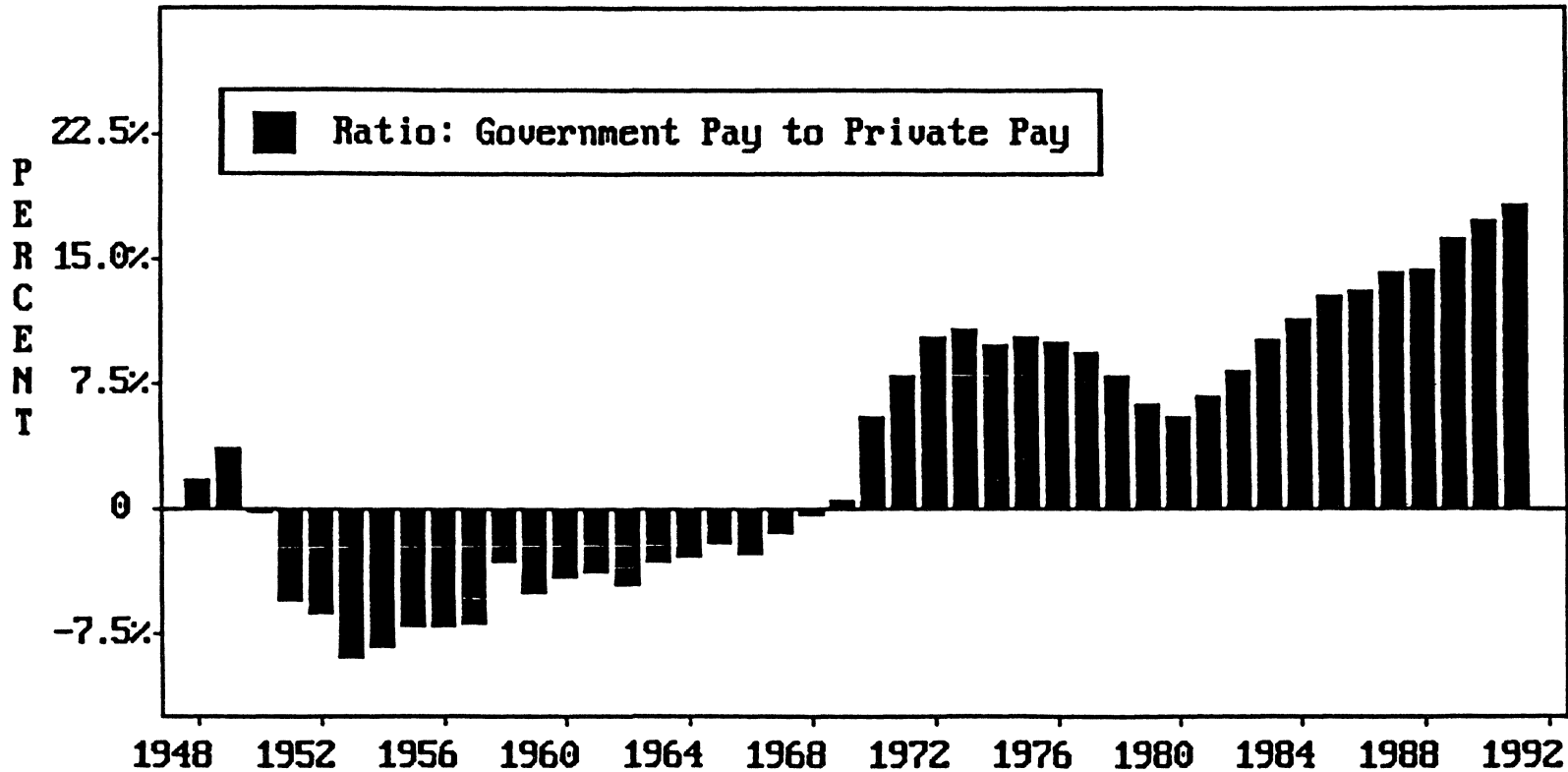


Notes: The chart shows annual compensation per full-time equivalent worker in nonfarm goods industries (solid bar) and in private service industries (shaded bar). Data are thousand current dollars, weighted by industry employment.

Sources: Haver Analytics; Heinemann Economic Research

GOVERNMENT WORKERS GET PREMIUM PAY CHECKS

September 12-13, 1993



Notes: The chart shows the ratio of total compensation per full-time equivalent employee in government to the same figure in the private sector. Data are millions of current dollars and thousands of workers. Ratio minus one in percent.

Sources: Haver Analytics; Heinemann Economic Research

HEINEMANN ECONOMICS PROSPECTS FOR MONEY AND THE ECONOMY

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

Highlights

- Despite suggestions of a stronger economy, business is mired in a bog of taxes, regulation, falling productivity and rising unit labor costs. Indications of higher consumer spending are a mirage. **MIRE DOW N.** [Page 39]
- Yields on long-term Treasury bonds have finally broken through **THE SIX PERCENT BARR IER.** This is not a new era. Investors should be wary of bond peddlers eager to sell paper at progressively higher prices. [Page 41]
- Federal outlays ground to a halt this summer. The drop was tiny, but it was the first cut in annual expenditures since 1956. It won't last. Increased U.S. borrowing is ahead. **THE FEDERAL SPENDING FREEZE.** [Page 43]
- A boom in investment was key to the recovery. A surge in cash flow overcame barriers to business expansion. Even so, profits have fallen as a share of income. The nation must address the **LIMITS TO GROWTH.** [Page 44]

MIRE DOW N

[On Sunday, September 12, members of the Shadow Open Market Committee gathered in Washington. The SOMC is a group of academic and business economists who regularly comment on economic issues. What follows are notes we prepared for the other members of the SOMC.]

Over the past three years, the Federal Reserve System increased total reserves in the U.S. banking system at an average annual rate of more than 13 percent. Rapid growth of bank reserves will contribute little or nothing to sustainable real growth in the American economy. However, by flooding financial markets with high-powered funds (in effect, raw material for the money supply), the central bank has already financed a substantial increase in the market value of financial assets. Further inflation in the prices of goods and services is likely to follow.

Despite superficial suggestions of a stronger economy this summer, business activity remains mired in a deep bog of higher taxes, increased regulatory costs and—more recently—falling productivity and rising unit labor costs. Indications of an increase in consumer spending are mostly a statistical mirage. Much of the increase in consumption last spring was bunched at the end of the quarter. Thus, even if outlays in the third quarter were unchanged from June through September, the quarterly average would be up.

Do not mistake such number games as a sign of genuine strength. Sales of automotive vehicles have been a mainstay of the consumer economy this year. In August, purchases of cars and light trucks fell sharply to their lowest level in six months. We see little likelihood of a material revival.

The key problem, of course, is the slump in productivity and the surge in unit labor costs during the first half of 1993. This pattern developed coincident with the only "normal period of hiring thus far in the current business expansion. As we see it, managers in the private sector have little incentive to add to the head count in their firms. This is particularly true now that "reform" of the health care system and higher minimum wages have moved to the center of the economic policy stage. In a literal sense, no one knows what it will cost to put additional workers on the payroll.

UNCERTAIN LEADERSHIP

According to Professor William C. Dunkelberg of Temple University, the index of small business optimism fell 9.5 points from January through August, and is now at its lowest point since the recession. Professor Dunkelberg compiles the index for the National Federation of Independent Business. He added that "the outlook for economic growth has lost 59 points since January." Only 9 percent of firms expect the economy to improve over the next six months—a 20-year low. Professor Dunkelberg said that "uncertainty over economic leadership and policies is a big part of the problem. Only three percent of respondents said the President was doing a 'good job.' None gave him an 'excellent' rating."

Figure 1 shows how higher taxes have helped to shut down hiring by newly formed businesses. According to the Bureau of Labor Statistics, net new business formation accounted for over 90 percent of the net jobs added in the private sector between March 1981 and March 1992. In the 1980-1982 recession, new businesses added about 1 million new jobs annually.

In the much milder 1990-1991 downturn, the new business hiring rate dropped close to 100,000. It seems logical to expect a further drop in net business hiring in the wake of the much larger tax hike that Mr. Clinton signed into law last month. Lest we forget, Congress raised taxes in the fall of 1990 to "balance the budget."

THE SIX PERCENT BARRIER

Yields on long-term Treasury bonds have finally broken through the magic 6 percent barrier. The last time yields were this low—and bond prices this high—was January 1973, shortly before the Arab oil embargo that helped to trigger a decade of soaring inflation and interest rates.

Wall Street pundits, who create long-term trends about as often as they change their socks, hailed last week's milestone as the harbinger of a new era of falling rates and inflation. Sober examination, however, suggests that investors, no less than economists, should be skeptical of bond sales people eager to peddle paper at progressively higher prices. Here are some reasons why:

First, despite continuous anti-inflation propaganda from the Federal Reserve, the U.S. has had a militant easy money policy for three years. Domestic spending money, a key measure of the Fed's impact on the economy, increased at an average rate of 13.5 percent in the past year, a record. Sustained easy money always leads to higher inflation. Twenty years ago, a surge to 7.8 percent was enough to set the state for soaring prices.

Second, despite claims of a \$500 billion cut in the Federal deficit, the Treasury's demands on the credit markets will go up during the Clinton Administration. Projections by the White House Office of Management and Budget show federal borrowing from the public will average \$237.6 billion annually from fiscal year 1993 through 1996, up from \$233.7 billion from fiscal year 1989 through 1992 (see Figure 2).

Third, an exceptional—but temporary—drop in the federal deficit played a major role in propelling bond prices to a 20-year record. The Commerce Department reported last week that the Treasury's red ink fell to a rate of only \$227.6 billion in the second quarter, roughly \$100 billion below the official deficit forecast at that time. This is the national income accounts deficit, which shows economic impact, not the political accounting that most news accounts feature. (See page 43 for further discussion of this subject.)

During the debate over President Clinton's \$250 billion tax hike, the White House suppressed news about the huge short-run drop in the budget deficit. Mostly, this was to avoid diluting the case for higher taxes. However, the ploy also reflected the fact that White House insiders know these gains were largely due to the first actual freeze in federal outlays in almost 40 years, a freeze the Administration cannot sustain.

The official White House line is that "the stunning drop in long-term interest rates . . . occurred during time the President's deficit-reduction program was developed, announced, debated and enacted . . . There is a widespread consensus that expectations of lower budget deficits drove long-term interest rates down."

At best, this statement is disingenuous. Most important, of course, is the fact that Mr. Clinton's own projections show the federal deficit will rise, not fall, during his Administration. The "\$500 billion budget cut" that the President cites *ad nauseam* is from a hypothetical future baseline budget, not from actual spending. It is a cut from what might have been, not from what was.

VOTE OF CONFIDENCE?

Furthermore, long-term interest rates have been dropping for almost three years, long before Mr. Clinton announced that he was a candidate for the White House. About half the decline in rates occurred before Mr. Clinton took office.

Naturally, Washington views the drop in rates as a vote of confidence from Wall Street. That may be, but it is equally plausible that the financial community expects Mr. Clinton's "program" to shut down the economy. That would further reduce an already weak demand for credit from the private sector.

The Federal Reserve's massive injections of fresh cash into the nation's money markets are the real key to the drop in rates. Easy money breeds inflation, but history shows that investors usually ignore this risk until evidence of rising prices is clearly visible. In the meantime, investors (especially commercial banks) have to put the Fed's freshly-printed money to work. The resulting scramble for earning assets drives bond prices up and rates down. Bankers end up getting hurt in the process. Lemming-like, they repeat the mistake in cycle after cycle.

DOUBLE THE FUN?

The White House claims that the economy will grow 2 percent from the fourth quarter of 1992 to the fourth quarter of 1993. This prediction represents a substantial cut from the 3 percent expansion that Mr. Clinton's advisers expected earlier this year. Even so, it is probably too optimistic.

If you work out the arithmetic, gross domestic production would have to increase at an annual rate of 2.7 during the second half of 1993 in order to reach the 2 percent target for the full year because, in the first half, GDP grew at a rate of only 1.3 percent.

While the year is far from over, incoming economic data do not suggest a doubling of economic growth. Indeed, many key indicators are down. The number of payroll jobs, which rose 1.2 million from December through July, dropped in August. The number of workers rose more than 400,000 last month, but over half these individuals were part-time employees. In longer perspective, the number of workers has increased less rapidly than the number of jobs—a typical symptom of weakness in the labor market.

The gross value of industrial output declined from February through July. Total vehicle sales (passenger cars and light trucks) dropped to an annual rate of 13.2 million in August, down sharply from 13.8 million in July. The August sales rate was the lowest since March. The drop implies that overall retail sales were down last month.

The bottom line is simple. The economy is stagnant. Easy money is setting the foundation for the next round of inflation. In the coming environment of stagflation, interest rates won't stay down very long. If you need to borrow, grab all the cheap fixed-rate money you can get.

THE FEDERAL SPENDING FREEZE

In June and July, the vast, ponderous machinery of federal spending ground to a halt for the first time in almost 40 years. Treasury Department data show that federal outlays totaled \$1.395 trillion in the 12 months ended July, down \$6.2 billion from the \$1.401 trillion total in the 12 months ended July 1992. There was a similar, but smaller, drop in the year ended June (see Figure 3).

Tiny as they were, these were the first year-to-year declines in Washington's annual outlays since 1956, when the nation was disarming after the Korean War. By contrast, outlays in the 12 months ended December 1992 were \$101.1 billion higher than a year earlier. The 1993 spending freeze has been largely unnoticed in Wall Street because federal budget results are so erratic. Few analysts take the trouble to calculate 12-month running total which spotlight underlying trends.

Federal revenues, meanwhile, increased \$56 billion in the year ended July 1993, reflecting the modest recovery in the economy. As a result, the federal deficit totaled \$259 billion in the last 12 months, down sharply from the \$327 billion shortfall in the year ended last December. This result is \$22 billion below the Clinton Administration's latest forecast for fiscal year 1993, which ends this month. Naturally, there was a corresponding drop in federal borrowing.

There is good news and bad news in these developments. The good news is that spending curbs initiated by President Bush have finally taken hold. The bad news is that Mr. Clinton allowed the Bush program to go out of control, thus provoking the halt in federal spending. A continuing freeze in outlays, coupled with the huge tax increase that Mr. Clinton just signed into law, would produce a big drag on the economy.

INADVERTENT ERROR

Indications are that the federal spending freeze in the last 12 months was (a) inadvertent or (b) a mistake or (c) a combination of the two. Whatever the origin of the freeze, we expect Democrat Congressional leaders to revert to form and thaw the federal spending process during the coming fall and winter. At the same time, a sluggish economy should offset much of the revenue that higher tax rates are supposed to generate.

The result could be a surge in the federal deficit and in Treasury borrowing. The official deficit forecast for fiscal 1994 is now \$259 billion, unchanged from the reading for the 12 months ended July 1993. In our view, the Treasury is unlikely to achieve that target. A significant increase in the Treasury's preemptive demand for credit is not part of the current consensus forecast for progressively lower rates. If federal borrowing requirements do increase, they would collide with private credit demand, which has also started to revive.

LIMITS TO GROWTH

As we predicted more than two years ago, a cyclical boom in business investment has played a key role in the recovery of the economy. A surge in corporate cash flow overcame some of the formidable barriers to business expansion.

The White House and Congress have created numerous blocks to new business formation. These include sharply higher marginal tax rates on the individuals most likely to form new enterprises and sharp increases in implicit corporate taxes in the form of mandated outlays for health, safety and the environment. One result has been a long-term drop in profits as a share of national income (see Figure 4). Consequently, a new business starts have dried up and net business investment is still close to its postwar low.

The nation must address these limits to long-term growth. Federal health, safety and environmental regulation is "absurdly inefficient," as Robert Crandall of the Brookings Institution has charged. Populist groups routinely use environmental policy as a device to cap economic expansion. It seems clear that part of the implicit tax burden from unfunded Federal mandates falls on the business sector. The drop in profitability to levels far below the norm of the last half century is not surprising. The decline in profitability has undercut the incentive for business investment. By taxing investment rather than consumption to fund health, safety and environmental regulation, the nation has burdened its economy. The threat of stagnation will remain until these investment disincentives are repealed.

WARNING FROM THE SHADOWS

In a draft of the statement that the Shadow Open Market Committee plans to issue today, Allan Meltzer of Carnegie Mellon University warned that the Clinton Administration's "fiscal policy is a triumph of the politics of redistribution over rational economic policy. The architects of this policy have not learned that just as you cannot penalize luxury boat buyers without hurting luxury boat builders, you cannot tax the 'rich' without reducing economic activity."

Professor Meltzer, who is the chair of the SOMC, noted that "high marginal tax rates reduce the taxed activity . . . Conventional analysis estimates the loss at one-half of one percent of GDP in the first year, or approximately \$30 billion. Market data," he continued, "appear to be more pessimistic. The rapid decline in interest rates and the modest increase in stock prices imply that expected corporate earnings will decline substantially." Professor Meltzer's calculations show the drop will be "at least" 10 to 12 percent. Investors, take note.

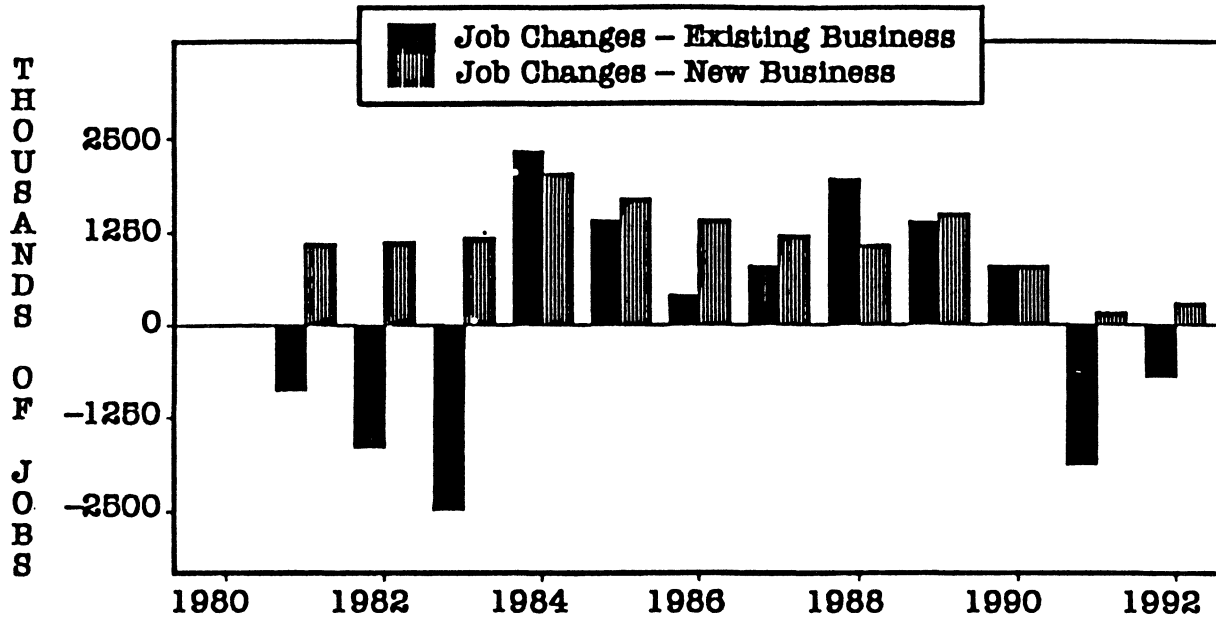
WEEKLY MONETARY DATA
(Billions of dollars, except as noted)

	Latest Week	Change from Previous week	--Rates of Change Over--			Week Ended
			3 Months	6 Months	12 Months	
MONEY SUPPLY						
M-1 (Cash, Demand and other Checkable Deposits)	\$1,097.9	\$1.7	10.6%	12.4%	12.2%	30-Aug-93
M-2 (M-1 Plus RPs, Euros, MMMFs, MMDAs, Consumer Time A/Cs)	3523.3	-5.3	2.3	2.9	1.4	30-Aug-93
M-3 (M-2 Plus Large time A/Cs, Term RPs and Euros)	4172.6	1.9	-0.3	1.7	-0.3	30-Aug-93
Domestic M-1	503.3	0.5	11.4	15.2	13.1	30-Aug-93
FRB RESERVE AGGREGATES						
Monetary Base	376.462	3.180	10.1	10.9	11.1	01-Sep-93
Total Reserves	58.344	0.570	5.9	11.8	15.1	01-Sep-93
Nonborrowed Reserves	58.039	0.696	4.0	10.6	14.9	01-Sep-93
Borrowing, ex. Extended Credit (NSA) (millions of dollars)	0.305	-0.126	NM	NM	NM	01-Sep-93
ST. LOUIS RESERVE AGGREGATES						
Adjusted Monetary Base	413.4	-0.1	9.6	8.8	11.1	01-Sep-93
Adjusted Fed Credit	383.7	0.4	11.2	10.1	13.0	01-Sep-93
Total Commercial Paper	545.283	1.671	2.3	2.0	-0.7	01-Sep-93
C&I Loans - All Large Banks	272.709	1.121	-1.4	-2.7	-2.7	01-Sep-93

Notes: Data, except as noted, are seasonally adjusted. NM - Not meaningful. NA - Not available.
Domestic M-1 is an estimate of holdings of American currency in the U.S. plus demand deposits.
Rates of change are compound annual rates based on four-week moving averages.

Figure 1

JOB CREATION BY NEW BUSINESS FADED AFTER 1990



Notes: The chart shows annual net changes in private nonfarm payroll jobs accounted for by existing business (solid bar) and new business (shaded bar). Thousands of jobs, years ended March. Based on BLS "required bias adjustment" data.

Sources: Haver Analytics; Heinemann Economic Research

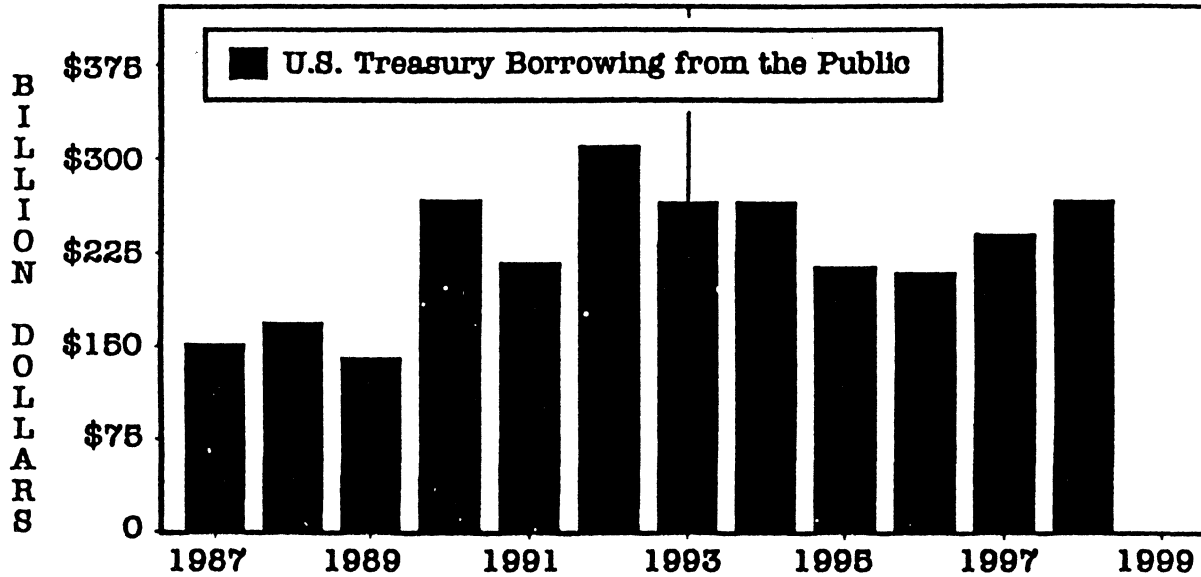
WEEKLY ECONOMIC DATA

		Latest Week	Change from Previous Week	----Rates of Change Over----			Week Ended
		190.7	0.9	3 Months	6 Months	12 Months	28-Aug-93
BUSINESS WEEK PRODUCTION INDEX*							
OUTPUT, Production:							
Autos (Units)	P	102308	6310	-84.7	-41.6	-4.1	04-Sep-93
Trucks (Units)	P	99092	105	62.5	7.7	13.0	04-Sep-93
Paper (Thousands of tons)	P	812.6	0.8	26.9	11.0	6.0	28-Aug-93
Paperboard (Thousands of tons)	P	826.5	8.6	5.6	-1.4	3.1	28-Aug-93
Raw Steel (Thsds of short tons)	P	1914	-40	40.8	26.7	12.1	04-Sep-93
Bitum. Coal (Thsds of short tons)	P	17932	251	-19.1	-12.4	-8.4	28-Aug-93
Crude Oil (Thousands of bbls)	P	13448	-81	-4.7	1.1	3.0	04-Sep-93
Electricity (Millions of kwh)	P	64366	-1075	54.4	11.1	6.8	04-Sep-93
Rotary Rigs (US units operating)	P	819	-3	62.3	45.1	20.0	10-Sep-93
TRANSPORTATION							
Class I Railroad Freight Traffic (Billions of ton-miles)	P	21.1	0.3	-14.1	-2.7	-3.0	28-Aug-93
SALES							
Total Vehicle Sales (Million Units, 10 Days SAAR)	P	13.82	-0.18	-23.50	8.54	6.50	31-Aug-93
PRICES							
Spot Index All Commodities 1967=100		236.65	0.55	3.7	-2.1	-3.5	07-Sep-93
Raw Industrials		254.73	-0.11	-4.1	-10.2	-9.7	07-Sep-93
Foodstuffs		212.60	1.31	16.0	11.1	6.2	07-Sep-93
Domestic Spot Mkt Crude Oil Price		17.00	-0.95	-33.6	-23.7	-17.7	09-Sep-93
Trade-weighted Value of the US Dollar (March 1973=100)	P	92.40	-1.35	15.3	-0.2	17.3	08-Sep-93
Common Stock Prices S&P 500		457.50	-3.90	8.1	7.0	10.0	09-Sep-93
EMPLOYMENT							
Initial Unemployment Claims (Thsds)		316	-10	-19.4	-15.7	-17.0	04-Sep-93
Claimant Level (Thousands)		2774	-44	3.8	12.1	-12.3	28-Aug-93

Notes: *Copyright, McGraw-Hill, Inc. Used with permission. Data, except prices, seasonally adjusted. P - Preliminary. Changes are compound annual rates based on four-week averages, except vehicles, which are based on three periods.

Figure 2

TREASURY BORROWING WILL REMAIN HIGH THROUGH 1998

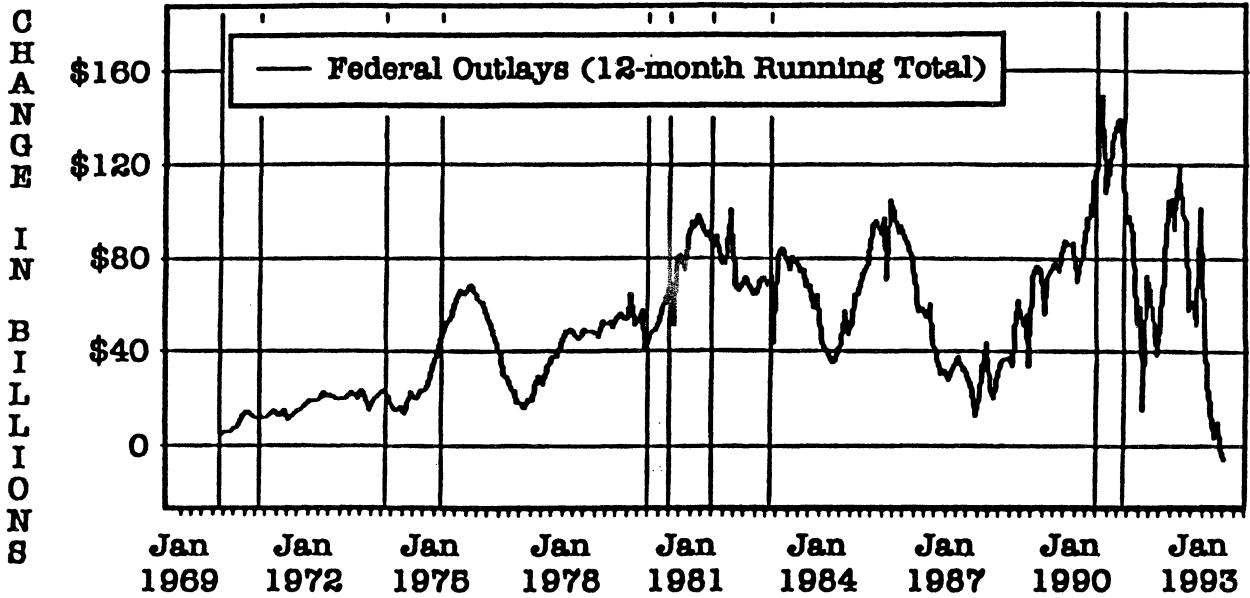


Notes: The chart shows total borrowing from the public by the United States Treasury. Actual data from 1987 through 1992. Clinton Administration projections, 1993-1998. Data are for fiscal years ending September. Current dollars.

Sources: Haver Analytics; Heinemann Economic Research

Figure 3

GROWTH IN FEDERAL SPENDING SUDDENLY STOPPED IN 1993

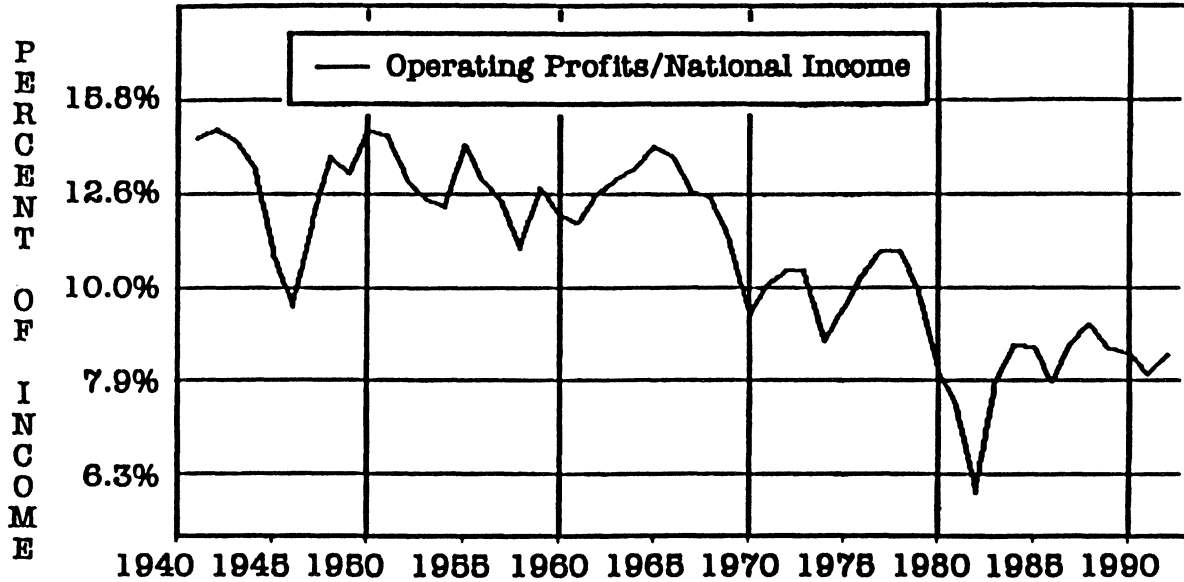


Notes: The chart shows year-over-year changes in a 12-month running total of aggregate federal expenditures. The data are in billions of current dollars. The vertical lines show periods of recession in the economy.

Sources: Haver Analytics; Heinemann Economic Research

Figure 4

THE LONG-TERM EROSION IN THE PROFIT SHARE OF INCOME



Notes: The chart shows aggregate pretax profits from current operations as a percent of national income. Underlying data are in billions of current dollars, IVA-CCA adjusted. Annual averages. The vertical scale is logarithmic.

Sources: Haver Analytics; Heinemann Economic Research

September 12-13, 1993

ECONOMIC AND FINANCIAL UPDATE

Mickey D. LEVY
NationsBank

Actual economic performance exceeds perceptions of economic conditions. The recent benchmark revisions reveal that the recession was shallower than first estimated and the pace of recovery stronger. Following a weak first quarter 1993, growth is picking up. Even with the modest negative impact of the budget package, a real GDP is projected to expand at its historical average rate through 1994.

The measured pace of economic expansion has been associated with a gradual decline in inflation. While inflation is projected to remain muted on the near term, continued low inflation is a necessary condition for sustained economic expansion. To date, the rapid monetary growth provided by the Federal Reserve has generated significant appreciation of financial asset prices (i.e., bonds and stocks), but not goods price inflation. Certain adjustments and atypical characteristics in the economy has constrained nominal spending growth that fuels inflation. But continued monetary stimulation and an emerging asset price bubble is not a stable or sustainable situation. The Fed must slow reserve growth to avoid an undesired outcome.

IMPROVING ECONOMIC CONDITIONS

The recovery and subsequent expansion from the shallow recession, which at times has sputtered, is accelerating. According to benchmark revisions, real GDP grew 1.2 percent in 1991, declined 0.7 percent in 1992, recovered 2.8 percent in 1992, and expanded at a 1.3 percent pace in the first half of 1993. Real growth is projected to be approximately 3 percent in the second half of this year and continue to expand 2.5 to 3.0 percent in 1994.

The mildness of the recession does not capture the full flavor of the adjustment processes and structural shifts that have characterized economic performance in recent years, including its unevenness in different regions and industries. Some industries continue to adjust and constrain economic growth.

Defense cutbacks and military base closings are forcing private defense contractors to restructure, generating weakness in certain regions. Contraction of the defence industry which slowed GDP growth by over 1 percent in the first half of 1993, has been a significant factor underlying the continued decline in manufacturing employment.

Nonresidential construction rose modestly (3.4 percent annualized) in the first half of 1993 following sharp declines of 10.8 percent in 1991 and 6.0 percent in 1992. However, office and industrial vacancy rates remain too high to permit any substantial growth in nonresidential construction.

The net export sector, which was a major source of economic growth from 1986 to 1991 and provided an important buffer against the falling domestic demand during the recession, has been subtracting from domestic output since early 1992. While export growth has slowed, import growth has accelerated, widening the trade deficit. The slowdown in export growth—to 3.2 percent in the first half of 1993 from a 7.0 percent average in the previous 3 years—has reflected the impact of recessionary conditions throughout much of the industrialized world. Export growth to developing nations remains strong. Import surged 12.3 percent in the first half of 1993, a sharp acceleration following a 8.7 percent rise in 1992 and the 0.5 percent decline in 1991. The largest source of this rapid increase is imports of capital goods excluding autos, suggesting that a sizable portion of the rise is production-oriented.

Healthy growth in business investment, housing activity, and consumption have more than offset these weaknesses. Business investment in producer durable goods rose at a dramatic 18.7 percent annual pace in the first half of 1993, following robust gains in 1992. Investment in information processing equipment has been the driving force behind this increase, as businesses continue to seek productivity-enhancing changes in their production processes, and take advantage of strong corporate balance sheets and very low costs of capital.

Residential investment, which has generated firm gains during the recovery, declined modestly in second quarter following 9.4 percent growth in the previous year. While housing activity has benefited from lower mortgage rates, it has been constrained by the changing demographic trend of lower new family formation, uncertainty about future real estate values, and generally weak consumer confidence.

Real personal consumption expenditures have grown 3.3 percent in the last year, despite surveys suggesting weak consumer confidence. This has involved particularly strong demand for motor vehicles and other durable goods. The 0.4 percent monthly rise in real consumption in July points to consumer spending exceeding 3 percent in the third quarter.

Thus, while there remains a wide variance of performance by sector, annualized growth in real final sales has exceeded 3 percent in three of the last four quarters. Its modest decline in first quarter 1993 reflected largely the robust 5.8 percent growth in fourth quarter 1992 and the negative impact of the March storm. So far this year, wide quarter-to-quarter swings in inventory accumulation have partially offset swings in final sales and smoothed real GDP growth.

Following a year and one-half of rapid productivity gains but very sluggish new job creation, employment growth has picked up so far in 1993, rising at a 1.5 percent annual pace. Manufacturing employment has continued to decline, as selected manufacturing firms continue to restructure and defense-related manufacturers consolidate. At the same time, however, average hours worked per week in manufacturing remains in an upward trend, and manufacturing output continues to expand.

The rise in total hours worked exceeded the growth in economic output in the first half of this year, labor productivity fell. This is a typical cyclical pattern, and does not signal a new trend. Since 1991, the combination of productivity gains and significant slowdown in wage increases has generated a substantial reduction in unit labor cost increases. This has contributed to lower core inflation and wider profit margins. The resulting rise in corporate profits and cash flows have fueled business investment and improved balance sheets.

Decelerating inflation is a very favorable outcome of the measured pace of economic expansion. CPI inflation has receded to 2.8 percent year-over-year, and it has been virtually flat in the last three months. Excluding the more volatile food and energy components, the yearly rise in the CPI has been 3.2 percent. The PPI has risen 1.2 percent, 1.5 percent excluding food and energy, while increases in the implicit GDP deflator have hovered near 2.5 percent for a year. The relatively slow growth in product demand—nominal GDP has grown 5.2 percent in the last year and at a 4.2 percent rate in the first half of 1993—provides insufficient support for a widespread acceleration in product prices.

INTEREST RATE AND CAPITAL MARKET CONDITIONS

Interest rates have fallen and the yield curve flattened in response to lower inflationary expectations and modest economic growth and weak credit demands. In particular, *ex ante* real rates have fallen as the higher taxes reduce expected rates of return on investment. The lower rates have fueled the stock market rally; however, measured from either the announcement of the budget package or its passage, stock prices have risen less than the percentage decline in interest rates. This suggests a downward revision of expected corporate earnings. While price/earnings ratios have risen to high levels, valuations presently are not above a range consistent with the level of interest rates and the growth of profits.

The lower costs of capital in the debt or equity markets and significant increases in corporate cash flows have generated substantial increase in new equity issuance, reduced the market value of outstanding debt, and lowered debt/equity ratios. The rise in internal funds and lower cost of capital from alternative external sources underlies continued declines in bank commercial and industrial loans.

ECONOMIC OUTLOOK

Most of the factors are in place to generate a pickup in economic growth in the second half of 1993 and 1994, with a general continuation of recent industry and regional trends. Inflation is not an immediate threat and U.S. production costs are at or below other industrialized nations. Monetary policy remains stimulative as measured by the continued double-digit growth in bank reserves and M1, and low interest rates. The banking system is fully repaired and is awash with liquidity. Business inventories have been growing slower than GDP and the inventory/sales ratio remains low. Employment continues to grow at a modest pace, fueling sufficient growth in disposable income to support healthy consumption growth.

The budget package is subtracting fractionally from economic growth. The sizable reduction in disposable income due to higher taxes will have a larger impact on private saving than on consumption. In FY 1994-1995, \$51.5 billion or 68 percent of the projected \$74.3 billion tax increase will be assessed on higher income taxpayers (through higher marginal rates and repeal of the HI taxable wage base). A sizable portion of the higher individual tax rates will actually be assessed on small businesses that file as subchapter-S corporations. This will dampen employment growth

among small businesses which have been the largest source of the nation's job gains since the late 1970s. Additional tax increases of \$13.5 billion assessed on fuels and social security benefits will have a larger direct impact on consumption.

The recent interest rate declines cushion the economy against the reduction in disposable income, but it should not be a surprise that they have not stimulated faster economic growth. Interest rates have fallen largely as a reflection of lower inflationary expectations, actual economic weakness and the perception that the budget package will dampen economic growth. The decline in nominal rates due to lower inflation expectations improves economic efficiency, but does not stimulate aggregate demand. Insofar as *ex ante* real rates have fallen in response to lower expected returns on investment and weakened economic and credit conditions, their fall is simply a price adjustment that does not stimulate aggregate demand.

Nominal GDP is estimated to grow approximately 5.5 to 6.0 percent, with roughly 2.5 to 3.0 percent real growth and 3 percent inflation. This would be accompanied by approximately 1.5 percent employment growth and a gradual reduction in the unemployment rate toward 6 percent by year-end 1994.

WHY FINANCIAL ASSET PRICE APPRECIATION AND NOT GOODS PRICE INFLATION?

The Federal Reserve has stated clearly its belief that low inflation is a necessary condition for sustained healthy economic expansion, yet it continues to allow bank reserves and the narrow monetary aggregates grow at rapid rates that in the past have generated accelerating inflation. To date, however, the persistently expansive monetary policy has generated only financial asset price appreciation and not goods price inflation. A pressing issue in the conduct of monetary policy and of more than casual interest to financial market participants is the following: why has this financial asset price bubble emerged, under what conditions will it persist, and what would change the situation and with what implications?

Bank reserves have grown at a 12.5 percent average rate in the last two years, while M1 has grown 12 percent. The federal funds rate, at its lowest rate since the 1960s has been close to zero in inflation-adjusted terms for approximately one year. Only the slow 1.4 percent M2 growth does not point to stimulative monetary policy. But this reflects the sharp drop in small time deposits, as depositors seek higher yielding financial assets, a trend well documented by the Fed.

The stimulative monetary policy has not exerted inflationary pressures because of the failure of nominal GDP to respond, generating a significant decline in M1 and monetary base velocity. In fact, nominal GDP actually decelerated to 4.2 percent in the first half of 1993. This has contributed to lower, not higher inflation pressures.

This nonaccelerating pattern of nominal GDP reflects many of the atypical adjustments that continue to characterize this cycle: the defense downsizing, the sluggishness of housing activity despite the sharply lower mortgage rates, and lower inflation expectations despite the rapid money growth. In addition, uncertainty about ongoing private sector adjustments and possible future government policy changes has dampened general business conditions.

The rapid reserve growth consequently has fueled the demand for financial assets, bidding up their prices. Banks, lacking loan demand but increasingly flush with liquidity, buy fixed income assets that provide wide spreads over their marginal funding costs. Depositors do not renew low yielding CDs, instead favoring stock and bond funds that offer higher expected rates of return (but presumably more risk). An additional boost is provided to U.S. treasury securities as portfolio managers seek to hedge rapid prepayments on their mortgage-backed securities. The large interest rate declines have driven up stock prices to historical highs.

This emerging financial asset price bubble will persist until there is:

- an acceleration in nominal GDP growth,
- a shift in economic policy, either monetary or fiscal, and/or
- a change in market expectations that induces a portfolio adjustment.

The eventual adjustment may be smooth or jarring, depending on how long the Fed fuels financial asset price increases, how high they go, and what precipitates the adjustment.

The increased liquidity provided to financial markets will not disappear: It will remain until nominal spending accelerates or it is drained. Accelerating nominal growth would raise interest rates and loan demand, eventually leading banks to sell fixed income assets. The Fed may initiate the adjustment process by raising short rates and slowing the growth of reserves. A shift to fiscal stimulus would accelerate aggregate demand, whereas another round of contractionary fiscal policy would generate more asset price adjustments, depending on the mix of tax and spending changes. A portfolio adjustment may unfold without any change in policy or acceleration in nominal growth. Such an adjustment may stem from an upward shift in inflationary expectations or a general response to perceived high market valuations.

The factors that have been inhibiting an acceleration of nominal GDP growth, including higher taxes, eventually will be offset by the significant downward adjustment of interest rates and monetary expansiveness. However, the length of adjustment is uncertain. Additionally, with the high degree of financial liquidity, bank loan demand may be slow to turn, extending the adjustment.

The Fed should begin to slow reserve growth. Allowing continued rapid monetary expansion while waiting for an acceleration in nominal GDP growth may fuel more asset price appreciation that could become excessive. This may lead to undesired long-run outcomes. It should be dissipated before it gets out of control.

Excessive asset price bubbles tend to have nasty endings. Several extreme episodes illustrate the difficulties of adjusting. The Bank of Japan played a crucial role in the recent extreme Japanese price bubble, which included real estate values as well as financial assets. It fueled the bubble with persistently stimulative monetary policy, and then choked it off through excessive tightening. The degree of the speculative bubble, the extent of the collapse and the subsequent recession are clear symptoms of "too much too late" monetary policy. United States monetary policy inadvertently played a roughly analogous role in the late 1920s and Great Depression. In the mid 1960s, low interest rates and very high P/Es dissolved in a somewhat more orderly fashion in response to a shift toward strict monetary tightening (the so-called mini "credit crunch" of 1967) and two consecutive contractionary fiscal policy actions—the elimination of the Investment Tax Credit and the imposition of a surtax on personal income taxes.

The U.S. is nowhere close to the first two extremes. In fact, ongoing private sector adjustments have improved economic fundamentals. Yet the Fed must guard against complacency, even if real growth and inflation are within desired ranges. It must recognize the limitations of monetary demand management, the price signals provided by the market, and the limitations of using the funds rate as a policy target. Despite the complexity caused by the loosened link between M2 and nominal GDP, the narrow monetary aggregates are superior policy guidelines than the level of the funds rate. Pegging the funds rate at 3 percent is not a "neutral" monetary stance. The growth of bank reserves should be slowed.

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ECONOMIC AND FINANCIAL PERSPECTIVES

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NATIONS BANK

SHADOW OPEN MARKET COMMITTEE

SEPTEMBER 12, 1993

S N A P S H O T												
QUARTERLY DATA	Levels				Quarterly % Change (annualized)				Yr-to-Yr % Change			
	1992		1993		1992		1993		1992		1993	
	III	IV	I	II	III	IV	I	II	III	IV	I	II
Nominal GDP	6059.5	6194.4	6261.6	6325.7	4.8	9.2	4.4	4.2	5.2	6.7	6.0	5.8
GDP	4998.2	5068.3	5078.2	5101.0	3.4	5.7	0.8	1.8	2.6	3.9	3.2	2.9
GNP	5006.4	5068.4	5080.7	5101.3	3.6	5.0	1.0	1.6	2.6	3.6	2.9	2.8
Domestic Demand	5040.7	5107.1	5138.1	5174.1	3.8	5.4	2.5	2.8	2.9	4.3	4.1	3.6
Final Sales	4988.6	5059.6	5048.9	5087.1	3.7	5.8	-0.8	3.1	2.4	3.8	2.5	2.9
Consumption	3350.9	3397.2	3403.8	3430.8	4.2	5.6	0.8	3.2	2.8	4.0	3.1	3.4
Residential Investment	196.2	210.6	211.4	206.8	1.2	32.8	1.5	-8.4	14.7	17.6	13.5	5.7
Business Investment	533.8	543.7	562.3	581.5	3.8	7.6	14.4	14.4	4.1	7.4	10.1	10.0
Inventory Investment	9.6	8.7	29.3	13.9	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Government Spending	950.2	946.9	931.3	941.1	4.1	-1.4	-6.4	4.3	0.3	1.1	-1.3	0.0
Exports	579.3	591.6	588.0	595.0	6.5	8.8	-2.4	4.8	5.9	4.9	3.0	4.3
Imports	621.8	630.3	647.9	668.1	9.2	5.6	11.6	13.1	8.7	8.5	10.5	9.8
GDP Deflator	121.2	122.2	123.3	124.0	1.0	3.3	3.6	2.3	2.5	2.8	2.8	2.6
Employment Costs (Private)	114.7	115.7	116.9	117.9	3.2	3.5	4.2	3.5	3.4	3.4	3.5	3.6
Unit Labor Costs (Non-Farm)	135.2	135.4	137.0	138.4	0.8	0.6	4.8	4.2	0.8	0.5	1.6	2.5
Productivity (Non-Farm)	112.0	112.9	112.4	111.7	2.9	3.3	-1.8	-2.5	2.7	2.9	1.4	0.4
Compensation (Non-Farm)	151.4	152.9	154.0	154.6	3.5	3.9	3.0	1.6	3.3	3.5	3.0	3.0
Corporate Profits A/T	(a) 227.8	254.9	258.9	264.3	-11.2	11.9	1.6	2.1	-0.7	6.2	0.6	3.0
Operating Profits A/T	(a) 237.4	284.5	271.2	275.9	-8.2	19.8	-4.7	1.7	4.8	15.9	3.2	6.6
Net Cash Flow	(a) 500.3	513.2	518.7	525.6	-3.4	2.6	1.1	1.3	4.1	3.4	0.2	1.5
Current Account	(c) -17.8	-23.7	-22.2	NA	1.9	-23.6	5.8	NA	-23.7	-64.2	-62.3	NA
MONTHLY DATA	Levels				Monthly % Change				12 Month % Change			
	1993		1993		1993		1993		1993		1993	
	Apr	May	Jun	Jul	Apr	May	Jun	Jul	Apr	May	Jun	Jul
Purchasing Managers Index	49.7	51.1	48.3	49.5	-6.9	2.8	-5.5	2.5	-4.8	-8.3	-7.6	-6.8
Non-Farm Payrolls	(b) 109.820	110.058	110.102	110.264	255	238	44	162	1.4	1.5	1.5	1.5
Manufacturing Payrolls	(b) 17.863	17.827	17.772	17.759	-72	-36	-55	-13	-1.4	-1.6	-1.7	-1.7
Unemployment Rate	(c) 7.0	6.9	7.0	6.8	0.05	-0.10	0.04	-0.11	-0.27	-0.53	-0.74	-0.71
Average Workweek (sa)	34.4	34.7	34.4	34.5	0.8	0.9	-0.9	0.3	0.3	0.6	0.3	0.6
Avg. Hourly Earnings (sa)	10.77	10.82	10.80	10.82	-0.1	0.5	-0.2	0.2	2.5	2.7	2.3	2.4
Total Unit Auto Sales	9.0	9.1	8.8	8.6	7.3	0.6	-2.4	-2.2	8.5	7.9	1.8	4.2
Domestic Unit Auto Sales	6.9	6.9	6.9	6.6	7.3	0.1	-0.2	-4.2	12.6	9.9	6.5	4.4
Industrial Production	110.4	110.2	110.2	110.6	0.3	-0.2	0.0	0.4	3.9	3.3	4.0	3.6
Capacity Utilization	81.7	81.5	81.3	81.5	0.1	-0.2	-0.2	0.2	2.3	1.7	2.3	1.9
PPI	125.2	125.2	124.8	124.6	0.5	0.0	-0.3	-0.2	2.2	1.9	1.4	1.2
PPI Ex. Food & Energy	136.9	137.2	137.0	137.2	0.2	0.2	-0.1	0.1	1.6	1.4	1.5	1.5
CPI	144.2	144.4	144.4	144.5	0.4	0.1	0.0	0.1	3.2	3.2	3.0	2.8
CPI Ex. Food & Energy	151.8	152.1	152.3	152.5	0.4	0.2	0.1	0.1	3.5	3.4	3.4	3.2
Retail Sales	170.5	171.7	172.1	172.3	1.9	0.7	0.2	0.1	6.4	6.6	6.7	6.1
Housing Starts	1206	1248	1246	1212	7.3	3.5	-0.2	-2.7	10.1	4.3	9.2	9.6
Permits	1101	1121	1115	1162	6.5	1.8	-0.5	4.2	5.9	6.5	6.4	7.3
Federal Budget	(d) 8.1	-37.0	11.1	-39.6	-6.5	9.8	7.3	3.6	-280	-270	-263	-259
Durable Goods Orders	129.8	126.8	132.3	128.1	-0.1	-2.4	4.3	-3.1	5.4	5.2	6.9	6.9
Manufacturing Orders	252.4	248.3	255.5	250.2	-0.3	-1.6	2.9	-2.1	4.4	3.9	4.7	3.8
Personal Income (\$87)	4228.5	4238.7	4231.2	4220.3	1.1	0.2	-0.2	-0.3	2.8	2.8	2.6	2.3
Consumption (\$87)	3416.5	3427.3	3448.7	3462.2	0.8	0.3	0.6	0.4	3.2	3.4	3.7	3.8
Personal Saving Rate	(c) 4.9	4.7	4.0	3.3	0.14	-0.18	-0.75	-0.71	-0.46	-0.69	-1.26	-1.74
Leading Economic Indicators	152.0	151.4	151.6	NA	0.3	-0.4	0.1	NA	2.5	1.5	1.9	NA
Total Business Inventories	862.5	864.2	865.6	NA	0.4	0.2	0.2	NA	3.2	3.4	3.1	NA
Inventory/Total Sales	(c) 1.47	1.47	1.47	NA	0.00	-0.00	-0.00	NA	-0.04	-0.05	-0.04	NA
Merchandise Trade	(c) -10.2	-8.4	-12.1	NA	0.27	1.81	-3.69	NA	-3.18	-0.70	-5.21	NA
3 Month Bill	(c) 2.95	3.02	3.17	3.12	-9	7	15	-5	-95	-73	-62	-23
2 Year Note	(c) 3.84	3.98	4.16	4.07	-11	14	18	-9	-150	-125	-89	-29
10 Year Note	(c) 5.97	6.04	5.96	5.81	-1	7	-8	-15	-151	-135	-130	-103
30 Year Bond	(c) 6.85	6.92	6.81	6.63	3	7	-11	-18	-111	-97	-103	-97
DJIA	3423.6	3478.2	3513.8	3529.4	-0.5	1.6	1.0	0.4	3.9	3.0	5.3	6.0
S&P 500	443.08	445.25	448.06	447.29	-1.8	0.5	0.6	-0.2	8.8	7.3	9.7	7.8
U.S. Dollar (FRB)	90.6	90.2	91.8	94.6	-3.2	-0.4	1.7	3.0	0.9	2.2	6.9	14.6
Yen/\$	112	110	107	108	-3.9	-1.8	-2.7	0.3	-15.8	-15.8	-15.3	-14.5
DM/\$	1.60	1.61	1.65	1.72	-3.0	0.7	3.0	3.7	-3.2	-0.9	5.2	15.0
M1	1043.0	1068.8	1073.3	1085.5	0.7	2.3	0.6	1.1	10.8	12.0	12.7	12.7
M2	3476.7	3507.1	3514.7	3520.4	0.1	0.9	0.2	0.2	0.3	1.1	1.5	1.6
M3	4144.6	4175.2	4173.0	4166.9	0.3	0.7	-0.1	-0.1	-0.8	-0.1	0.1	-0.1
C&I Loans & Non-Financial CP	739.3	744.5	744.4	NA	0.4	0.7	-0.0	NA	-1.1	-0.2	0.3	NA
Consumer Credit	751.6	750.9	758.5	NA	0.2	-0.1	1.0	NA	2.7	2.8	3.8	NA

(a) Quarterly % changes are not annualized

(b) Monthly changes are in levels

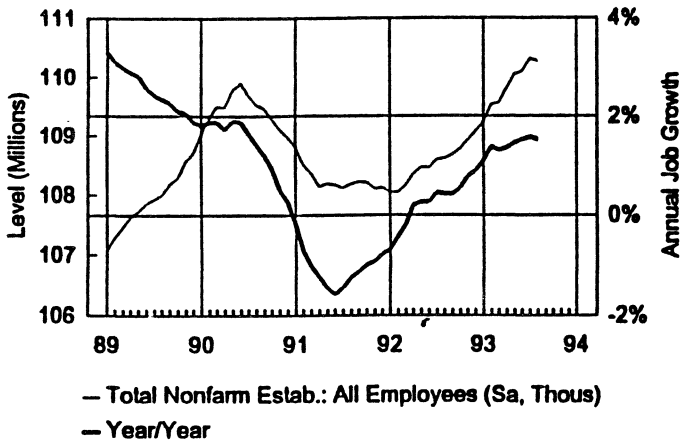
(c) All changes are in levels or basis points

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

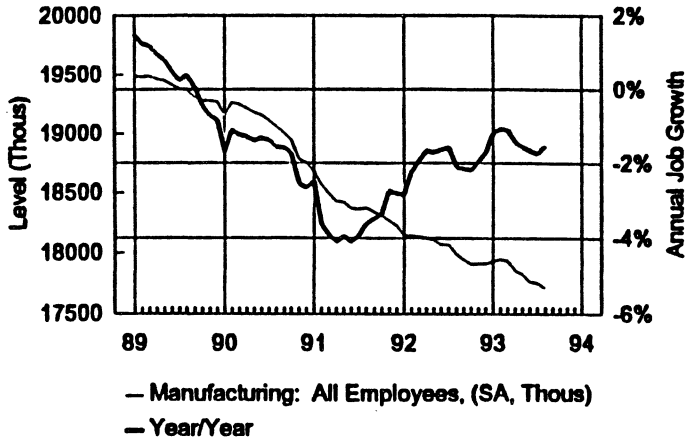
Chart 1

Selected Indicators: Employment and Production

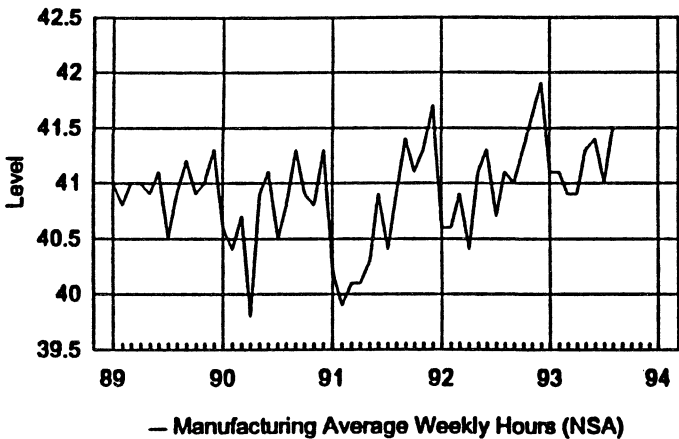
Non-Farm Payroll Employment



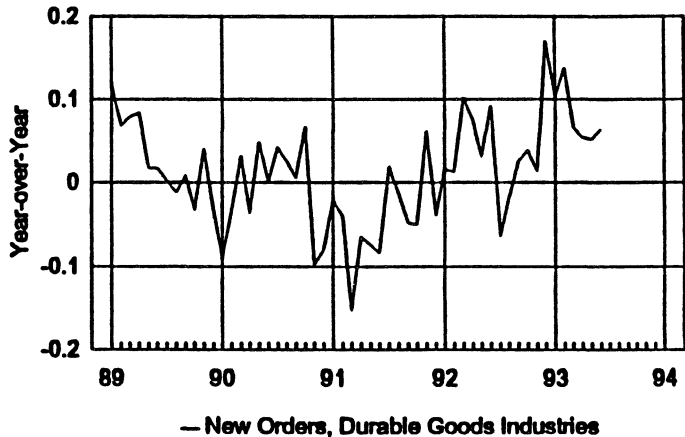
Manufacturing Jobs



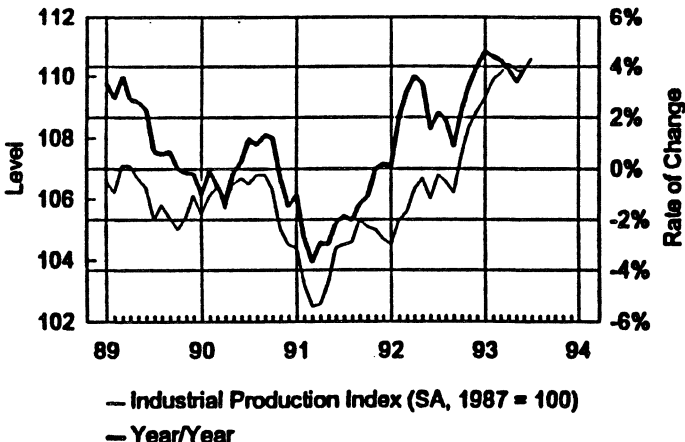
Average Workweek in Manufacturing



Durable Goods Orders



Industrial Production



Productivity

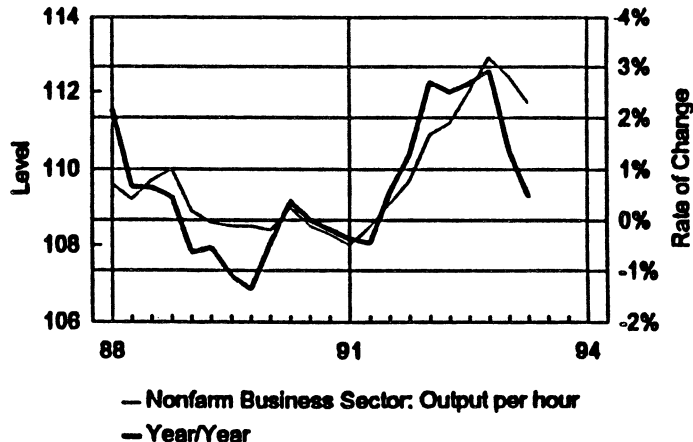
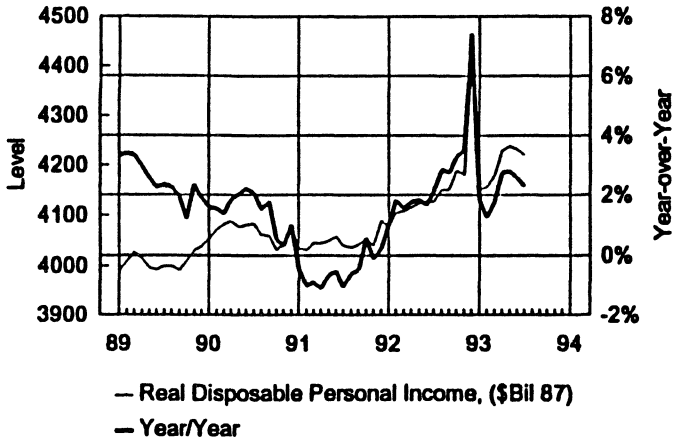


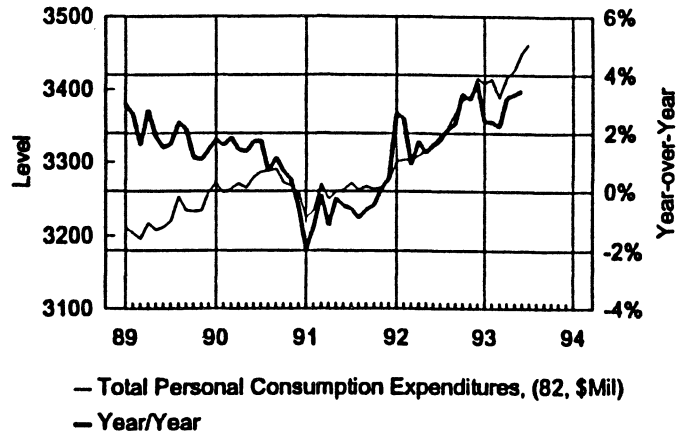
Chart 2

Selected Indicators: Income and Consumption

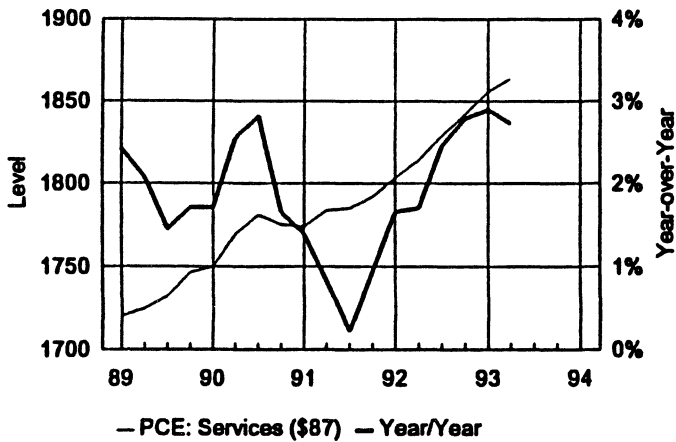
Real Disposable Personal Income



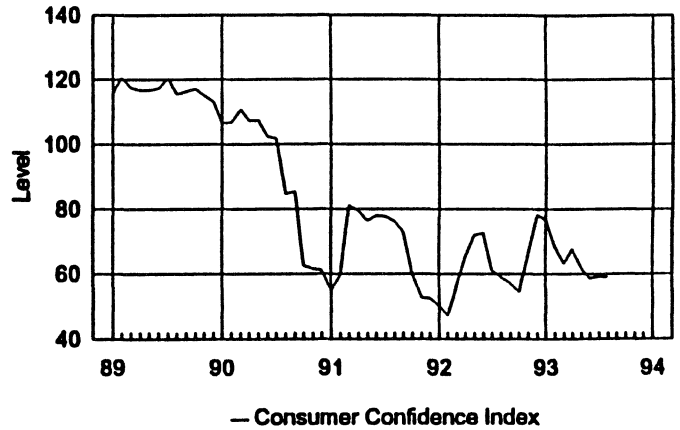
Consumption



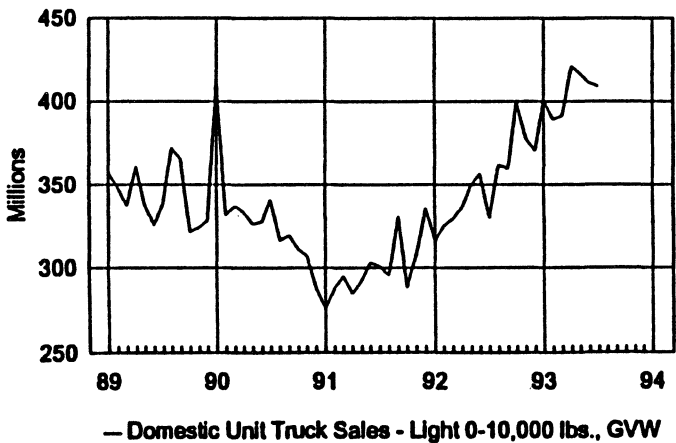
Real Personal Consumption Expenditures: Services



Consumer Confidence Index



Light Truck Sales



Retail Auto Sales

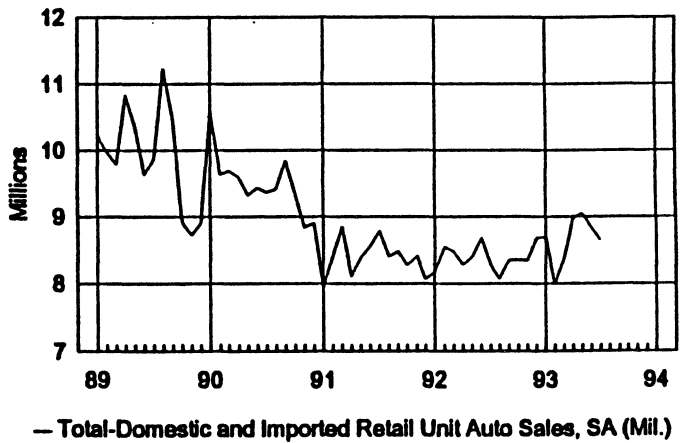
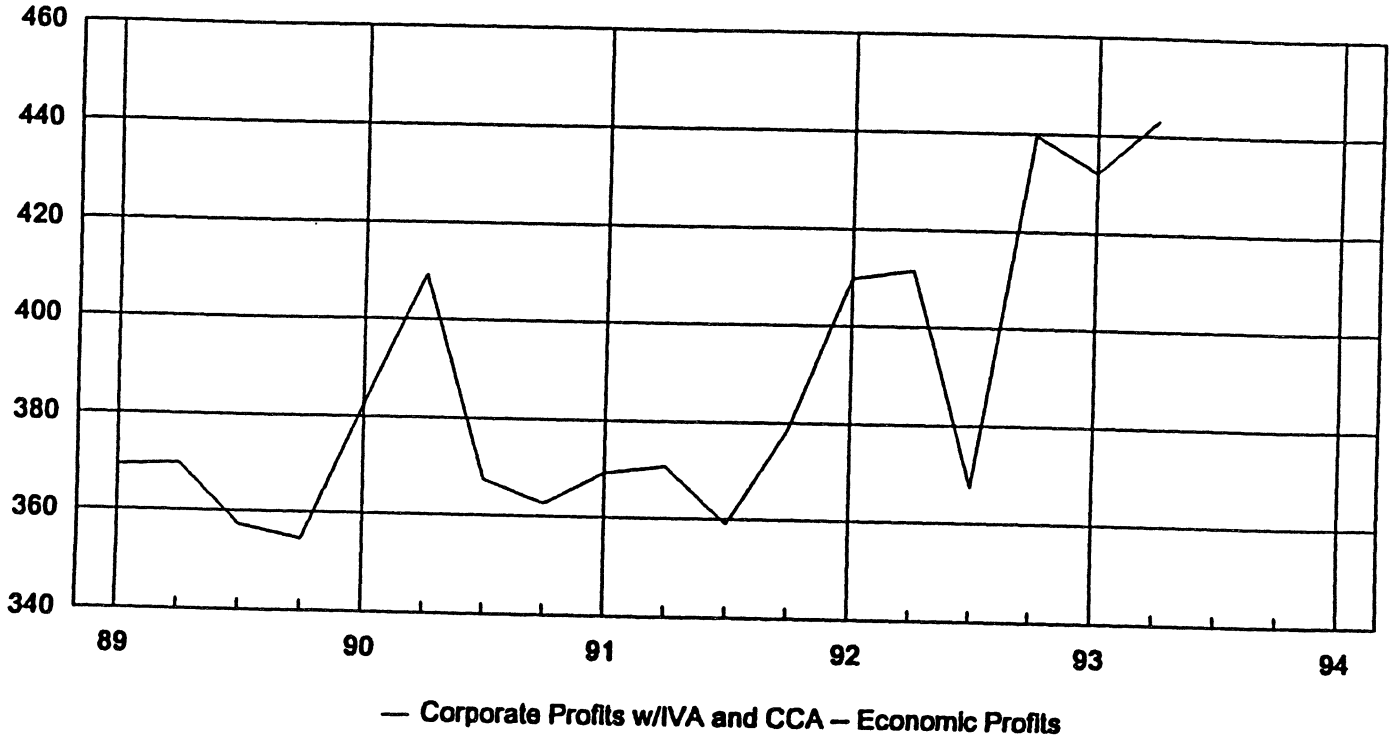


Chart 3 Trends in Corporate Profits and Cash Flow

Economic Profits



Corporate Cash Flow

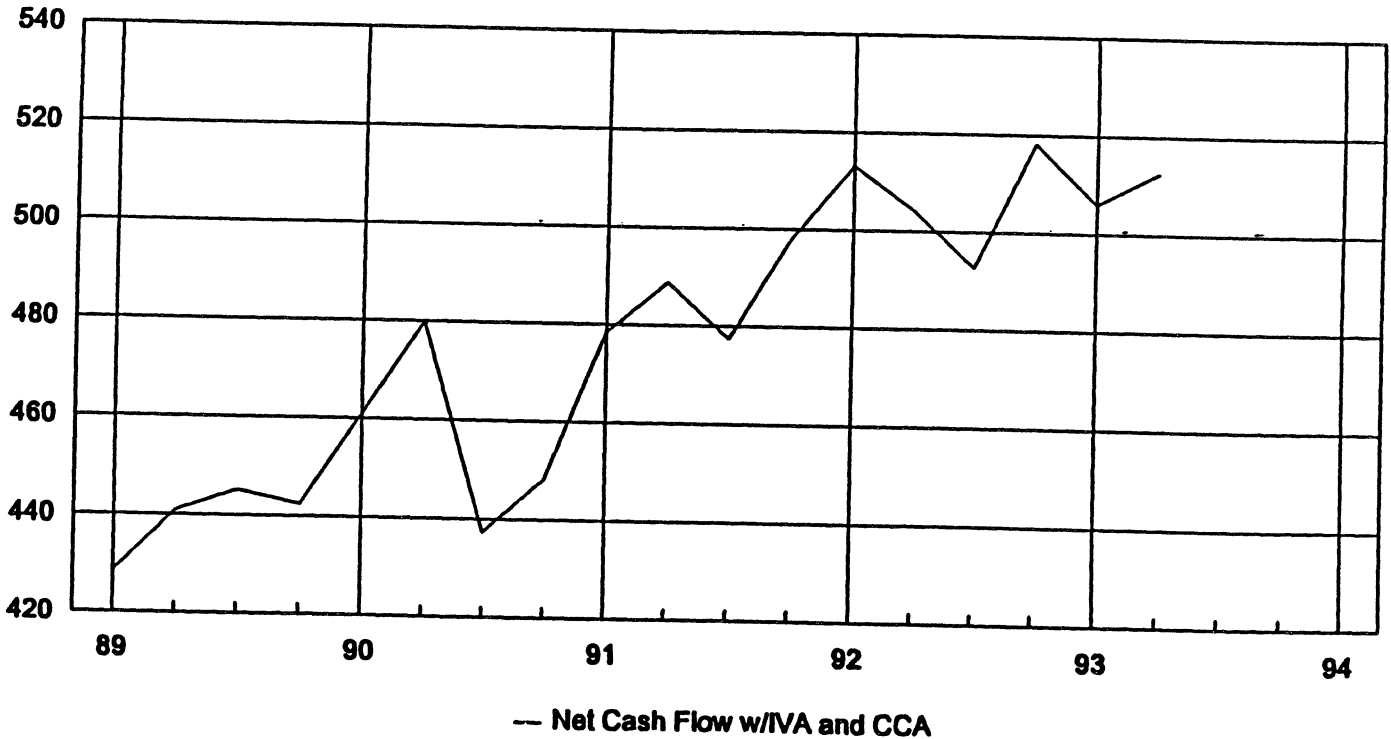
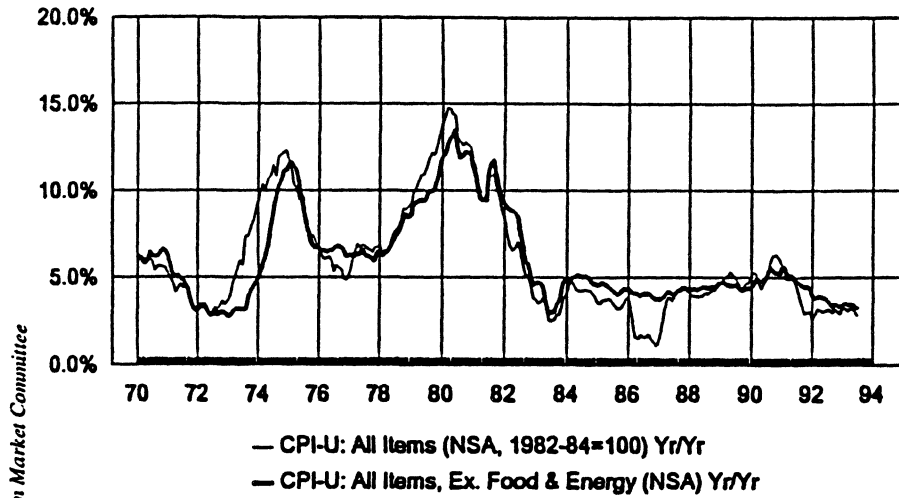
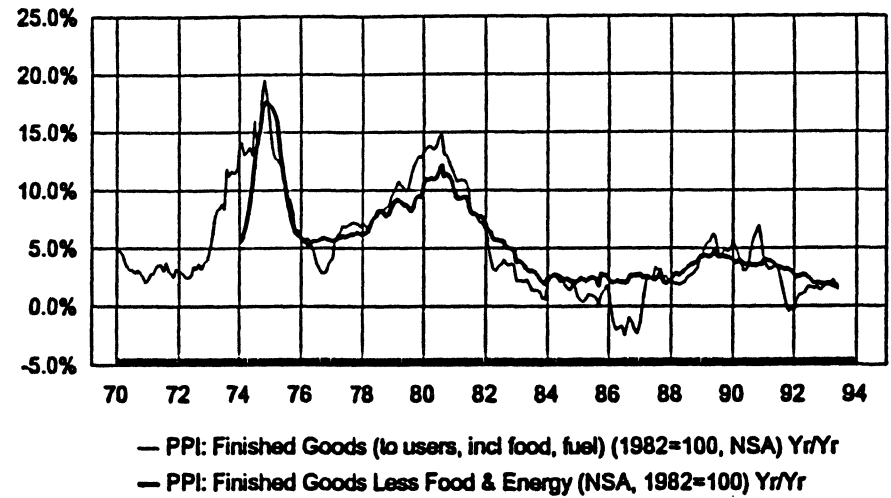


Chart 4 Measures of Inflation

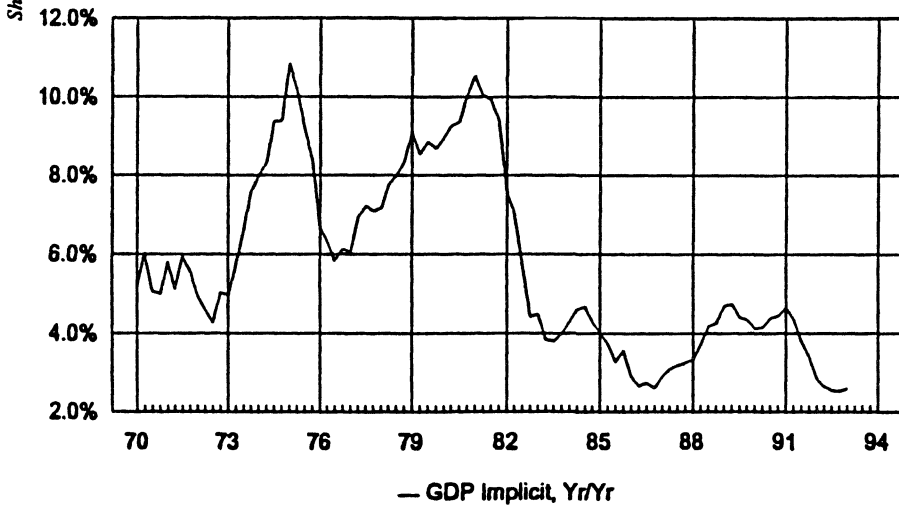
Consumer Price Inflation



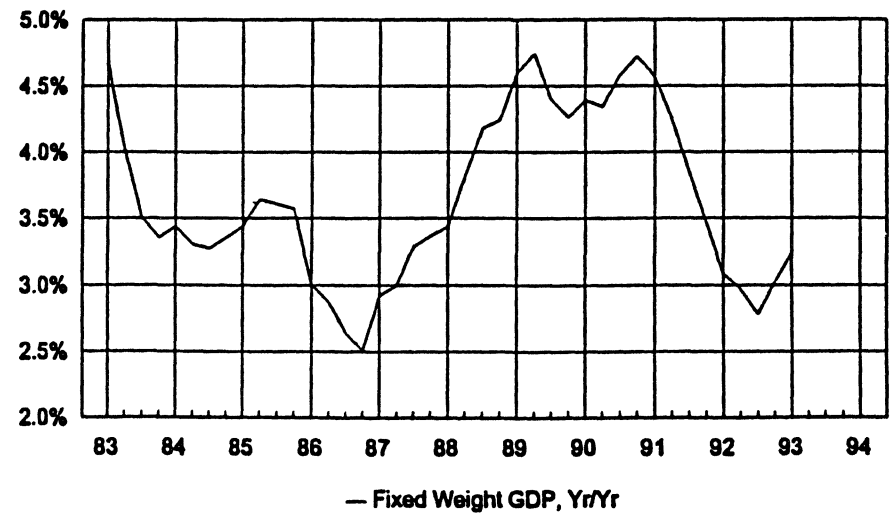
Producer Price Inflation



Implicit GDP Deflator



Fixed Weight GDP Deflator



Shadow Open Market Committee

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Chart 5 Trends in Inflation and Interest Rates

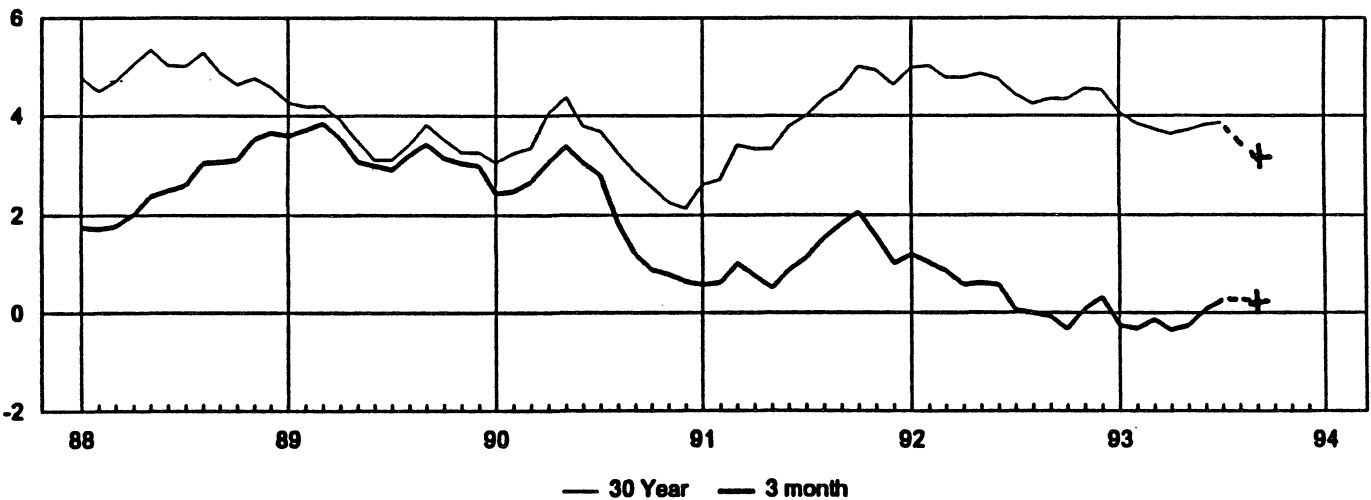
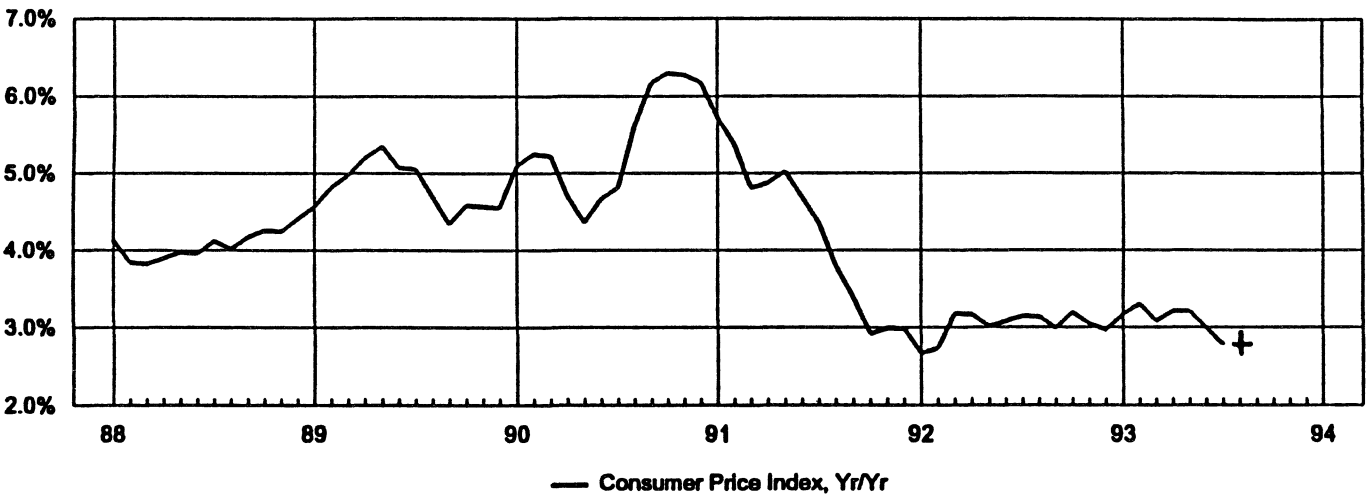
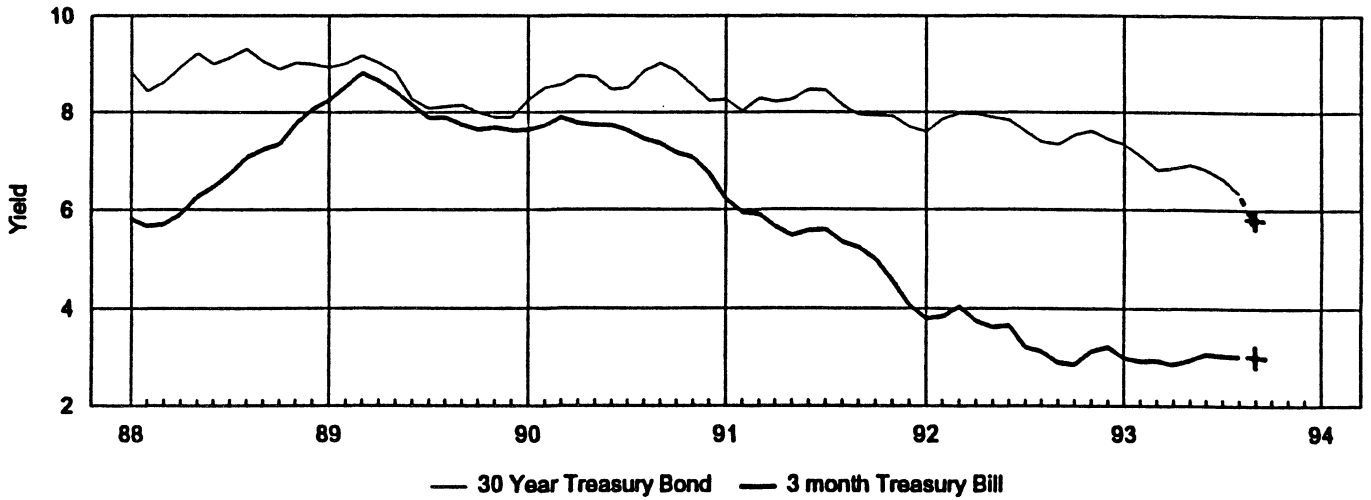


Table 1

Federal Reserve Objectives and Policy

I. Selected Economic Variables (Percent Change):

	Central Tendency * Forecast Q4:92 - Q4:93		1st Half 1993	Year Over Year
	Feb.	July		
Real GDP	3.0 - 3.25	2.5 - 2.75	1.3	2.6
Inflation (CPI)	2.5 - 2.75	3.0 - 3.25	3.4	2.8
Nominal GDP	5.5 - 6.0	5.0 - 5.75	4.2	5.2
Unemployment Rate, 4th Qtr. Avg.	6.75 - 7.0	6.75 - 7.0	7.0	

II. Selected Monetary Aggregates

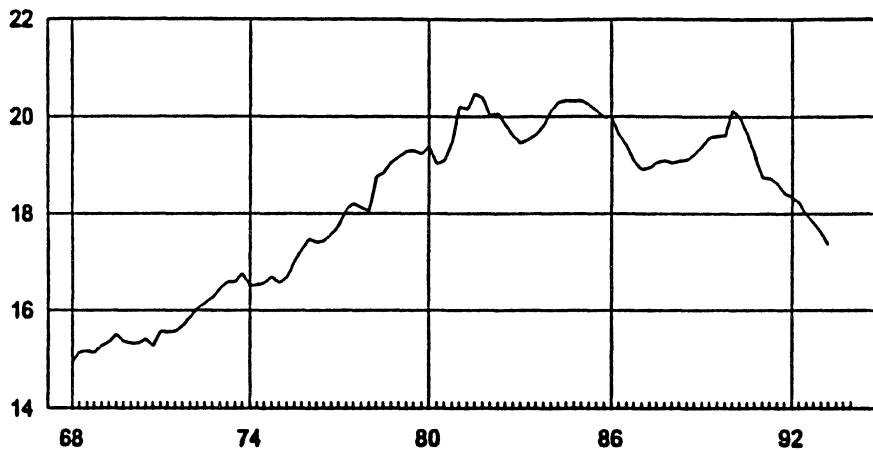
	Targets Q4:92 - Q4:93		1st Half 1993	Year Over Year
	Feb.	July		
Bank Reserves	(not targeted)		8.2%	11.8%
M1	(not targeted)		10.2%	12.7%
M2	2 - 6	1 - 5	0.7%	1.5%
M3	½ - 4 ½	0 - 4	-1.3%	-0.2%

* Preliminary central tendency forecasts for Q4:93 - Q4:94:

Real GDP	2.5 - 3.25
CPI	3.0 - 3.5
Nominal GDP	5.0 - 6.5

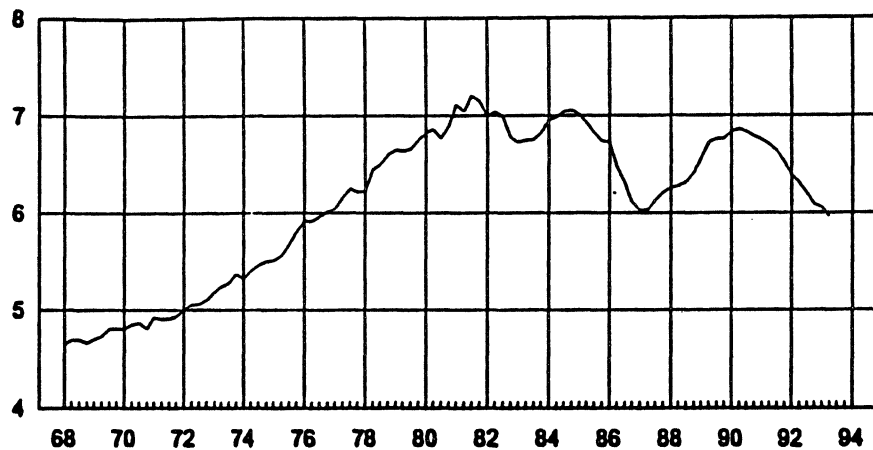
Chart 6 Money Velocity

Monetary Base Velocity



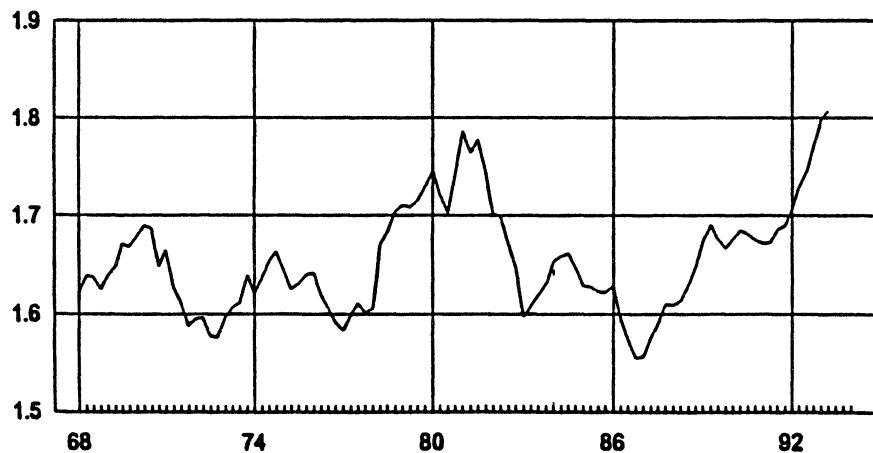
— Base Velocity

M1 Velocity



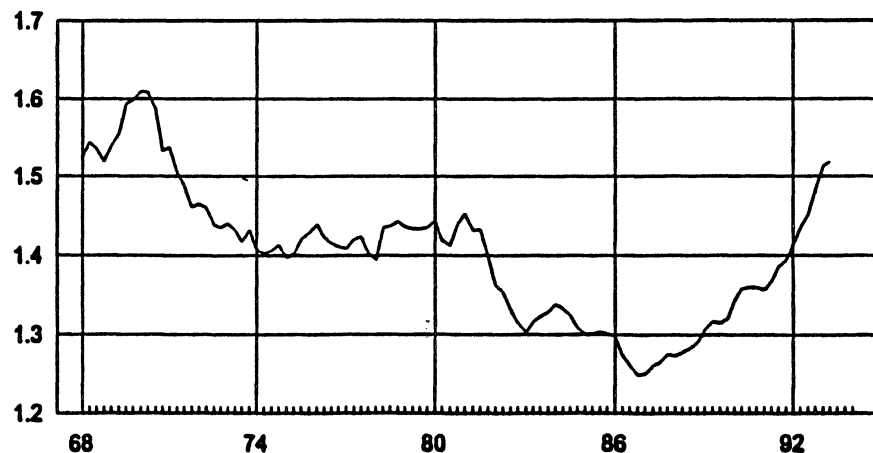
— M1 Velocity

M2 Velocity



— M2 Velocity

M3 Velocity



— M3 Velocity

September 12-13, 1993

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Chart 7 International Comparisons of Industrial Production

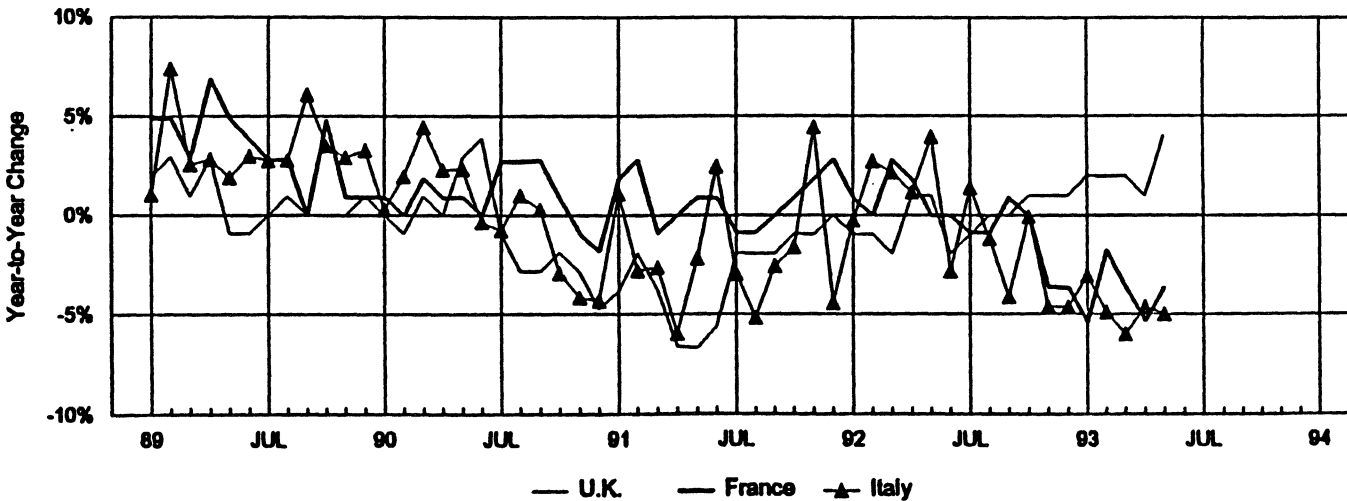
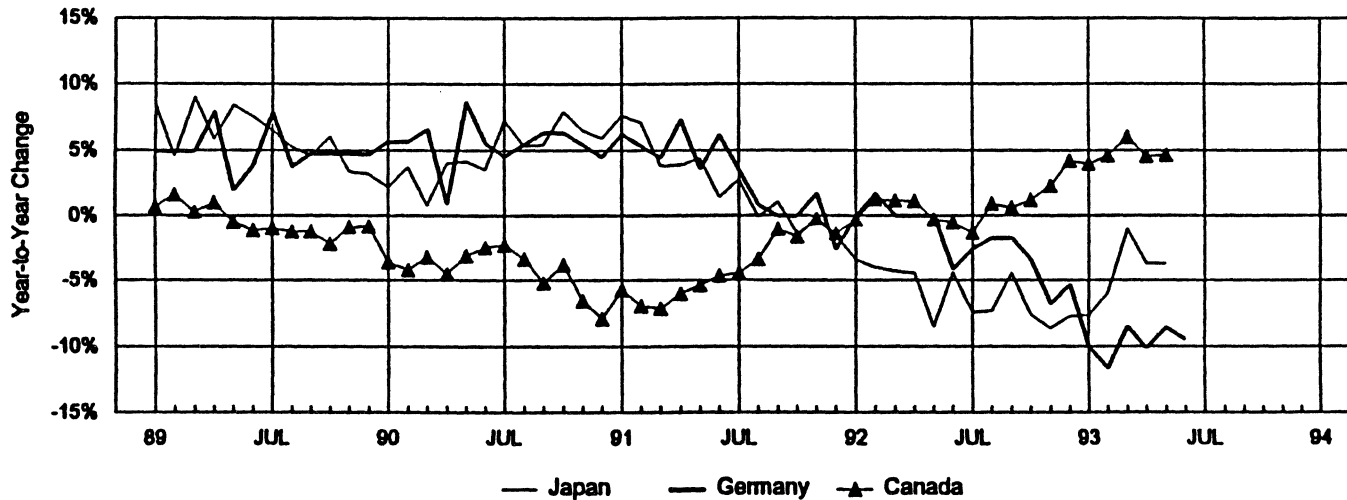
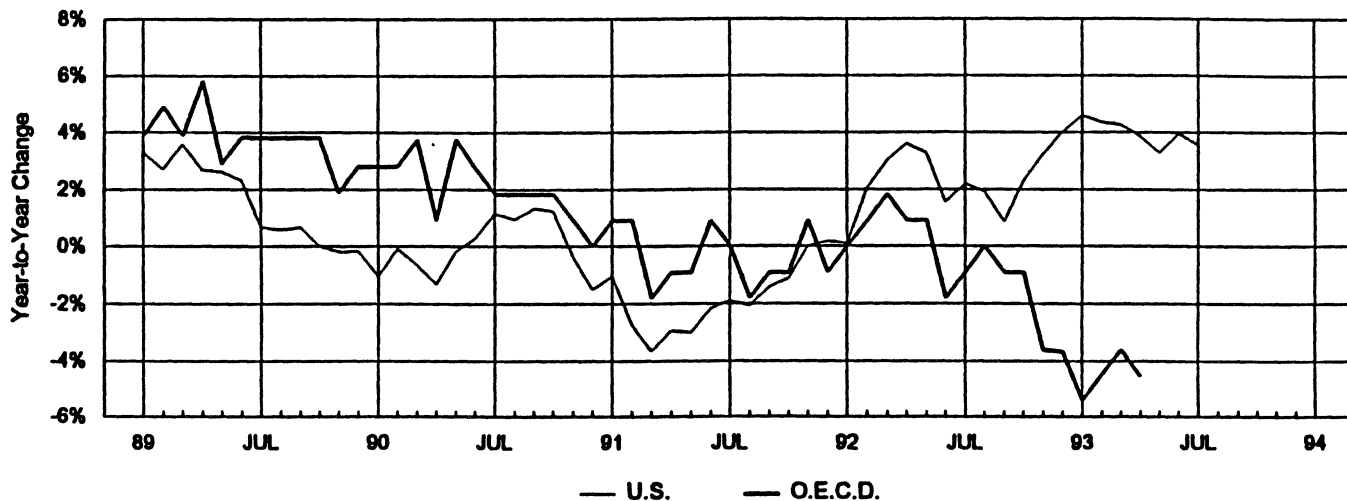
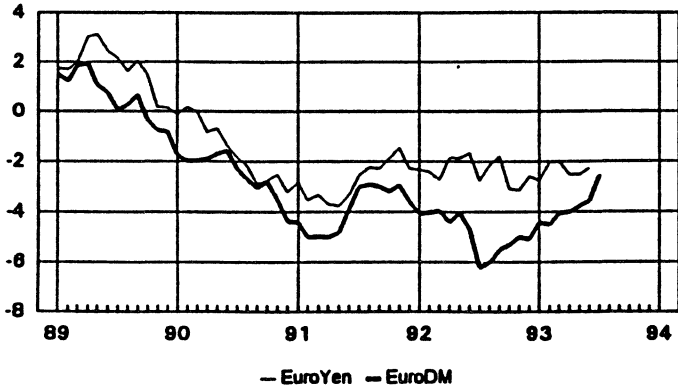


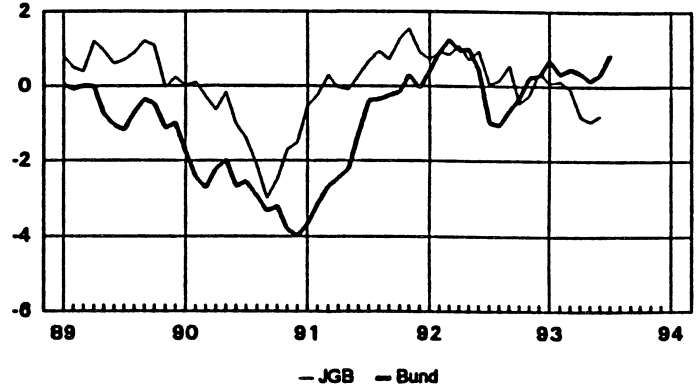
Chart 8 International Financial Trends

Real Three Month Eurocurrency Rate Differentials
U.S. Rate minus Foreign Rate



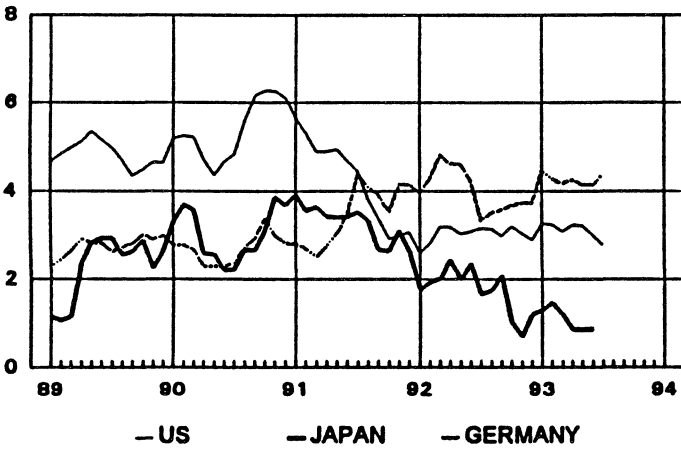
Nominal rates deflated by year-to-year CPI rate.

Real Ten Year Note Rate Differentials
U.S. Rate minus Foreign Rate

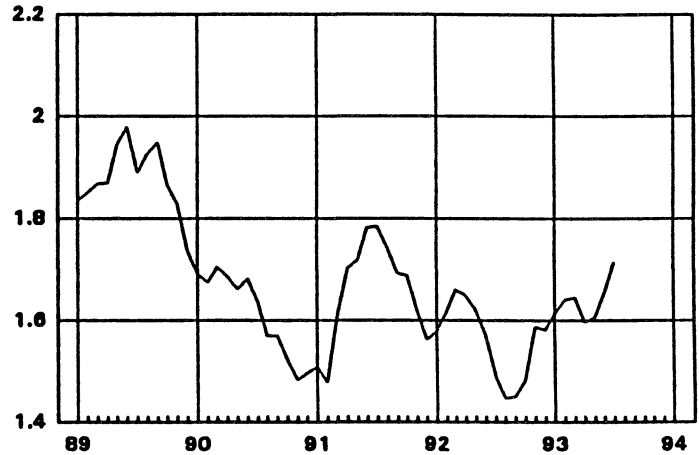


Nominal rates deflated by year-to-year CPI rate.

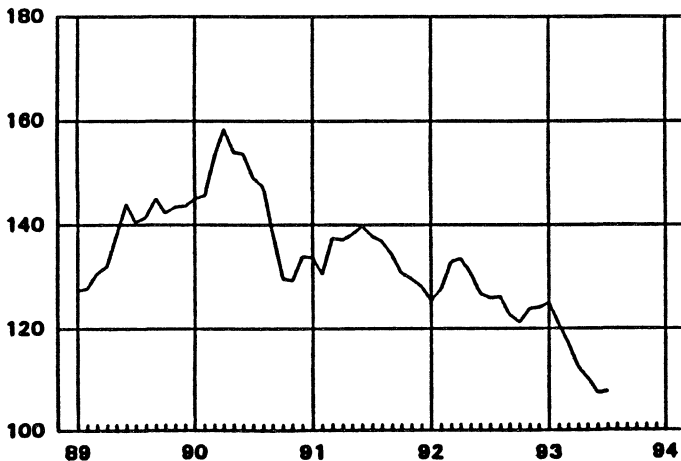
INFLATION



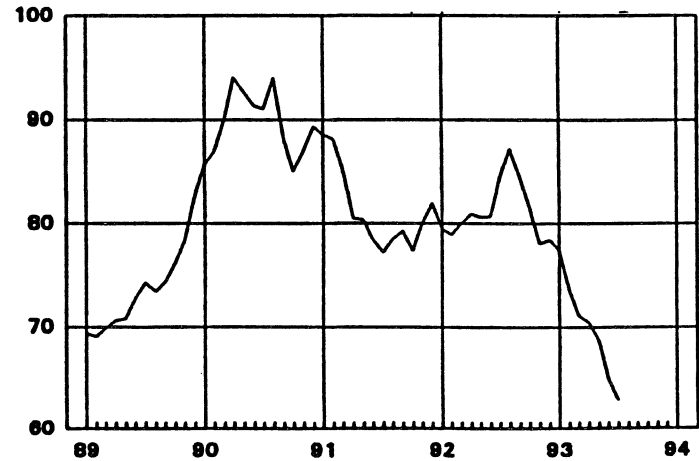
DM/\$



Yen/\$



Yen/DM



PROJECTED DEFICIT REDUCTION BUT NOT FISCAL REFORM

Mickey D. LEVY
NationsBank

As President Clinton signed his economic program into law, he stated "When I presented this program to Congress, I had hoped for something quite different." We concur. The Budget compromise will reduce the deficit—although not as much as projected—something the Bush Administration failed to accomplish. However, it will slow economic growth in the near term and does little to improve the foundations for long-run job growth or standards of living. As such, it is basically a plan for income redistribution.

This deficit reduction is not a step toward fiscal policy reform. It will reduce private saving and not materially raise the national rate of saving. Its impact on private investment will be neutral at best. It retains existing distortions of the tax system, and increase reliance on income taxes. It leaves unaltered the rising share of federal outlays for consumption-oriented entitlement spending, and does not add to the share of investment. It leaves unchanged the structures of the key spending programs that are the primary sources of deficits, and does not reduce or eliminate many failed and economically distorting programs.

Supporters of the legislation point to three general accomplishments: 1) it will reduce deficits sufficiently to halt the rise in the federal debt-to-GDP ratio, 2) it is the best compromise that politics would allow and, as such, is a necessary first step in the right direction (toward deficit reduction), and 3) its income redistribution improves fairness in the tax code. These arguments provide the Administration and Congressional policy makers a temporary sense of accomplishment. Yet the accomplishment of the final compromise was largely political. Measured in purely economic terms, against a standard of true fiscal reform, the weaknesses in the package overshadow the deficit reduction. Without the benefit of future legislative promises, this is yet another disappointing attempt at fiscal responsibility.

MISPLACED FOCUS

The overriding concern with the magnitude of deficit reduction and income redistribution steered the compromise away from meaningful fiscal reform, including permanent significant cuts in the nonmeans-tested retirement programs or increasing reliance on consumption-based taxation.

While elected officials lament their loss of credibility, the narrow focus on deficits also generated the same silliness that has characterized recent budget debates, including artificial deficit cut targets (remember the \$500 billion cut of OBRA of 1990?), numerically favorable baselines, double-counting, unspecified cuts in discretionary programs, back-loaded spending cuts, and verbal promises for future legislative progress. On the other hand, the deficit fixation buried the Administration's ill-conceived short-term stimulus package and generated a number of effective but small spending cuts.

The projected \$504 billion cut in deficits is measured against an artificially high baseline. It is achieved through an acceleration of tax revenue growth to 5.8 percent average annualized during 1994-1998 from 4.7 percent in its recent baseline, and a modest reduction in average annual spending growth to 4.1 percent from 4.7 percent. Thus, spending will continue to grow faster than inflation. Some of the spending growth reduction actually reflects higher fees, taxes, and asset sales. Of the total projected \$255 billion in spending cuts, \$108 billion are unspecified relying on an extension of the discretionary caps imposed by OBRA of 1990 that requires new legislation to achieve. Another \$86 billion is reduced debt service costs. Of the remaining \$71 billion in saving, \$49 billion is from Medicare cuts. These Medicare savings are largely in the form of lower fees to providers, which will not reduce the demand for health care. Moreover, in all probability, these savings will be more than offset by new spending for President Clinton's forthcoming health care package, even though they will not appear in the Medicare budget function.

Receiving insufficient attention in the budget debate was the broader economic agenda, namely, how should fiscal and budget policy be altered to raise national saving and investment in order to create permanent jobs and raise long-run productive capacity and living standards? The U.S. rate of private saving is among the lowest in the industrialized world. The rate of investment is disturbingly low and the rate of growth of real net private investment as a percent of real net domestic product remains in a downward trend. The tax system discourages saving and investment and includes numerous provisions that generate resource misallocations. Wasteful and poorly structured government spending programs add to the stock of debt and divert national resources from growth-oriented investment. Certainly, deficit reduction is a critical component of fiscal reform, but of considerable importance is how the deficit is cut and the allocative affects of the tax and spending structures underlying the deficit. Lack of attention to these broader issues precluded meaningful reform.

SAVING AND INVESTMENT

The budget compromise will reduce private investment and will not raise total national saving or increase additional resources for investment by anywhere close to the magnitude of projected deficit reduction. Nor will it encourage investment.

National saving is reduced by government dissaving, but is also affected by the adverse impact the government's tax and spending programs on private saving. The low rate of U.S. national saving is partly a function of heavy reliance on income taxation, which encourages consumption and suppresses private saving (household saving and corporate retained earnings), as well as large budget deficits. The U.S. saving rate is strikingly lower than other industrialized nations that rely significantly more on consumption-based taxation, including those nations with government deficits as a percent of GDP as high or higher than the U.S..

The budget compromise will suppress the rate of private saving of disposable income and economic output and by raising disincentives to save. The dynamics of the budget compromise make its impact difficult to quantify. However, its negative impact on private saving will be significantly larger than past experience. Based on private estimates, the CBO finds that a one percent deficit reduction reduces private saving by approximately 0.3 percent. This package will have a larger negative impact on private saving because a sizable portion of the deficit reduction is derived from income tax increases, and the vast majority of the tax hikes are assessed on high savers.

This drain on private saving, a clear result of the political inability to reduce the fastest growing spending programs, is a major shortcoming of the budget package, and may prove to be a high cost to pay for its income distribution. Substantially increasing the already heavy U.S. reliance on income taxes is particularly striking compared to the opposite trend in most industrialized nations with high rates of private saving.

The budget package is likely to result in a modest reduction in private investment. The higher taxes reduce expected rates of return on investment, but this negative impact is mitigated by the responding downward adjustment of *ex ante* real interest rates and the reduction of the tax rate on capital gains relative to the tax rate on ordinary income. Also, most of the investment incentives originally proposed by President Clinton were dropped from the compromise, and the surviving provisions are minor. As a result, this fiscal action will not arrest the declining trend of real private net investment growth.

Nor will the budget package materially change the share of government budget outlays for investment-oriented activities. Many of the new spending programs designated as investment instead are traditional income maintenance programs (for example, expansion of the earned income tax credit and the food stamps program). Meanwhile, adherence to the discretionary budget caps imposed by OBRA likely would continue to suppress outlays for public investment as government spending for transfer payments rise; at the same time, public infrastructure projects financed by state and local governments remain stalled by their budget squeezes.

The recent decline in interest rates will *not* stimulate economic activity and investment sufficiently to offset the reduction in disposable income. Interest rates have fallen largely as a *reflection* of actual and expected weakness in response to the tax package and lower inflation expectations (heightened confidence in the Federal Reserve's inflation-fighting credibility). Insofar as *ex ante* real rates have declined in response to lower expected returns on investment and weakened economic and credit conditions, their fall is simply a price adjustment that does not stimulate aggregate demand. (The lower expected rates of return on investment are evidenced by the diverging pattern of stock and bond prices. Measured either from the announcement of the tax package or its enactment, the stock market has risen by significantly less than the percentage decline in interest rates, reflecting a downward revision in future earnings.) Declines in nominal rates due to lower inflation expectations improve economic efficiency but similarly do not stimulate aggregate demand.

Foreign capital inflows will be reduced by the deficit cuts which lower government dissaving. In addition, capital inflows will be affected by the impact of the tax and spending changes on domestic saving and investment. The precise measure of these impacts is complex, involving the direct affects of disposable income reduction, the interest elasticity of saving and investment, and the dynamic impact of the downward adjustment of real interest rates and exchange rates. Although uncertain, the fiscal change presumably will have a larger impact on private domestic saving than on investment.

Based on recent experiences, the CBO has estimated that every one percent of deficit reduction reduces foreign capital inflows by approximately 0.4 percent. But this is based on the assumed casual direction from deficit reduction to lower interest rates to lower exchange rates, which reduces capital inflows, without careful distinction between how different tax and spending changes underlying deficit reduction alter investment and saving decision. This fiscal change may have less of an impact on foreign capital inflows than the CBO estimate based on past deficit reductions to the extent that private domestic saving is reduced by more than private domestic investment.

THE MIX OF SPENDING AND RESOURCE ALLOCATION

Generally, the budget package does little to alter the general mix of federal spending. Under the new law, spending on nonmeans-tested entitlements will continue to grow in real terms and rise as a share of total federal spending. Taxing a higher portion of social security benefits of higher income recipients will reduce after-tax benefits by only 1.5 percent, allowing net benefits to rise 4.5 percent annually. The other retirement programs, primarily for military and civil service, remain virtually unchanged. These will cost approximately \$73 billion in 1994, or 4.8 percent of total outlays, and are projected to grow to nearly 25 percent to \$91 billion in 1998. Thus, the budget compromise fails to alter the benefit structures of some of the primary sources of deficit spending. The decline in defense spending enacted during the Bush Administration will continue, while the share of outlays for domestic discretionary programs depends on whether OBRA's discretionary caps are imposed through new legislation.

ECONOMIC IMPACT

The budget package will slow growth in the current expansion, but only fractionally, and not generate recession. The reduction in disposable income will slow growth of consumption and product demand. However, the biggest chunk of the projected deficit reduction of \$47 billion in 1994 and \$83 billion in 1995 (0.8 and 1.3 percent of GDP respectively) is higher income taxes on high savers. This will have a larger short-run impact on saving than on consumption. Also, the short-run economic impact will be cushioned by the downward adjustment of interest rates. Scheduled cuts in defense spending will continue to suppress federal government purchases. The rapid defense downsizing has been reducing employment by approximately 30,000 per month, largely in manufacturing.

The impact on long-run economic performance will be modest, insofar as the compromise will not significantly raise total national saving or investment, not will it materially reallocate resources by changing the mix of federal spending. As a result, it will not generate permanent jobs or lift standards of living or international competitiveness, falling far short of the Administration's objectives.

September 12-13, 1993

GROWTH OF BASE MONEY AND NOMINAL GDP

Allan H. MELTZER
Carnegie Mellon University
Visiting Scholar, American Enterprise Institute

At the last SOMC meeting, I introduced a chart that corrected growth of the monetary base for the growth of foreign holdings of U.S. currency. The correction was based on the interesting work by Richard Porter at the Federal Reserve.

The chart used a six quarter lag between growth of the domestic and subsequent growth of nominal GDP. The chart suggested that growth of the monetary base in recent years was about 2 percent faster than is consistent with inflation at a maximum rate of 2 percent if real growth remains at 2 1/2 to 3 percent.

Adjusting for foreign holding of U.S. currency corrects partially for the decline in base velocity in the recent past. An alternative is to adjust base growth adaptively to sustained past changes in intermediation and payments technology (base velocity) and in the growth of real output. This is the procedure, I have proposed in several previous papers. No adjustment is made to the base for foreign holdings of currency. Increases in these holdings reduce base velocity.

The proposal calls for increasing the base at a non-inflationary rate. To compute this rate, I subtract the 12 quarter moving average growth of base velocity (\bar{V}) from the twelve quarter moving average growth of output (\bar{y}). If base growth remained close to $\bar{y} - \bar{V}$, inflation would remain close to zero. To get inflation to average about 2 percent, base growth should average

$$\bar{y} - \bar{V} + 2.$$

Chart 2 of the proposed statement (reproduced here) shows the annual growth of the base computed as

$$b_t = \ln B_t - \ln B_{t-4}$$

using data from the St. Louis Fed. Since \bar{y}_t and \bar{V}_t are not known until after b_t is revealed, the chart compares b_t to $\bar{y}_{t-1} - \bar{V}_{t-1}$.

The chart shows that as the moving averages rose inflation declined in 1983 and 1984 despite rising base growth. Similarly, disinflation in the 1990s is mainly the result of rising value for the moving averages $\bar{y} - \bar{V}$.

b_t can differ from the current rate of inflation if the current growth of output and velocity differ substantially from their moving averages, i.e. if $y_t - \bar{y}_{t-1} - (V_t - \bar{V}_{t-1})$ is large or highly variable. For the period 1981/1 - 1993/1, I have computed the mean and standard deviation for this sum and also for other relevant measures. These are shown in the table.

Means and Standard Deviations

	mean	σ	mean
(1) $y_t - \bar{y}_{t-1} - (V_t - \bar{V}_{t-1})$	0.002	0.013	0.010
(2) $\bar{y}_{t-1} - \bar{V}_{t-1}$	0.025	0.023	0.030
(3) $b_t - (\bar{y} - \bar{V})_{t-1}$	0.050	0.026	0.050

The data in line 1 show that the absolute mean error from using the two moving averages is about 1 percent. The remaining difference arises because of the growth rate of the base fluctuates. Steady, more predictable growth of base money would reduce the mean and variance of $b_t - (\bar{y} - \bar{V})_{t-1}$ shown in line 3. As the difference falls, the correspondence between line 3 and inflation would fall.

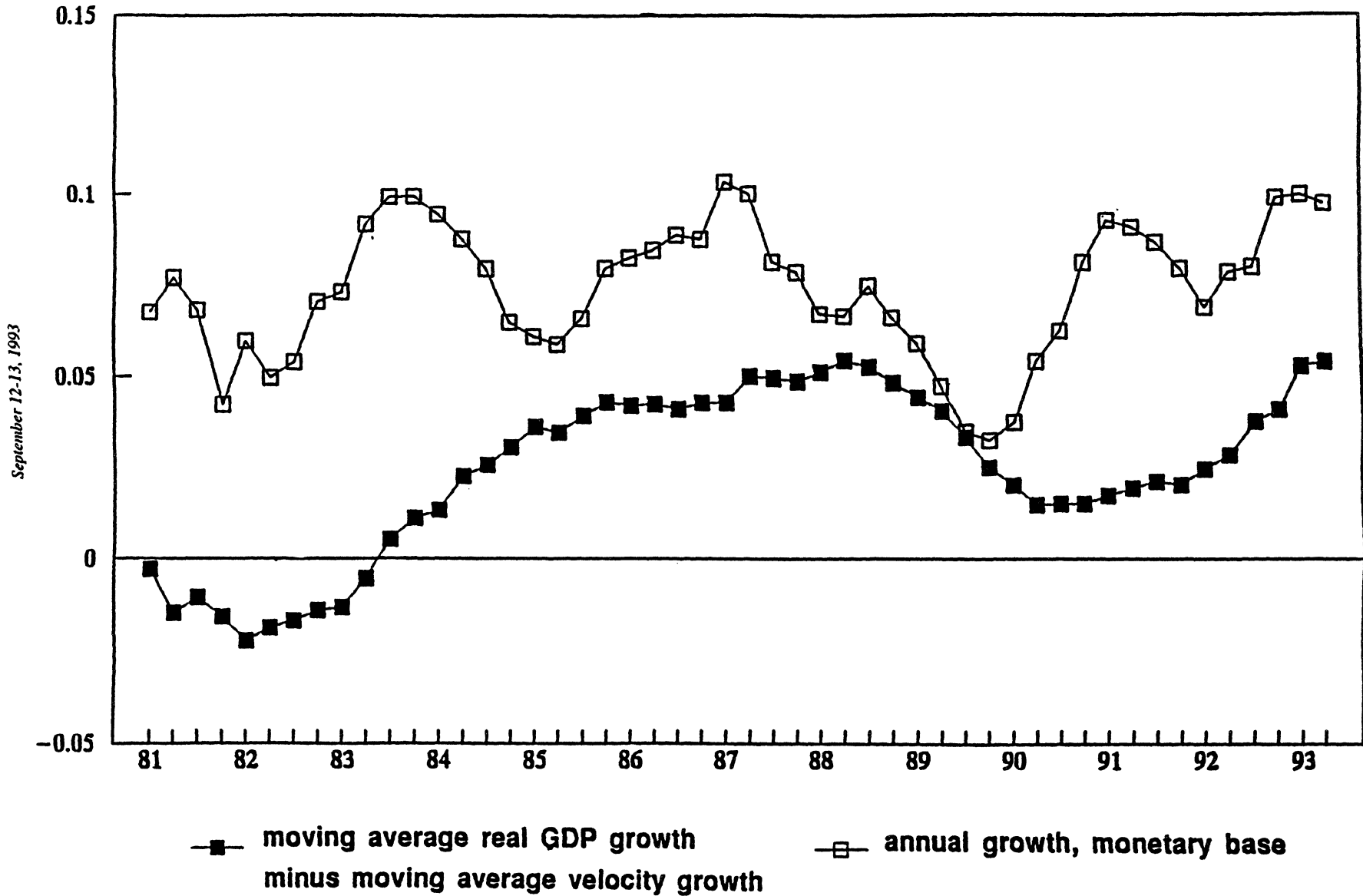
The differences $b_t - (\bar{y} - \bar{V})_{t-1}$ for the past six quarters are (in percent):

92/1	4.4	93/1	4.7
2	5.0	2	4.3
3	4.2		
4	5.8		

The mean difference is 4.73 percent. The mean rate of increase of the base is 10.1 percent for the same period. During this period, the mean absolute error $(y_t - \bar{y}_{t-1} - V_t - \bar{V}_{t-1})$ is .005, below the average for the years 1981-93.

To reduce inflation to 2 percent maximum, given these data, growth of the base must be lowered by 2 3/4 percent. Growth of $(\bar{y} - \bar{V})_{t-1}$ may change as interest rates, real output and inflation change. The adaptive rule would adjust to these changes as they occurred.

Chart 2 The Thrust of Monetary Policy



THE REAL RATE OF INTEREST AS A GUIDE TO MONETARY POLICY

William POOLE*
Brown University

One important guidepost [for monetary policy] is real interest rates, which have a key bearing on longer-run spending decisions and inflation prospects. . . . Maintaining the real rate around its equilibrium level should have a stabilizing effect on the economy.

(Alan Greenspan, "Testimony" before the Subcommittee on Economic Growth and Credit Formation of the Committee on Banking, Finance and Urban Affairs, U.S. House of Representative, July 20, 1993, p. 11.)

The Federal Reserve, in its midyear monetary policy report to Congress, downgraded M2 as a guide to monetary policy and elevated, or seemed to elevate, the real interest rate as a guide to policy. I doubt that the real interest rate can substitute for monetary aggregates as a guide to policy, and I doubt that the Fed really believes that it can either. I will first discuss some of the well-known problems with employing the real interest rate as a guide to monetary policy and then will offer some speculations on why the Fed discussed real rates at all and on the risks of this approach.

PROBLEMS WITH EMPLOYING THE REAL RATE AS A GUIDE TO MONETARY POLICY

The real rate of interest on a particular interest-bearing instrument is its nominal rate of interest less the average rate of inflation over the life of the instrument. For example, if the one-year Treasury bill has a yield of 3.3 percent and the rate of inflation is 3.0 percent, then the real rate of interest is 0.3 percent.

The future rate of inflation cannot be known with certainty, and so we must distinguish between the expected, or *ex ante*, real rate of interest and the realized, or *ex post*, real rate of interest. The *ex ante* real rate is the nominal interest rate less the rate of inflation *expected* over the life of the instrument. The *ex post* real rate is the nominal rate less the *actual* rate of inflation over the life of the instrument.¹ The inflation expectations upon which the *ex ante* real rate depends are not directly observable in the United States, although trading in indexed bonds in the United Kingdom provides a direct market measure of the *ex ante* real rate in that country.

The *ex ante* rather than the *ex post* real rate is relevant for the most decisions of investors. People borrow and lend on the basis of expectations of the future. Many different types of expectations are relevant to investors—the strength of product demand in particular markets, the income flows to service borrowing, prices of competing assets such as equities, and so forth. The expected rate of inflation is relevant because borrowers need to estimate the real burden, and not just the money burden, of repaying debt and lenders need to estimate the real return, and not just the money return, from investing in debt securities.

Economists conventionally calculate a real rate by subtracting from the nominal rate of interest the rate of inflation as measured by a broad price index such as the consumer price index or the GDP deflator. However, individual borrowers and lenders often will be more interested in particular prices rather than prices in general. An oil company, for example, considering investment in oil exploration is more interested in the price of petroleum than in the consumer price index.

To use a real rate of interest as a guide to monetary policy, the authorities may have to calculate a number of different real rates based on information about market expectations for several different price indexes. The consumer price index for durable goods might be most relevant for understanding consumer behavior in borrowing to finance durable goods purchases. Commercial construction depends importantly on expectations of future building rents. Credit demand by farmers depends on the expected prices of wheat and of agricultural land.

Use of a broad price index hides much relevant detail, but can be justified on the ground that the behavior of those affected by particular prices expected to rise more rapidly than average more or less cancels out the behavior of those affected by particular prices expected to rise less rapidly than average. To the extent that this assumption does not hold, the relationship between the measured real rate and the state of the economy will be variable, as it will in any event for numerous other reasons.

A serious problem in studying how the real rate of interest might be employed as a monetary policy guide is the lack of reliable information on market expectations of inflation. Some progress can be made by using survey information and statistical extrapolations from observed inflation, but the problems are formidable. Another approach is to examine the *ex post* real rate, which can be measured after the fact, and add assumptions concerning inflation forecasting errors.

Consider the figure at the end of this memo. I've defined the real rate on commercial paper as the average commercial paper rate in a particular year less the realized rate of CPI inflation from

that year to the next. Given that the commercial paper maturity is 6 months, I should properly have done this exercise by half years, but the figure still gives us a good idea of the long history of the commercial paper rate, nominal and real.

The negative real rates of interest associated with the inflations of World Wars I and II and the Korean War show up clearly in the figure, as do the negative real rates associated with the inflations of the mid and late 1970s. Putting aside these cases, the other examples of a real rate as low as today's are 1956 and 1967-68, which were years of rising inflation. The level of the *ex ante* real rate during these inflations was surely not as low as the *ex post* real rate shown in the figure because the economic agents typically (an unavoidably) underestimate the extent to which inflation is rising. Still, it is probable that the *ex ante* real rate was rather low in these episodes.

The real rate, however, was also low in 1975-76, which was a period of stable inflation and recovery from the sharp 1973-75 recession. Real rates were low in the early years of recovery following the depression trough in March 1933. We can conclude that low real rates are often but not invariably associated with inflation.

The most notable examples of high real rates are 1920-21 and 1930-31; these, of course, were recession and depression years. The real rate was also high in the recessions of 1893, 1907, and 1981-82. Here again, the *ex ante* real rate was not as high as the *ex post* real rate—some part of the sharp decline in inflation in each of these episodes was unexpected. But the real rate was also quite high 1983-85, a period of substantial economic expansion. Given that the inflation rate was fairly stable during this period, the gap between the *ex ante* and *ex post* real rates was probably fairly small.

Chairman Greenspan was careful to note that the relevant magnitude for policy makers is the relationship between the real rate and the equilibrium real rate. I assume that what the Fed means by the "equilibrium" is the real rate consistent with normal real growth at an unchanged inflation rate. Unfortunately, economists do not have reliable models of the determinants of the equilibrium real rate, and so there is very little practical content in a recommendation that monetary policy should keep the market real rate close to the equilibrium real rate.

Employing the real rate a guide to monetary policy is complicated by the fact that market interest rates are affected by expectations about future monetary policy as well as by expectations about inflation. Of course, many other considerations, such as prospective budget deficits, changes in the tax law, and so forth are also relevant, but I'll concentrate on prospective inflation and prospective monetary policy in this discussion.

Prospective monetary policy is important to the market for two related reasons. First, the Fed controls the federal funds rate quite tightly day to day; the yield on, say, a 13-week Treasury bill is importantly determined by investor expectations of the average overnight federal funds rate over the next 13 weeks. Over longer and longer horizons, the Federal Reserve has less and less discretion over interest rates, because the central bank cannot set nominal rates for long periods independent of fundamental economic forces. We can best think of the Fed as adjusting the federal funds rate as required over longer periods to achieve its policy objectives, the most important of which is control over the price level. Suppose, for present purposes, that the Fed's target inflation rate is 3 percent. If economic fundamentals require a market interest rate averaging 3 percent to be consistent with inflation of about 3 percent, then the Fed will on average end up with a fed funds target of 3 percent. If, instead, the fundamentals require a 5 percent market interest rate to be consistent with a 3 percent inflation rate, then on average the Fed will end up with a fed funds target of 5 percent. It is in this sense that the Fed wants to adjust the fed funds rate to match, as best it can, the equilibrium interest rate, where the equilibrium is determined by fundamentals beyond the Fed's control.

The market knows that the Fed has certain policy objectives. The Fed has repeatedly argued that the most important of its objectives is low inflation—an objective that the SOMC has applauded. If the market has confidence in the Fed's objectives, its backbone, its political skill in pursuing its objectives, and its technical competence, then it is rational for the market to form its expectations about many aspects of the future course of the economy by watching what the Fed says and does. When the Fed raises the fed funds rate, the market rationally expects a stronger economy and/or greater inflationary pressures than it did before the Fed acted. The market acts just as I would if I went to a race track; as one totally uninformed about horses, I would place my bets by watching what a skilled and experienced player did (if I could identify such a person) and not by following my own poorly informed opinion.

Nominal interest rates change, then, partly because market expectations about future inflation change and partly because expectations about future Fed actions change. When the Fed adjusts the federal funds rate, longer-term interest rates change based on the market's assessment of the significance of the funds rate change. To the extent that interest rate changes reflect expectations of changes in Fed policy, the Fed cannot extract from interest rates reliable information about inflation expectations and/or real rates. For example, as reported CPI inflation rose last spring and interest rates tended to rise also, did the rise in rates reflect an increase in inflation expectations or an expectation that the Fed would soon respond to higher current inflation by raising the fed funds rate? Without a direct reading on inflation expectations, there is no way to know.

In short, the greater the market's confidence in the Fed, the more the market will concentrate on predicting what the Fed will do and the less the market will concentrate on forming its own expectations about future inflation. Greater market confidence in the Fed, then, yields interest rate behavior that is less informative to the Fed because rates will be heavily influenced by expectations about future Fed policy rather than by expectations concerning economic fundamentals such as the inflation rate. The Fed should not employ the market rate as a guide to its policy actions but should instead seek guides to policy that are not circular.

Finally, an important function of an announced guide to monetary policy is to provide information to the market about the direction of Fed policy. Monetary aggregates, for all their problems, have provided quantitative information to the market. At the present state of knowledge, there is no possibility that the Fed will be able to announce an informative quantitative target for the real interest rate that will provide useful information to the market.

WHY HAS THE FED FLOATED THE REAL INTEREST RATE GUIDE?

My reading of Chairman Greenspan's testimony, and the Fed's "Monetary Policy Report to the Congress Pursuant to the Full Employment and Balanced Growth Act of 1978," suggests to me that the Fed's main motivation in discussing real interest rates is an effort to provide a little running room to raise the federal funds rate if necessary. Having latched onto M2 as its main monetary aggregate indicator a few years ago, the Fed is now discomfited by the slow growth of M2 at a time when experience suggests that interest rates will be soon rising as is normal during a period of cyclical expansion. To my taste, the Fed has made a mistake in suggesting that the real interest rate can serve as a substitute guide for monetary aggregates, but there is no denying that the Fed must have political room to raise the funds rate if necessary, and that it may soon be necessary.

Reading recent monetary policy statements of all kinds from the Fed leaves no doubt in my mind that the Fed is keenly aware that its main responsibility is to control inflation. I believe that the Fed is working above all to keep the inflation rate from rising to any significant extent, and if possible to ease the rate down, while supporting continuing growth in real output. I think this is the correct policy goal, and that the issues concern the Fed's ability, both technically and politically, to adjust interest rates as required to achieve its goal.

Given that M2 growth has been at or below the Fed's announced target range, some argue that the Fed should lower the federal funds rate; there would certainly not seem to be a strong case to raise rates. Other information, though, suggests that rate increases may well be appropriate, if

not now then in the near future. Some observers say rate increases are overdue. In any event, the Fed's problem is to develop political room and market understanding of the possible need to raise rates. Rather than elevate the real rate to the status of a policy guide substituting for M2, it would have been better for the Fed to refer to M1 and the monetary base, and other information including real rates, as providing evidence that measured M2 growth is providing a downward-biased measure of the thrust of monetary policy. The Fed should hang onto the monetary aggregates, even if the ranges have to be relatively wide, because with all their problems, there is no clearly better substitute around.

I believe that there is a strong case for the proposition that the Fed's actual policy over the last ten years has produced a better outcome for the economy than would have been the case if the Fed has pursued a monetary aggregates target in a rigorous way. It is still true, however, that total disregard of monetary aggregates is an invitation for trouble, as Britain discovered in the second half of the 1980s when it substituted an exchange rate target for aggregates targets. When the various monetary aggregates are all pointing in the same direction and when their growth rates are substantially above or below recent experience, then we will have a situation requiring prompt action to avoid big trouble. We should hope that such a situation will not arise, but perhaps the surest way to crate it is to ignore money growth.

Floating the idea of the real interest rate as a guide to policy could turn out to be a miscalculation for another reason. Suppose market interest rates start rising, but reported inflation and inflation surveys remain about the same or decline. With market real rates apparently rising, Fed critics could argue that the policy is getting tighter by the Fed's own standard. Of course, the Fed could argue that the equilibrium real rate is also rising, but given that the behavior of the equilibrium real rate is at best a guess and given that Fed critics might have little interest or competence to appreciate the relevance of the equilibrium rate concept, the Fed's reply might carry little weight. Substantial growth in monetary aggregates accompanying rising market interest rates would be a true danger sign that policy was dangerously expansionary.

The Fed should, I believe, reinforce the basic message of the value of monetary aggregates targets, especially if the behavior of the aggregates reinforces other information, and should downplay the usefulness of the real interest rate as a guide to policy.

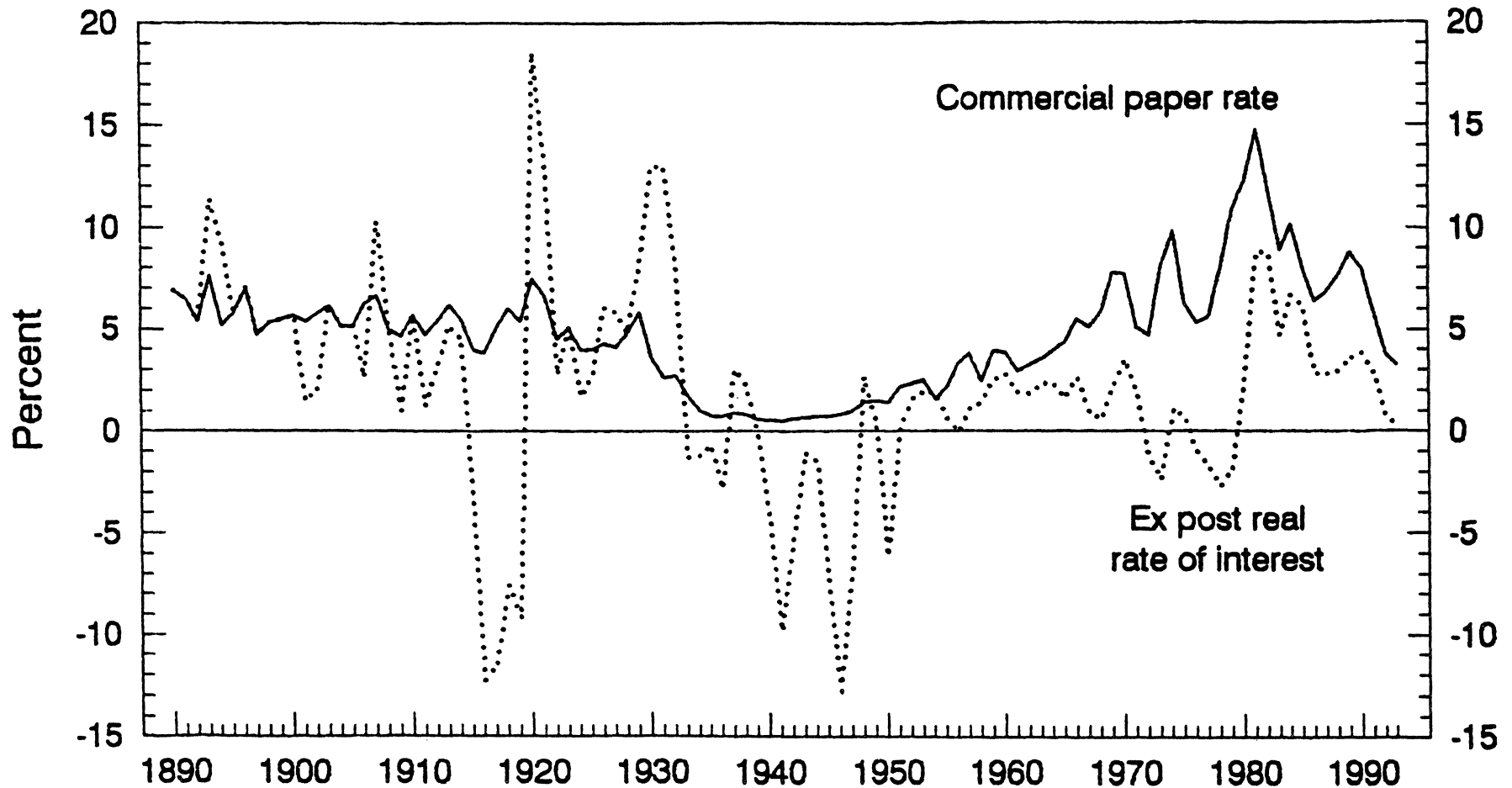
Notes

*I thank Data Resources, Inc. for providing access to its data bank, from which I drew most of the data for the figure.

¹Some analysts define the real rate as the nominal rate minus the inflation rate over a recent period, such as the most recent twelve months. This "trailing" definition is inadequate at best and dangerous at worst. For example, when inflation and inflation expectations are rising, the *ex ante* real rate will be below, and possibly much below, the trailing real rate. Monetary policy can be dangerously expansionary as measured by the *ex ante* real rate while appearing restrictive by the trailing real rate.

Nominal and Real Rates of Interest

Annually, 1890-1993



September 12-13, 1993

88

1993 observation is January-June average
commercial paper rate less assumed inflation
rate of 3 percent.