

**SHADOW OPEN MARKET COMMITTEE
(SOMC)**

Policy Statement and Position Papers

September 11-12, 1994

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TABLE OF CONTENTS

	Page
Table of Contents.	i
SOMC Members	ii
SOMC Policy Statement Summary.	1
Policy Statement	3
The Cost of Go-Stop-Go H. Erich Heinemann.	9
Budget Progress? Mickey D. Levy.	29
Economic Outlook Mickey D. Levy.	39
M2 and Base Growth Allan H. Meltzer.	61
A Note on Recent U.S. Productivity Growth William Poole	65
Recent Behavior of M2 Robert H. Rasche.	73
Myths in the Report of the Bretton Woods Commission Anna J. Schwartz.	77

SHADOW OPEN MARKET COMMITTEE

The Shadow Open Market Committee met on Sunday, September 11, 1994 from 2:00 PM to 6:30 PM in Washington, D.C.

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SOMC POLICY STATEMENT SUMMARY

Washington, D.C., September 12—The Shadow Open Market Committee warned the Federal Reserve today not to "overreact to a short-term increase in inflation." The SOMC, a group of academic and business economists who regularly comment on public policy issues, predicted that inflation would increase "near-term as a delayed response to the excessive money growth of the past." The Federal Reserve's goal, the SOMC said, "should be to achieve stable prices over time as a means of promoting real economic growth."

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

In its policy statement, the Shadow Committee stated that "inflation is caused by excessive aggregate nominal demand, not by real economic growth. The main reason for current concern about inflation is, as always, past growth of money and the monetary base—the excessive monetary stimulus that we criticized in 1992 and 1993."

The SOMC rejected the theory that the Federal Reserve should wait until the economy was close to full employment before acting to reduce inflation. This recommendation is not new, the Committee said. "It calls for a return to the policies that failed in the 1960s and 1970s...Rising inflation was the unintended consequence of a policy program to trade higher inflation for temporary increases in growth and employment."

The committee also criticized Federal Reserve chairman Alan Greenspan for using "a shifting series of indicators to describe monetary policy. Gold, commodity prices, real interest rates, the neutral interest rate, and other measures are put forward as guides to past or future policy. The one measure that is hardly ever mentioned is the one the Federal Reserve controls—MONEY. We continue to urge the Federal Reserve to control growth of monetary aggregates and to use the information about future inflation provided by sustained growth of the monetary aggregates."

The SOMC reviewed the performance of the World Bank and the International Monetary Fund, now 50 years old. "The two institutions could be eliminated or replaced by a single smaller agency with limited functions: (1) certification and information gathering, and (2) making transfers or concessional (subsidized) loans to the poorest countries.

September 11-12, 1994

"The Fund and the Bank are able to obtain information from member countries more readily than private lenders. Certification is relied on by private lenders and investors. Governments, acting together, make transfers and concessional loans to the poorest countries in the world. Although such loans often delay reform, they are likely to continue. An institution with information about the countries and their policies can play a modest role by combining transfers with advice and encouragement of reform."

SHADOW OPEN MARKET COMMITTEE

Policy Statement

September 12, 1994

The Federal Reserve has moved decisively to sustain long-term growth and reduce future inflation. The Shadow Open Market Committee applauds the Federal Reserve's actions this year and President Clinton's support of its actions.

Since March, year-to-year growth of the monetary base—bank reserves and currency—has fallen from above 10 1/2 percent to about 9 1/4 percent. For the past six months the base has increased at an 8 percent annual rate. This is the maximum rate we recommend at our meetings in September 1993 and March 1994. We are now on a path that, if sustained, is consistent with inflation of 2 to 3 percent. Modest further reductions are necessary if price stability is to be achieved. Therefore, the Federal Reserve should reduce base growth to 7 percent in 1995.

MONETARY POLICY

The effects of current policy actions on inflation will not be fully evident for months. We expect inflation to increase near-term as a delayed response to the excessive money growth of the past. The Federal Reserve should not overreact to a short-term increase in inflation. The goal should be to achieve stable prices over time as a means of promoting real economic growth.

Inflation is caused by excessive aggregate nominal demand, not by real economic growth. The main reason for current concern about inflation is, as always, past growth of money and the monetary base—the excessive monetary stimulus that we criticized in 1992 and 1993. The Federal Reserve was slow to respond to the prospect of inflation. The first response in February was a small and hesitant step. But the cumulative impact of Federal Reserve actions in 1994 has lowered base growth to a more appropriate range.

A year ago we warned that more rapid growth of the monetary base relative to growth of nominal GDP would remain compatible with low inflation only if the public continued to add to cash balances at a 5.5 percent annual rate. This would have required a continued decline in long-term

interest rates. We were skeptical that this would occur. We expected interest rates to rise and growth of average cash balances to slow relative to nominal GDP. For the year ending June, growth of average cash balances (M1/GDP) slowed almost to zero and long-term interest rates rose.

We remain concerned, however, about the Federal Reserve's analysis and discussion of monetary policy. There are two principal issues. One is reliance on the alleged relation between inflation and unemployment or real growth. The other is the reliance on an ever-changing set of indicators to guide monetary policy.

Some have urged the Federal Reserve and other central banks to rely on the relationship between inflation and unemployment known as the Phillips Curve. They argue that a central bank can reduce unemployment for as much as two or three years without risk of inflation. On this theory, the time for action to reduce inflation is when the economy is close to full employment.

This policy recommendation is not new. It calls for a return to the policies that failed in the 1960s and 1970s. Policymakers in that period did not intend to create rising inflation. Rising inflation was the unintended consequence of a policy program to trade higher inflation for temporary increases in growth and employment.

Attempts to exploit this tradeoff have always failed. It has taken many years to rid the economy of the effects of a decade or more of mistaken policies. A main lesson of the recent experience is that estimates of a Phillips curve tradeoff are unreliable guides for policy.

In his testimony to Congress and in public statements, Chairman Greenspan uses a shifting series of indicators to describe monetary policy. Gold, commodity prices, real interest rates, the neutral interest rate, and other measures are put forward as guides to past or future policy. The one measure that is hardly ever mentioned is the one the Federal Reserve controls—MONEY. We continue to urge the Federal Reserve to control growth of monetary aggregates and to use the information about future inflation provided by sustained growth of the monetary aggregates.

THE ECONOMY, THE BUDGET AND THE ADMINISTRATION

The budget deficit has fallen. The basic budget, net of interest payments, is again in surplus. The administration boasts about the decline in the budget deficit and takes credit for the change. Its claim, repeated many times, was that deficit reduction lowered interest rates and stimulated the economy.

Competent economists know that this argument is false. Tax increases do not increase growth. Changes in the deficit have, at most, modest effects on interest rates. Interest rates typically rise and fall with economic growth and expected inflation.

Interest rates were lower a year ago because economic growth was slow and inflation was subdued. Since that time, the average growth rate has more than doubled. Growth has been about 4 percent for the last four quarters. As we expected, interest rates rose with growth and with increased concern about future inflation.

Recent reductions in the deficit have resulted from the unwinding of the Resolution Trust Corporation (RTC), reductions in defense spending, and legislated tax increases. The RTC spent \$66 billion in 1991 to bail out failed thrift institutions. In 1993, the RTC made a net contribution of \$28 billion by selling assets, a contribution of \$94 billion toward a lower deficit. Net contributions from the RTC will continue this year and next.

Since 1989, defense spending has fallen from 27 percent to 19% of government outlays. However, the administration has increased our current or future military commitments as it has reduced military spending. This inconsistent strategy can lead to an inability to fulfill commitments.

Legislated tax hikes reduce saving and investment and lower long-term economic growth. Long term, higher taxes reduce economic activity. They should not be confused with fiscal responsibility.

THE LONGER-TERM OUTLOOK

The administration assumes that long-term growth is about 2 1/2 percent a year or slightly higher. To sustain this growth rate, productivity growth must return to a growth path that has not been sustained since the early 1970s. We doubt that this will be achieved. With current labor force growth about 1 percent a year, the economy's long-term growth path is not much more than 2 percent.

Slower productivity growth will reduce tax revenues below projections. By 1998 at the latest, budget deficits will start to rise as a share of GDP. The principal reasons are well-known—rising spending for entitlements, particularly health care. After 1998, caps on discretionary spending expire. These caps are estimated to reduce discretionary spending by 2 percent of GDP between 1993 and 1998. Removing the caps may be followed by a new surge in discretionary spending.

It is irresponsible to offer new entitlements for health care, welfare, and other social purposes. These expenditures will increase consumption at the expense of investment and slow long-term growth. The costs will be paid by our children, and their children, because we will save and invest less and leave them a small capital stock.

The budget problem is a spending problem and an allocation problem. More than 100 percent of the rise in budget deficits corresponds to the rise in transfer payments. Until growth of these programs is controlled, the programs will continue to be financed either by future generations or by selling assets to foreigners.

THE FUND AND THE BANK AT FIFTY

The International Monetary Fund and the World Bank were conceived at Bretton Woods in 1944 and began life after World War II. The Fund was given responsibility for supervising the operation of the fixed exchange rate system. The Bank was to be responsible for lending to reconstruct wartime damage and for development.

The fixed exchange rate system ended in 1973. Since that time, the IMF has looked for tasks to perform. It took responsibility for lending and credit certification during the debt problems of the 1980s. It stretched out the problem and delayed its resolution. Most recently, the industrialized countries gave the IMF a leading role as a lender to Russia and other former members of the Soviet bloc. Most the funds lent to these governments has been offset by capital flight from Russia. IMF lending thus helped to finance capital flight.

The Bank was organized on the presumption that markets would supply few loans to developing countries. The debt problems of the 1980s showed that, for many countries, this presumption was wrong. A number of countries borrowed more than they were able to repay. The availability of loans from the World Bank and other international agencies at reduced interest rates encouraged developing countries to borrow, to close their markets to equity investors, and to restrict foreign ownership of domestic assets.

The policy of relying on government borrowing was not in the interest of the borrowing countries. Several countries have recognized their previous mistakes and changed their policies. Private capital is now welcome in Mexico, Chile, Argentina, Peru, and in much of Asia.

The success of a market-based approach to lending and borrowing raises questions about the appropriate roles of the Bank and the Fund. What do these institutions do that cannot be done as efficiently, or more efficiently, by private lenders? Although the Bank has a subsidiary to lend to private investors, the Bank and the Fund lend mainly to governments. The functions of the two institutions overlap much more than in the past; there is duplication without the gains from competition. Both continue to lend for stabilization or adjustment. Many of the short-term loans, in which the Fund specialized at an earlier time, roll over and are extended for longer terms. They are, in fact, long-term loans. The Bank no longer concentrates on projects such as dams and roads. It, too, lends to facilitate adjustment.

The two institutions could be eliminated or replaced by a single smaller agency with limited functions: (1) certification and information gathering, and (2) making transfers or concessional (subsidized) loans to the poorest countries. The Fund and the Bank are able to obtain information from member countries more readily than private lenders. Certification is relied on by private lenders and investors. Governments, acting together, make transfers and concessional loans to the poorest countries in the world. Although such loans often delay reform, they are likely to continue. An institution with information about the countries and their policies can play a modest role by combining transfers with advice and encouragement of reform.

THE BRETTON WOODS (VOLCKER) COMMISSION

These proposals differ from the recent report of the Bretton Woods Commission chaired by Paul Volcker. The Commission offers myths about both the past the present and misguided policies for the future.

The Bretton Woods system of fixed but adjustable exchange rates broke down because the system was flawed. The main flaws in the system were: (1) no effective restriction on U.S. inflation, (2) no mechanism for devaluing the dollar when the U.S. inflated, and (3) no recognition of changes in the real terms of trade. The result was inflation in all major countries and misaligned exchange rates. Years of meetings and official discussions never resolved the system's problems. All the policymakers were able to agree on was creation of some useless pieces of paper called special drawing rights.

The present international monetary system is not ideal. Improvement will only come about if each major country chooses to pursue fiscal and monetary policies to achieve sustained growth and price stability. No shortcuts or clever schemes for coordinating actions can substitute for

September 11-12, 1994

disciplined policies. Attempts to block market adjustment of exchange rates by government policy are disruptive and costly. The Commission's proposals for "better international policy coordination aimed at stabilizing exchange rates" deserve the neglect they will surely get.

THE COST OF GO-STOP-GO

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Action by the Federal Reserve System to boost the discount rate and the Federal funds rate to 4 and 4.75 percent, respectively, will make a tight monetary policy even tighter. While the Fed's money squeeze is not likely to put a noticeable dent in the economy in 1994, it will increase the risk of recession in 1996.

Business activity has already slowed, but our work suggests that the deceleration was more a result of fiscal drag from higher marginal tax rates than from monetary restraint. Productivity was down in the second quarter, as we predicted last spring.

Inventories of electronic gear have started to build, and producers of heavy construction equipment say they see signs of softening in their order books particularly for publicly funded projects. Real retail sales fell in July. Total vehicle sales have dropped substantially. Single family housing starts have been flat since October.

Exports remain an area of remarkable strength. Real merchandise exports were a record \$484 billion at a seasonally adjusted annual rate in the second quarter, up more than 9 percent from 1993. That was almost double the growth of 5 percent one year earlier. We doubt that U.S. export sales can grow at this rate for an extended period. More likely, real exports will continue to rise along the 7 percent trend line typical since 1989.

American producers regularly achieve trade surpluses in four major sectors: services, industrial materials other than oil, capital goods other than automobiles and agriculture. In the nation's overall balance of trade, these areas of comparative advantage are more than offset by ongoing deficits in oil, consumer goods and automobiles.

In the wake of the Federal Reserve's rate action, officials may postpone the next increase in their interest rate target until after the mid-term elections in November. Meanwhile, bonds are oversold. The trading rally in bonds could bring yields close to 7 percent.

Assuming the monetary authorities continue on their current course over the next 18 to 24 months, then the risk of a recession during the 1996 Presidential campaign should rise substantially. The longer the money squeeze continues, the deeper that downturn is likely to be. Conventional wisdom notwithstanding, we believe that higher inflation is on the way—not because employers hired too many low-skill workers, but because the Fed printed too many high-powered dollars.

We think inflation is likely to accelerate to a range of 4 to 5 percent in 1995, regardless of actions that the central bank may or may not undertake in 1994. Aftereffects from easy money in 1991, 1992 and 1993 have already put their price structure into motion.

The Federal Reserve conducts monetary policy by setting a target for short-term interest rates. Since Fed officials cannot control day-to-day demand for short-term credit (or even know what that demand may be), they must supply whatever amount market players want at that target price.

Incoming economic data suggest that the Fed's current target of 4.75 percent for overnight money market loans (the Federal funds rate) is above market equilibrium. Consequently, the money managers must reduce the supply of bank reserves to prevent rates from falling.

Total bank reserves, the high-powered money that is raw material for the money supply, dropped sharply in the first half of August to a level \$1.4 billion below that of last February. Since last fall, reserve growth has declined substantially (Chart 1). At present, reserves are slightly lower than they were in October 1993. By contrast, from July 1992 to October 1993, reserves rose at a 16 percent rate. The abrupt closing of the monetary faucet has been a principal factor triggering the slump in the prices of financial assets thus far in 1994.

There is little that monetary policy can do to prevent inflation from accelerating, but the central bank could do a lot of damage by forcing an unsustainable contraction in the money supply. That course would continue the go-stop-go pattern of Fed policy. Policy that is too tight begets policy that is too easy, just as policy that is too easy begets policy that is too tight. There is a golden mean, but the Fed has not found it.

The mantra in Manhattan is that rising employment leads to higher wages and that higher wages fuel inflation. We believe that the analysis is wrong, but that the conclusion is right. Higher inflation is on the way. However, rapid growth in payroll jobs suggests weakness as much as strength. In July, as has been the true since 1991, most the new jobs were low-productivity, short-hour and low-pay.

Moreover, since January the number of jobs has risen by 1.9 million, but the number of workers has gone up only 556,000. This indicates that people are taking second and third (presumably part-time) jobs to maintain family income. Growth in full-time employment has indeed been sluggish.

The low quality of the ongoing growth in jobs shows clearly in the data on personal income. Real after-tax income per job declined from March to June and has grown at an annual rate of less than 1 percent over the past two years—indeed over the last 20 years. That indicates a weak foundation for sustained expansion in consumer spending.

The rapid rise in the employee headcount in a relative handful of industries (generally with the lowest productivity) implies that profit margins in these businesses are—or soon will be—under downward pressure. If profitability declines, then hiring will soon slow—most likely before the mid-term elections this fall.

At the national level, productivity dropped during the second quarter. Total hours worked rose at a rate of 6.47 percent, the highest in a decade, but output of goods and services went up only 3.7 percent. The Commerce Department said gross real product per hour in the nonfarm business sector fell at a rate of 1.4 percent this spring, in contrast to a 3.3 percent gain in the first quarter. This negative swing implied substantial negative pressure on profit margins.

Consumer spending rose at a \$10.8 billion rate in the second quarter down from the \$40 billion increase during the winter months. Most of the slowdown was in durable and nondurable goods, but service spending also rose at a slower pace.

Total vehicle sales were at an annual rate of 13.8 million units in July, down by almost 1 million units from the prior month—the fourth consecutive monthly drop. Vehicle sales averaged 14.4 million units at seasonally adjusted annual rates in the last three months, down at a 21 percent rate from the comparable period ending in March.

Consumption has been rising faster than real income for more than two years. This cannot continue—income will pick up, spending will slow, or some combination. This spring, both incomes and spending were slower, but spending slowed more than income.

Sales of new homes fell sharply in June. Leading homebuilders say a substantial recovery from the June sales level is not likely. A slump in home sales will likely translate to lower housing starts and cuts in construction jobs during the summer and fall. "Normal" links between housing starts and bond yields appear to support this conclusion.

Investors should recognize that the current expansion is narrow and therefore vulnerable to a setback. Since 1991, real GDP has risen \$441.3 billion. Volatile, cyclical sectors of the economy—consumer durables, business plant and equipment investment, housing and inventories—accounted for \$376.2 billion or 85.2 percent, of the gain.

Normally, the cyclical sectors are about one-quarter of the economy. Currently, these chronically unstable industries make up 27.7 percent of GDP, the highest since data were first compiled in 1929. Relatively stable noncyclical sectors (about 75 percent of the economy) have accounted for less than 15 percent of the expansion.

In capital goods, demand has focused narrowly on information processing and related equipment and trucks and buses. Other types of investment are at a 35-year low as a share of GDP (Chart 2).

Inflation accelerated in the second quarter. The fixed-weight deflator for gross domestic purchases rose at a rate of 3.2 percent, up from 2.5 percent. Ladenburg's Baseline Forecast indicates inflation will accelerate to a 5 percent rate in 1995, a delayed response to the Federal Reserve's easy money from 1991 through 1993.

Consumer spending was surprisingly soft in the second quarter. Real personal consumption goods rose at an annual rate of only 1.8 percent during the April-June period, down from 5.4 percent in the first three months of the year and 6.3 percent in the fourth quarter of 1993. A drop in auto sales played a major role in the slump, but real outlays for nondurables were down too.

Other major sector of GDP—fixed investment, net exports and government—either slowed or exerted a drag on economic activity. The real value of business investment in equipment was up at a rate of 6.5 percent in the second quarter, down from 10.6 percent last winter and 27.5 percent during the final three months of 1994.

The only big uptick in the second quarter was business inventories. Stocks of unsold goods accounted for \$31 billion of a total second-quarter gain of \$49 billion in real GDP. Real final sales to domestic purchasers appear to have risen at a rate of 2 percent, down from 3.9 percent in the first quarter and 6 percent in late 1993.

Much of the inventory surge was in imports. Nevertheless, cutbacks in production seem inevitable. That should set the stage for more sluggish expansion during the second half of 1994 in a range of 2.5 to 3 percent (see the attached Baseline Forecast). You should note the anomaly

of the surging job count this spring, accompanied by a slowdown in final demand ("A Million Jobs in a Slowing Economy"). Four business sectors accounted for the bulk of the hiring both in the second quarter and the expansion that officially started in the second quarter of 1991.

Construction, retailing, business services (including temp jobs) and health services were responsible for 67 percent of the 930,000 jobs that private employers added in the April-June period. That was somewhat below the average of 75 percent over the last three years.

We believe these employers are not beginning to add new workers at a marginal loss. Put simply, if a firm adds 100 people to its payroll, the unit profit on their additional output will be less than average unit profits on the output for the previous, smaller work force. This pattern appears to be a replay of 1988 and 1989, when marginal losses in private services set the stage for the 1990-1991 recession.

The service sector has dominated U.S. employment for a half century. Service producing industries account for more than 90 of every 100 jobs that employers have added since World War II—more than 71 in private firms and 19 in government.

Construction and non-production jobs in manufacturing accounted for the balance. Production employment in manufacturing hasn't changed since 1946, even though output is up more than 500 percent.

The growth rates of population, the labor force and total employment all slowed markedly in the 1990s. In the last five years, the number of payroll jobs rose 3.97 million, compared to average five-year growth of 6.1 million since 1946. A total of 3.75 million (95 percent) of these new jobs were in the Big Four sectors—construction, retailing, business services (including temp jobs) and health services.

More than 62.3 percent of the civilian population over age 16 was working during the second quarter, just seven-tenths of a point below the record in the first quarter of 1990. There were 122.4 million workers in June, 66 million men and 53 million women. More than 100 million workers had full-time jobs. The bulk of the 22 million people working part-time (17.3 million or 78 percent) were doing so voluntarily.

Large-scale displacement in the workplace of older, experienced men by younger, less experienced women appears to be coming to an end. Women aged 25 to 44 were 13.6 percent of the civilian workforce in 1960, 24.9 percent in 1991 and 24.5 percent today. Men aged 45 to 64

were 23.3 percent of workers in 1960, 14.7 percent in 1991 and 15.3 percent today. The change in the age and sex composition of the work force coincided with a slowdown in growth of productivity and real income per worker.

Most employment gains since 1991 have been in smaller states. Total employment in California, New Jersey and New York averaged 25.7 million in the second quarter, down 969,000 from the peak in second quarter of 1990. Elsewhere employment is up.

All three states have relatively high taxes and government regulation. The European community has the most comprehensive system of social services and taxes to match. It now has average unemployment of more than 11 percent, compared to 6 percent in the U.S.

As a result, productivity and profitability were down in the handful of industries that have done most of the hiring. The implication is that the second quarter spike in hiring won't continue. This conclusion is supported by our analysis of the main reasons why the economy slowed.

One, in recent months, real retail sales have averaged more than 51 percent of real after-tax income, by far the highest since 1959. As a result, the personal savings rate slumped to a 45-year low during the past year. Against this setting, consumers were bound to cut back.

Two, the basic federal budget (exclusive of net interest payments) moved to a substantial surplus in the first half of 1994 compared to a peak deficit of \$103.1 billion in third quarter of 1992. Our data suggest the basic budget is the best measure of the impact of the sharp reduction in deficit spending.

Three, the Federal Reserve has shifted to tight money. To date, Fed actions have had little effect on the real economy. The central bank must sustain a restrictive policy for an extended period to change spending patterns. Obviously, however, the longer tight money persists, the greater the risk of an economic downturn.

Conventional wisdom is that a slower growth rate signifies a corresponding drop in the risk of inflation. We disagree. The rate of inflation rose 50 to 75 basis points in the second quarter of 1994. The consumer price index, the CPI minus food and fuel (so-called core inflation) and the overall producer price index all showed faster rates of increase during the spring quarter than last winter.

While the rates of increase in these broad-based indices are still modest (mostly about 3 percent or less), they show clear signs of having bottomed for the current business cycle. The most

dramatic change was the consumer price index for commodities, which rose at a 2.1 percent annual rate. Over the prior 10 months, this measure of the prices people pay for goods rose a rate of nine-tenths of one percent. Higher oil prices are likely to add to the acceleration.

Both the timing and the amount of the pickup in prices are consistent with our forecast of stagflation in 1995 (see the Baseline Forecast). We believe inflation is caused by government printing too many dollars, not by employers hiring too many workers. Thus, despite 8 million unemployed workers, prices are moving higher. Long-term rates have gone up almost 200 basis points as market participants hedge the pending erosion in the real value of their principal.

During 1991, 1992 and 1993, the Federal Reserve increased total reserves in the U.S. banking system by almost 50 percent. Total reserves, the raw material for the money supply, are the best indicator of Federal Reserve policy. Recently, sustained accelerations and decelerations in the growth of total reserves have influenced price behavior with a lag of about three years (Chart 3).

We believe that the low rate of inflation in the last year and one half was a direct result of an exceptionally tight monetary policy from 1987 through 1990 (Chart 3). We also believe that the inflationary influence of easy money from 1991 through 1993 will be increasingly apparent in the months ahead.

Leading indicators of inflation are easy to see. Commodity prices have gone up as they always do at this stage of the cycle. The price of gold is flirting with \$400 an ounce. However, these indicators are symptoms of the inflation process. The underlying cause is record growth in domestic spending money, fueled by expanding bank reserves.

Rapid money growth lies behind the increase in national income to an average of \$5.3 trillion in the first quarter. That represented a 7 percent rate of gain during the past one and one-half years—more than double its growth from 1990 through 1992. More dollars are chasing the available supply of goods.

LADENBURG, THALMANN / HEINEMANN ECONOMIC RESEARCH

Baseline Forecast - September 1994

	IV'93 A	I'94 A	II'94 A	III'94 F	IV'94 F	I'95 F	II'95 F	III'95 F	IV'95 F	1993 A	1994 F	1995 F
THE ECONOMY:												
Gross Domestic Product (\$87)	\$5,218.0	\$5,261.1	\$5,310.2	\$5,344.6	\$5,374.8	\$5,407.3	\$5,438.9	\$5,469.7	\$5,497.4	\$5,134.6	\$5,322.7	\$5,453.3
Pct Chg	6.26%	3.35%	3.79%	2.6%	2.3%	2.4%	2.4%	2.3%	2.0%	3.12%	3.7%	2.5%
Personal Consumption (\$87)	\$3,506.2	\$3,546.3	\$3,558.6	\$3,577.7	\$3,606.0	\$3,625.6	\$3,645.9	\$3,666.9	\$3,682.7	\$3,458.7	\$3,572.2	\$3,655.3
Pct Chg	3.97%	4.65%	1.39%	2.2%	3.2%	2.2%	2.3%	2.3%	1.7%	3.26%	3.3%	2.3%
Business Investment (\$87)	\$627.2	\$643.6	\$657.9	\$675.5	\$688.4	\$702.5	\$713.3	\$725.8	\$736.3	\$591.6	\$666.3	\$719.5
Pct Chg	21.09%	10.88%	9.19%	11.1%	7.9%	8.5%	6.3%	7.2%	5.9%	12.49%	12.6%	8.0%
Structures (\$87)	\$148.7	\$144.1	\$150.7	\$151.9	\$153.5	\$156.5	\$158.5	\$159.9	\$163.3	\$147.7	\$150.1	\$159.5
Prod. Dur. Equip. (\$87)	\$478.5	\$499.4	\$507.3	\$523.6	\$534.8	\$546.1	\$554.8	\$565.9	\$573.0	\$443.9	\$516.3	\$560.0
Residential Invest. (\$87)	\$224.5	\$229.9	\$240.0	\$240.6	\$240.1	\$243.1	\$245.5	\$244.7	\$247.2	\$213.1	\$236.1	\$245.1
Pct Chg	28.16%	9.97%	7.33%	11.7%	-0.8%	5.2%	4.0%	-1.3%	4.1%	8.17%	10.8%	3.8%
Change in Inventory (\$87)	\$10.8	\$25.4	\$56.3	\$51.3	\$48.3	\$46.7	\$50.5	\$55.5	\$59.5	\$15.3	\$45.3	\$53.1
Net Exports (\$87)	(\$82.2)	(\$104.0)	(\$112.9)	(\$120.1)	(\$128.7)	(\$132.5)	(\$139.2)	(\$147.5)	(\$153.4)	(\$73.9)	(\$116.4)	(\$143.2)
Government Purchases (\$87)	\$931.5	\$919.9	\$916.3	\$919.7	\$920.7	\$921.9	\$922.8	\$924.2	\$925.1	\$929.8	\$919.1	\$923.5
Pct Chg	-0.13%	-4.89%	-1.56%	1.5%	0.4%	0.5%	0.4%	0.6%	0.4%	-0.76%	-1.1%	0.5%
Final Domestic Sales (\$87)	\$5,289.4	\$5,339.7	\$5,366.8	\$5,413.4	\$5,455.2	\$5,493.2	\$5,527.6	\$5,561.7	\$5,591.3	\$5,193.1	\$5,393.8	\$5,543.4
Pct Chg	6.02%	3.86%	2.05%	3.5%	3.1%	2.8%	2.5%	2.5%	2.1%	3.67%	3.9%	2.8%
Gross Dom. Prod. (\$ Current)	\$6,478.1	\$6,574.7	\$6,685.5	\$6,792.3	\$6,898.9	\$7,012.7	\$7,122.8	\$7,250.9	\$7,374.2	\$6,343.3	\$6,737.9	\$7,190.1
Pct Chg	7.69%	6.10%	6.91%	6.5%	6.4%	6.8%	6.4%	7.4%	7.0%	5.37%	6.2%	6.7%
Disposable Income (\$87)	\$3,747.8	\$3,779.2	\$3,804.7	\$3,819.8	\$3,838.9	\$3,854.8	\$3,873.3	\$3,888.9	\$3,902.5	\$3,704.1	\$3,810.7	\$3,879.9
Pct Chg	4.32%	3.39%	2.73%	1.6%	2.0%	1.7%	1.9%	1.6%	1.4%	1.54%	2.9%	1.8%
Savings Rate (Percent)	4.0%	3.6%	3.9%	4.1%	3.9%	3.8%	3.7%	3.6%	3.5%	4.13%	3.9%	3.6%
Operating Profits (\$ Current)	\$533.9	\$508.2	\$547.3	\$553.3	\$560.0	\$566.7	\$572.3	\$578.0	\$581.3	\$485.8	\$542.2	\$574.6
Pct Chg	36.99%	-17.9%	34.5%	4.5%	4.9%	4.9%	4.1%	4.0%	2.3%	19.91%	11.6%	6.0%
Industrial Prod. (1987=100)	112.90	115.20	116.40	117.3	118.4	119.1	120.1	121.2	121.8	111.03	116.8	120.5
Pct Chg	6.76%	8.40%	4.23%	3.2%	3.9%	2.3%	3.2%	3.6%	2.0%	4.19%	5.2%	3.2%
Housing Starts (Mill. Units)	1.476	1.364	1.41	1.37	1.35	1.35	1.32	1.34	1.27	1.295	1.37	1.32
Pct Chg	61.00%	-27.07%	15.42%	-12.2%	-5.9%	2.0%	-9.6%	6.1%	-18.5%	7.21%	6.1%	-3.7%
Tot Vehicle Sales (Mill Units)	14.546	15.540	14.880	14.0	14.1	14.3	14.2	14.3	14.1	13.887	14.6	14.2
Pct Chg	32.49%	30.27%	-15.94%	-21.9%	2.4%	8.2%	-3.9%	2.4%	-5.7%	8.24%	5.3%	-2.6%
Nonfarm Payroll Jobs (Mill)	111.363	111.976	112.993	113.3	113.7	114.3	114.6	114.6	114.8	110.521	113.0	114.45
Pct Chg	2.21%	2.22%	3.68%	1.1%	1.2%	1.7%	0.7%	0.8%	0.9%	1.77%	2.2%	1.3%
Unemployment Rate (Percent)*	6.53%	6.57%	6.16%	6.1%	6.0%	5.9%	5.7%	5.6%	5.5%	6.75%	6.2%	5.7%
Comp. Per Hour Non-Farm Bus**	160.4	162.8	163.1	165.1	167.1	169.2	171.5	173.7	176.2	158.9	164.5	172.65
Pct Chg	2.5%	6.1%	0.7%	4.9%	5.1%	5.2%	5.4%	5.5%	5.7%	3.4%	3.6%	4.9%
Productivity Non-Farm Bus**	117.2	118.0	117.2	117.8	118.4	118.9	119.4	120.0	120.5	115.5	117.9	119.70
Pct Chg	4.9%	2.8%	-2.7%	2.1%	2.1%	1.5%	1.9%	1.9%	1.6%	1.6%	2.0%	1.6%
Unit Labor Cost Non-Farm Bus**	136.9	137.9	139.1	140.1	141.1	142.4	143.5	144.8	146.2	137.6	139.5	144.23
Pct Chg	-2.3%	3.0%	3.5%	2.9%	2.9%	3.6%	3.4%	3.6%	4.0%	1.7%	1.5%	3.4%
GDP Deflator (1987=100)	124.1	125.0	125.9	127.1	128.4	129.7	131.0	132.6	134.1	123.54	126.6	131.84
Pct Chg	1.35%	2.67%	3.01%	3.8%	4.1%	4.2%	4.0%	5.0%	4.8%	2.18%	2.5%	4.2%
CPI Less Energy (1982-84=100)	151.6	152.6	153.7	155.2	156.7	158.4	160.1	162.2	164.3	150.1	154.6	161.23
Pct Chg	3.07%	2.75%	2.91%	4.0%	3.9%	4.4%	4.5%	5.1%	5.3%	3.10%	3.0%	4.3%
Fed'l Deficit (\$ Current NIA)	(\$220.1)	(\$176.2)	(\$145.0)	(\$134.9)	(\$126.8)	(\$128.0)	(\$137.2)	(\$148.6)	(\$163.9)	(\$241.4)	(\$145.7)	(\$144.5)
FINANCIAL MARKETS:												
Federal Funds Rate	2.99%	3.21%	3.94%	4.6%	5.1%	5.5%	6.0%	6.3%	6.6%	3.02%	4.2%	6.1%
Three-month Bills (Discount)	3.06%	3.24%	3.99%	4.3%	4.8%	5.2%	5.6%	5.9%	6.3%	3.01%	4.1%	5.8%
Prime Rate, Major Banks	6.00%	6.02%	6.90%	7.4%	7.8%	8.0%	8.2%	8.4%	8.6%	6.00%	7.0%	8.3%
30-Year Treasury Bonds	6.13%	6.56%	7.36%	7.7%	8.1%	8.2%	8.4%	8.6%	8.8%	6.60%	7.4%	8.5%
Money Supply (M-1, \$ Current)	\$1,121.4	\$1,138.2	\$1,144.9	\$1,157.4	\$1,168.1	\$1,176.2	\$1,182.5	\$1,192.9	\$1,201.4	\$1,077.9	\$1,152.1	\$1,188.3
Pct Chg	9.80%	6.13%	2.4%	4.4%	3.7%	2.8%	2.1%	3.6%	2.9%	11.52%	6.9%	3.1%
Velocity (Ratio: GDP to M-1)	5.78	5.78	5.84	5.87	5.91	5.96	6.02	6.08	6.14	5.89	5.82	6.05
Trade-Weighted \$ (1973=100)	94.83	95.56	92.93	89.7	89.4	91.2	90.9	91.8	91.6	93.17	91.9	91.4

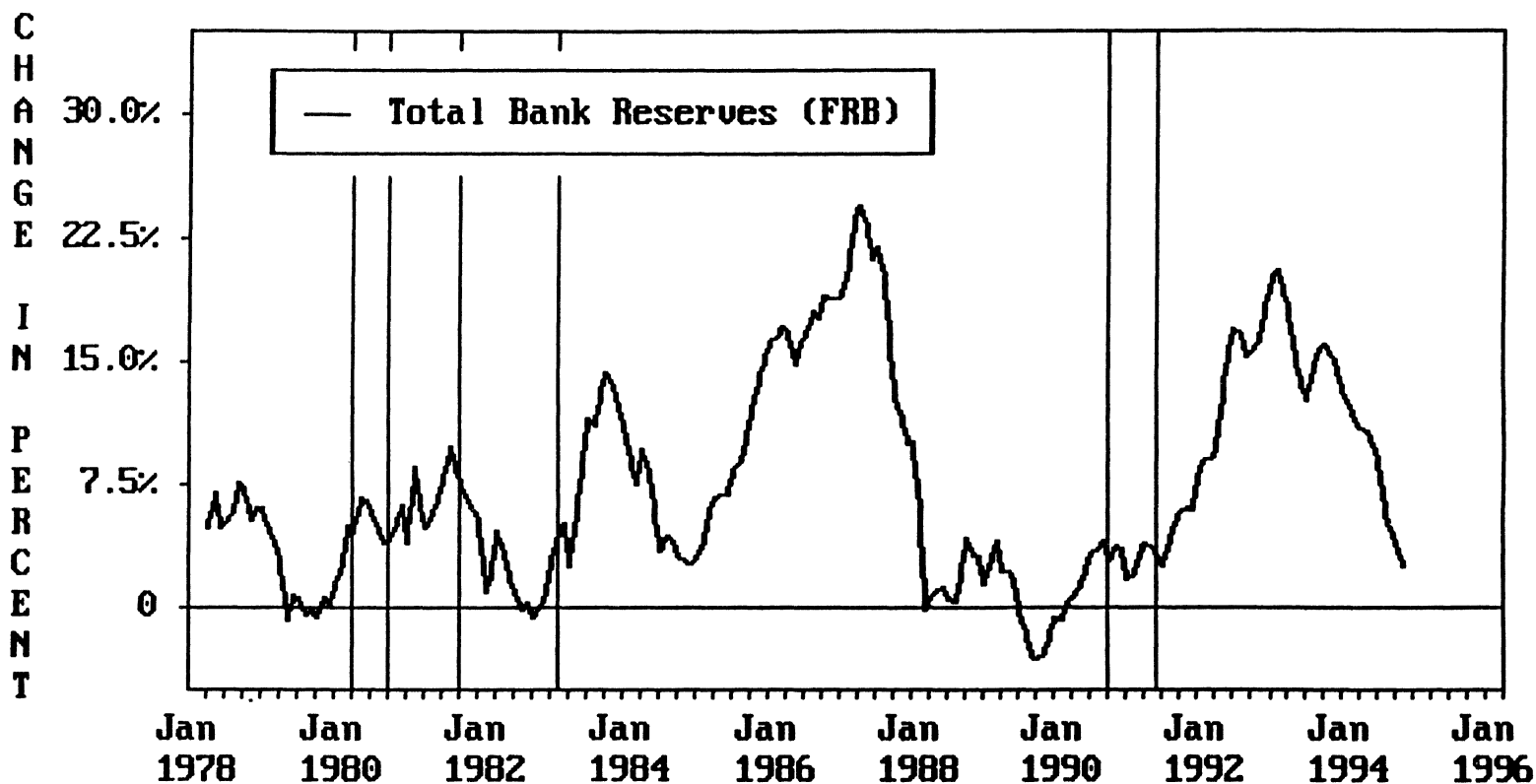
A=Actual F=Forecast Billions of dollars unless noted.

*Break in series, January 1994. **Compensation, productivity and unit labor costs are index numbers, 1982=100.

Sources: Haver Analytics; Heinemann Economic Research

	I'93 A		II'93 A		III'93 A		IV'93 A		1993 A	
THE ECONOMY:	\$ Change	Pct Chg	\$ Change	Pct Chg	\$ Change	Pct Chg	\$ Change	Pct Chg	\$ Change	Pct Chg
Gross Domestic Product (\$87)	\$14.6	1.16%	\$30.1	2.39%	\$34.2	2.69%	\$78.4	6.26%	\$155.3	3.12%
Personal Consumption (\$87)	\$13.8	1.10%	\$22.0	1.75%	\$33.0	2.60%	\$34.0	2.71%	\$109.2	2.19%
Business Investment (\$87)	\$19.4	1.54%	\$20.7	1.65%	\$16.9	1.33%	\$29.3	2.34%	\$65.7	1.32%
Structures (\$87)	\$0.9	0.07%	\$0.1	0.01%	\$0.2	0.02%	\$1.2	0.10%	(\$2.1)	-0.04%
Prod. Dur. Equip. (\$87)	\$18.4	1.46%	\$20.7	1.65%	\$16.6	1.31%	\$28.2	2.25%	\$67.7	1.36%
Residential Invest. (\$87)	\$2.7	0.21%	(\$4.1)	-0.33%	\$4.7	0.37%	\$13.5	1.08%	\$16.1	0.32%
Change in Inventory (\$87)	\$11.9	0.94%	\$0.4	0.03%	(\$5.9)	-0.46%	(\$2.2)	-0.18%	\$12.9	0.26%
Net Exports (\$87)	(\$19.1)	-1.52%	(\$11.7)	-0.93%	(\$17.0)	-1.34%	\$4.1	0.33%	(\$41.5)	-0.83%
Government Purchases (\$87)	(\$14.1)	-1.12%	\$2.8	0.22%	\$2.5	0.20%	(\$0.3)	-0.02%	(\$7.1)	-0.14%
Final Domestic Sales (\$87)	\$21.8	1.73%	\$41.4	3.29%	\$56.9	4.48%	\$76.7	6.12%	\$183.9	3.69%
GDP (\$87) Four qtr chg (%)		3.19%		3.19%		2.98%		3.11%		
	I'94 A		II'94 A		III'94 F		IV'94 F		1994 F	
THE ECONOMY:	\$ Change	Pct Chg	\$ Change	Pct Chg	\$ Change	Pct Chg	\$ Change	Pct Chg	\$ Change	Pct Chg
Gross Domestic Product (\$87)	\$43.1	3.3%	\$49.1	3.8%	\$34.4	2.6%	\$30.2	2.3%	\$188.1	3.7%
Personal Consumption (\$87)	\$40.1	3.1%	\$12.3	0.9%	\$19.1	1.5%	\$28.4	2.1%	\$113.5	2.2%
Business Investment (\$87)	\$16.4	1.3%	\$14.3	1.1%	\$17.6	1.3%	\$12.9	1.0%	\$74.7	1.5%
Structures (\$87)	(\$4.6)	-0.4%	\$6.6	0.5%	\$1.2	0.1%	\$1.7	0.1%	\$2.4	0.0%
Prod. Dur. Equip. (\$87)	\$20.9	1.6%	\$7.9	0.6%	\$16.3	1.2%	\$11.3	0.9%	\$72.4	1.4%
Residential Invest. (\$87)	\$5.4	0.4%	\$4.1	0.3%	\$6.6	0.5%	(\$0.5)	-0.0%	\$23.1	0.4%
Change in Inventory (\$87)	\$14.6	1.1%	\$30.9	2.4%	(\$5.0)	-0.4%	(\$3.0)	-0.2%	\$30.0	0.6%
Net Exports (\$87)	(\$21.8)	-1.7%	(\$8.9)	-0.7%	(\$7.2)	-0.5%	(\$8.5)	-0.6%	(\$42.6)	-0.8%
Government Purchases (\$87)	(\$11.6)	-0.9%	(\$3.6)	-0.3%	\$3.4	0.3%	\$0.9	0.1%	(\$10.6)	-0.2%
Final Domestic Sales (\$87)	\$50.3	3.9%	\$27.1	2.1%	\$46.6	3.5%	\$41.7	3.1%	\$200.7	3.9%
GDP (\$87) Four qtr chg (%)		3.7%		4.0%		4.0%		3.0%		
	I'95 F		II'95 F		III'95 F		IV'95 F		1995 F	
THE ECONOMY:	\$ Change	Pct Chg	\$ Change	Pct Chg	\$ Change	Pct Chg	\$ Change	Pct Chg	\$ Change	Pct Chg
Gross Domestic Product (\$87)	\$32.5	2.4%	\$31.6	2.4%	\$30.8	2.3%	\$27.7	2.0%	\$130.6	2.5%
Personal Consumption (\$87)	\$19.6	1.5%	\$20.3	1.5%	\$21.0	1.6%	\$15.7	1.2%	\$83.1	1.6%
Business Investment (\$87)	\$14.1	1.1%	\$10.8	0.8%	\$12.5	0.9%	\$10.5	0.8%	\$53.2	1.0%
Structures (\$87)	\$2.9	0.2%	\$2.0	0.2%	\$1.4	0.1%	\$3.3	0.2%	\$9.5	0.2%
Prod. Dur. Equip. (\$87)	\$11.2	0.8%	\$8.7	0.7%	\$11.1	0.8%	\$7.1	0.5%	\$43.7	0.8%
Residential Invest. (\$87)	\$3.0	0.2%	\$2.4	0.2%	(\$0.8)	-0.1%	\$2.4	0.2%	\$9.0	0.2%
Change in Inventory (\$87)	(\$1.6)	-0.1%	\$3.8	0.3%	\$5.0	0.4%	\$4.0	0.3%	\$7.7	0.1%
Net Exports (\$87)	(\$3.9)	-0.3%	(\$6.6)	-0.5%	(\$8.3)	-0.6%	(\$5.9)	-0.4%	(\$26.7)	-0.5%
Government Purchases (\$87)	\$1.2	0.1%	\$0.9	0.1%	\$1.4	0.1%	\$0.9	0.1%	\$4.4	0.1%
Final Domestic Sales (\$87)	\$38.0	2.9%	\$34.4	2.6%	\$34.1	2.5%	\$29.6	2.2%	\$149.7	2.8%
GDP (\$87) Four qtr chg (%)		2.8%		2.4%		2.3%		2.3%		

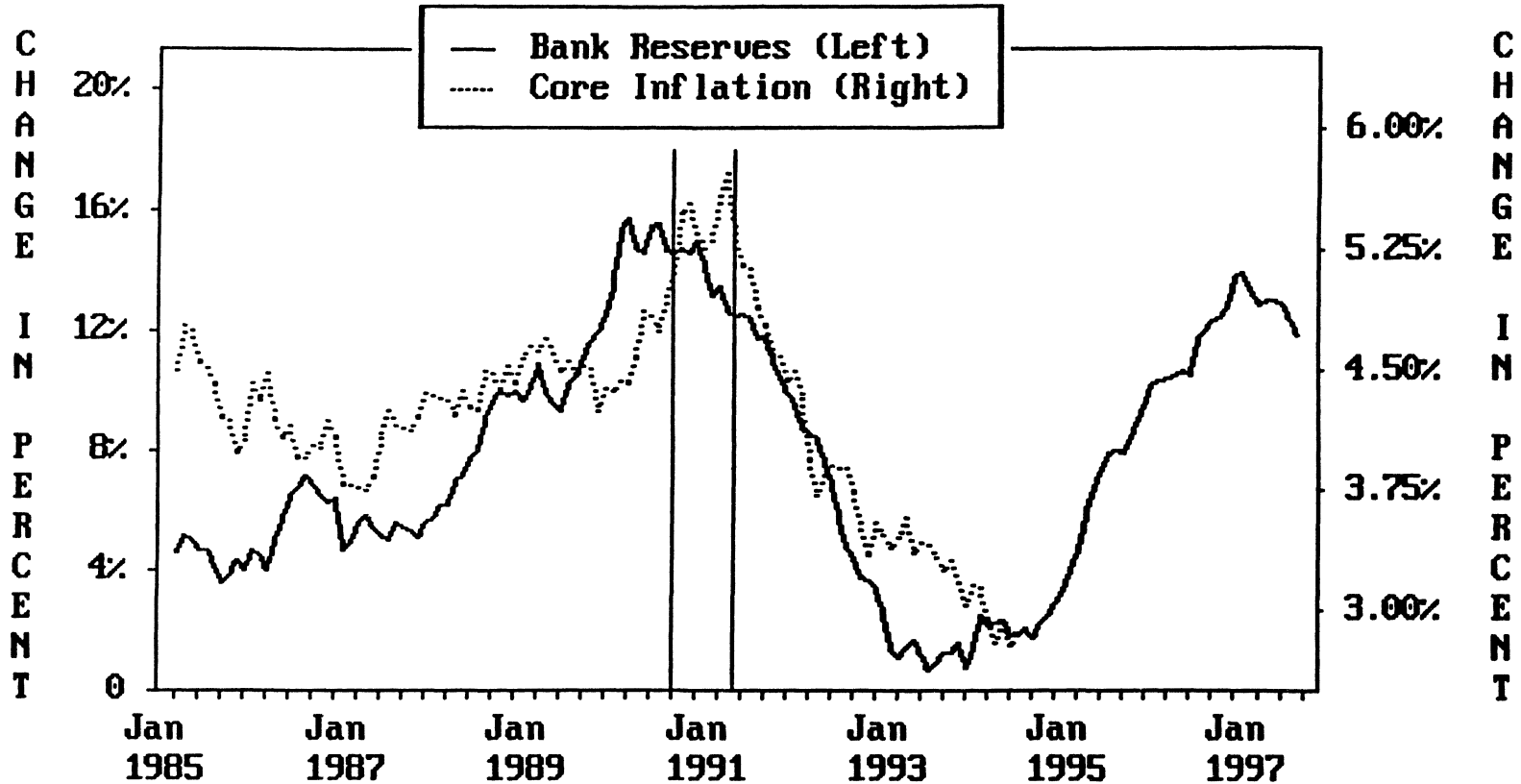
GROWTH IN TOTAL BANK RESERVES HAS SLOWED SHARPLY



Notes: The chart shows year-over-year changes in total bank reserves adjusted for shifts in reserve requirements. Federal Reserve Board data in millions of current dollars. First half August 1994 plotted. Vertical lines show recessions.

Sources: Haver Analytics; Heinemann Economic Research

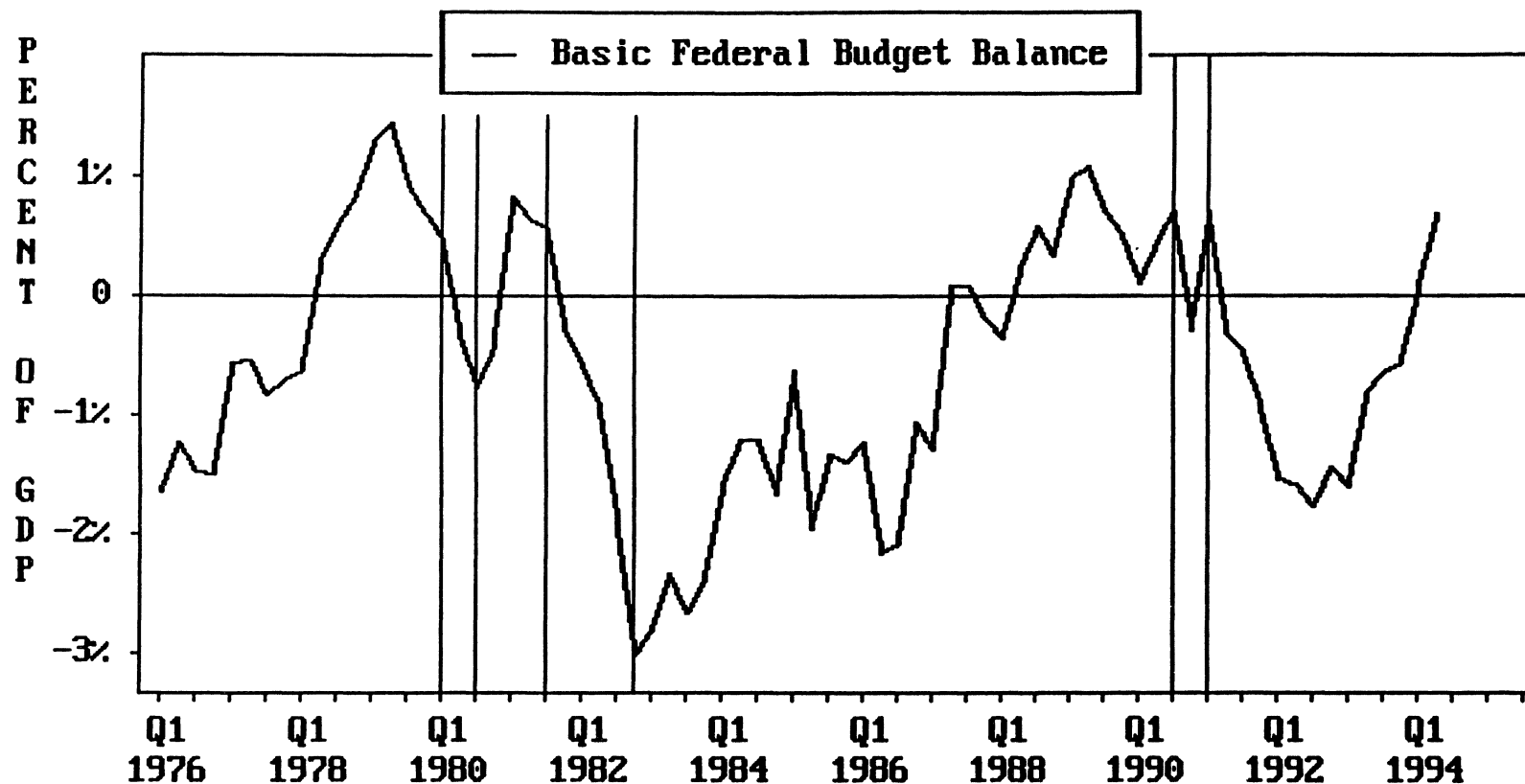
FEDERAL RESERVE POLICY IMPACTS INFLATION WITH A LONG LAG



Notes: The chart shows three-year annualized rates of change in total bank reserves, lagged 36 months (left scale, line) and one-year changes in core inflation (CPIU less food and fuel, right scale, dot). Vertical lines show the recession.

Sources: Haver Analytics; Heinemann Economic Research

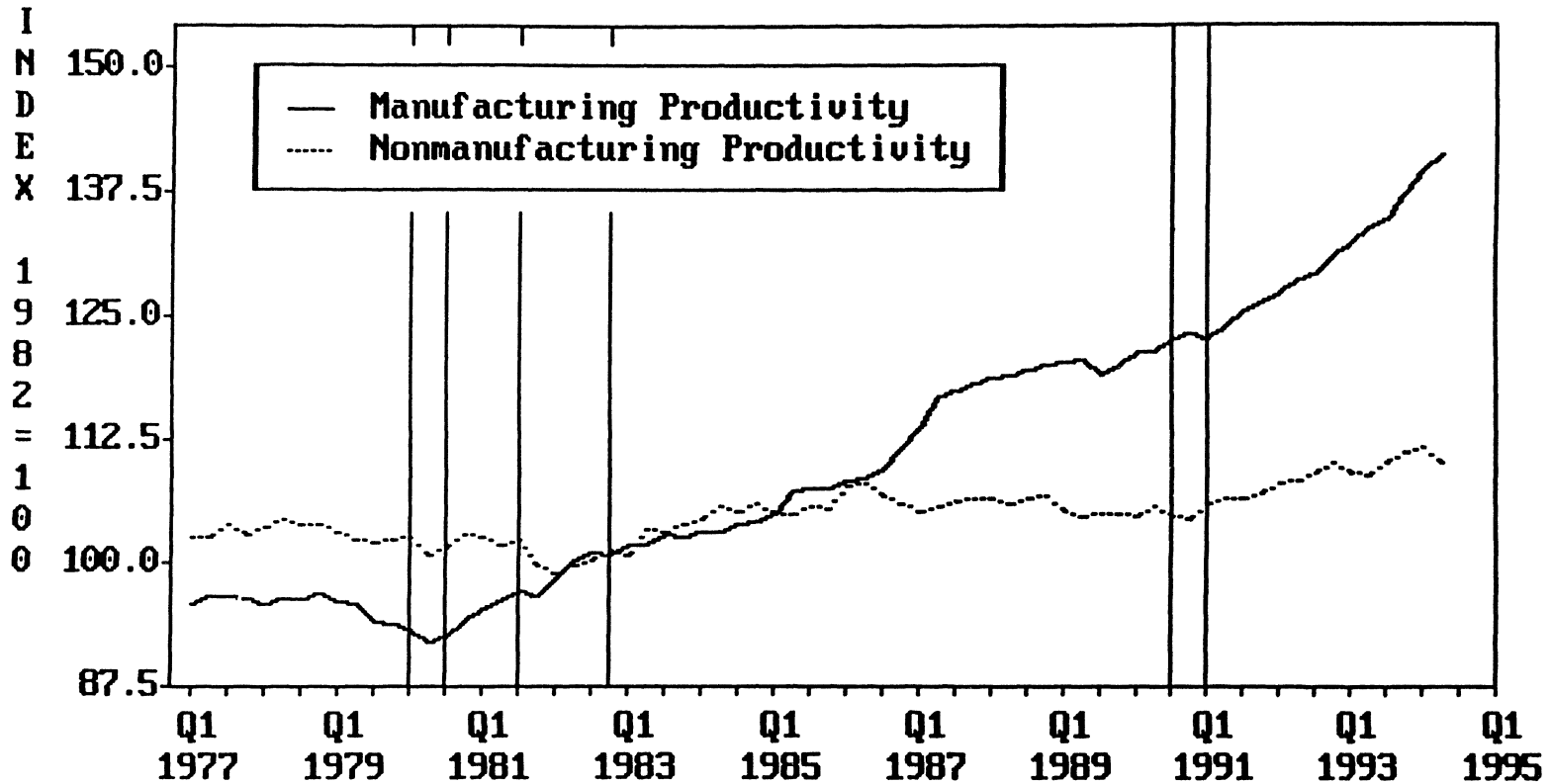
THE BASIC FEDERAL BUDGET IS IN SURPLUS



Notes: The chart shows the basic surplus (+) or deficit (-) in the federal budget as a percent of GDP (revenues less expenditures other than interest). Underlying data in current dollars, SAAR. NIA basis. The vertical lines show recessions.

Sources: Haver Analytics; Heinemann Economic Research

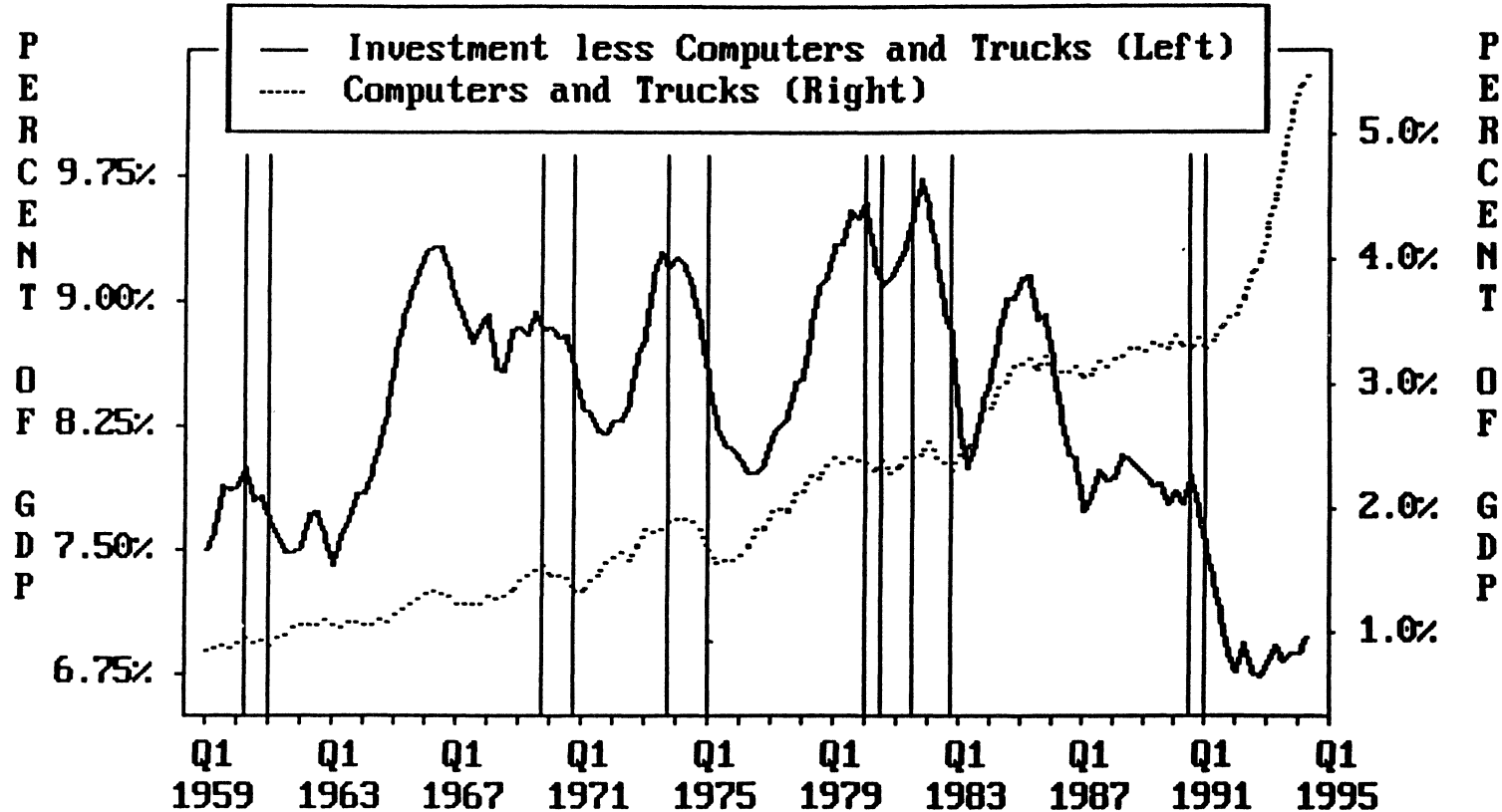
PRODUCTIVITY IS UP IN MANUFACTURING, FLAT ELSEWHERE



Notes: The chart shows indexes of output per hour of all persons in manufacturing (line) and nonmanufacturing (dot). Non-manufacturing calculated from Bureau of Labor Statistics data, SA. Log scale. The vertical lines show recessions.

Sources: Haver Analytics; Heinemann Economic Research

CHANGES IN THE STRUCTURE OF THE CAPITAL GOODS MARKET



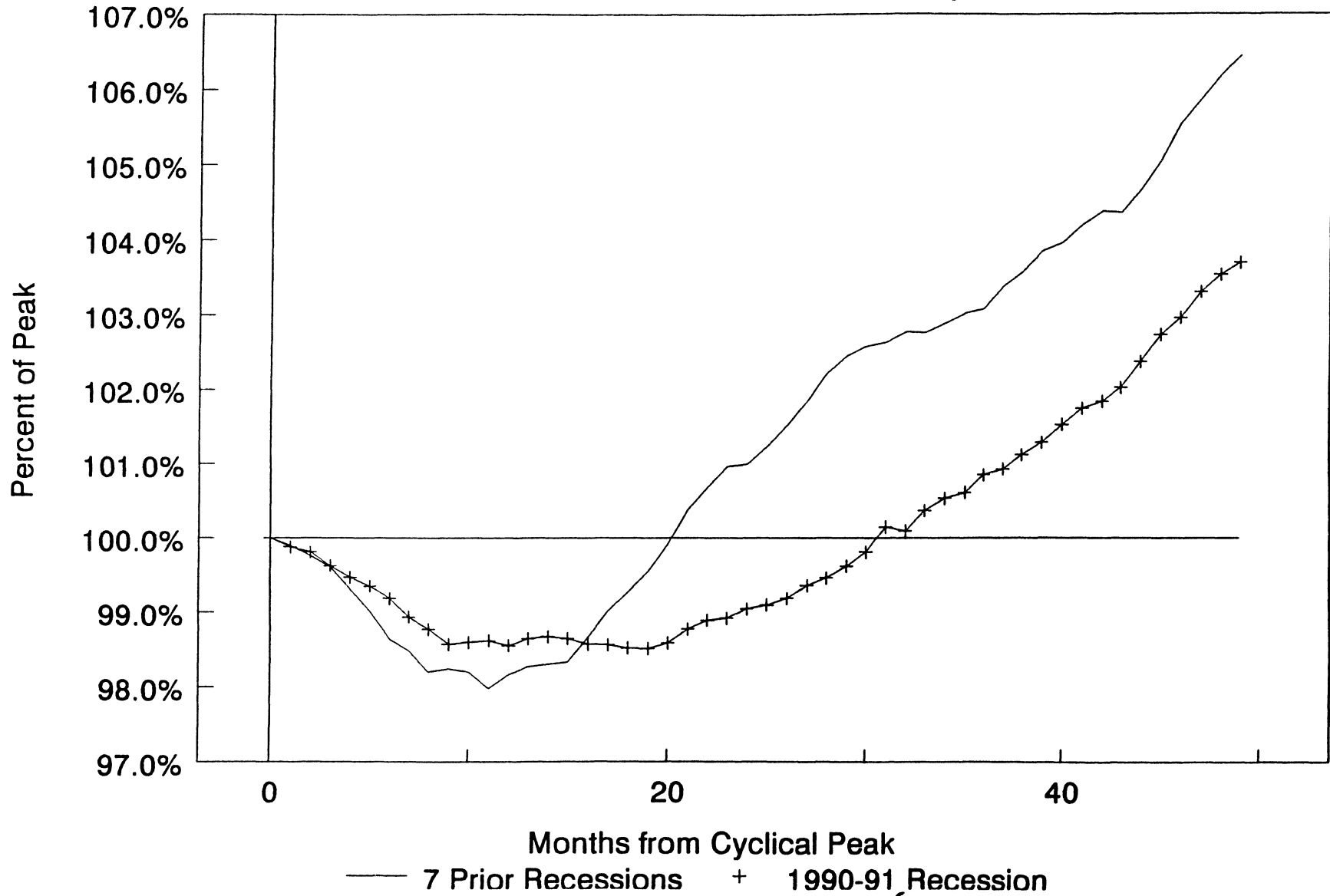
Notes: The chart shows fixed investment less information processing and related plus trucks and busses (line) and information processing and related plus trucks and busses (dot) - both as a percent of GDP. The vertical lines show recessions.

Sources: Haver Analytics; Heinemann Economic Research

NONFARM PAYROLL EMPLOYMENT

Patterns of Recession and Recovery

Shadow Open Market Committee



08-Sep-94 (Federal Reserve Board Monetary Base)
Table 1 - Part 1

Federal Reserve Action and Monetary Growth

(\$ Billions)

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
Date	Monetary Base	Currency	Total Adjusted Bank Reserves	Demand Deposits	Savings & Small Time Deposits*	Large Time Deposits	Non-deposit Liabl.	Foreign Deposits	Treasury Deposits	Total Deposits**
Jul 91	307.3	259.6	47.7	594.8	2118.8	462.5	207.7	9.5	20.8	3414.1
Aug	309.2	261.3	47.9	599.2	2117.3	456.1	210.4	9.4	17.1	3409.5
Sep	310.9	262.8	48.1	602.1	2114.2	449.9	205.0	9.3	26.9	3397.6
Oct	312.8	264.4	48.4	607.7	2112.2	440.5	208.8	9.2	28.6	3405.3
Nov	315.0	265.8	49.2	617.6	2109.9	431.6	211.2	9.5	28.6	3408.4
Dec	317.2	267.2	50.0	624.3	2107.2	424.7	206.4	10.0	25.3	3401.2
Jan 92	319.4	269.0	50.4	634.9	2103.3	418.9	204.5	10.2	33.1	3397.1
Feb	322.8	270.8	52.0	647.6	2102.2	413.6	206.6	9.3	25.2	3412.4
Mar	324.7	271.9	52.8	655.5	2098.3	407.4	207.0	9.2	20.1	3402.6
Apr	326.7	273.6	53.1	659.8	2093.6	402.2	201.7	9.6	17.7	3387.0
May	328.9	275.1	53.8	669.3	2089.2	396.0	198.7	9.5	21.0	3380.4
Jun	330.2	276.6	53.6	668.2	2081.7	389.4	200.8	9.7	25.1	3370.8
Jul	333.2	279.5	53.7	676.1	2075.5	382.7	201.5	10.2	19.6	3371.1
Aug	336.8	282.3	54.5	685.9	2072.4	382.0	209.9	9.4	22.4	3379.2
Sep	341.6	285.5	56.1	695.6	2071.3	377.7	208.0	10.2	28.6	3385.2
Oct	344.8	287.5	57.3	708.4	2067.3	371.0	210.0	10.2	21.8	3395.5
Nov	347.8	289.5	58.3	718.9	2061.1	364.6	209.9	10.0	16.5	3386.3
Dec	350.8	292.2	58.6	724.5	2054.1	360.3	207.3	10.6	19.5	3373.3
Jan 93	353.1	294.5	58.6	730.5	2044.6	353.2	201.4	10.1	33.1	3359.3
Feb	355.9	297.0	58.9	730.4	2037.5	350.1	206.7	10.2	29.5	3368.0
Mar	358.6	299.3	59.3	732.8	2029.2	344.8	215.7	9.9	17.4	3361.9
Apr	361.2	301.8	59.4	737.2	2024.9	348.8	216.1	9.5	20.3	3353.9
May	365.3	304.4	60.9	755.2	2027.5	348.2	215.0	9.9	20.3	3376.1
Jun	368.2	307.2	61.0	761.4	2024.3	345.3	218.1	9.8	26.5	3379.2
Jul	371.3	309.7	61.6	769.2	2016.6	341.8	220.9	10.2	25.6	3385.2
Aug	374.3	312.4	61.9	775.1	2012.5	341.6	223.9	9.7	23.8	3388.4
Sep	378.1	315.4	62.7	782.0	2008.3	340.4	228.1	10.0	28.7	3392.6
Oct	381.4	317.6	63.8	787.9	2003.7	341.6	230.5	9.9	17.1	3402.3
Nov	384.0	319.5	64.5	795.0	2002.5	339.4	235.1	10.0	12.8	3399.1
Dec	385.9	321.4	64.5	799.1	2001.1	339.0	236.1	10.8	21.4	3398.9
Jan 94	389.6	325.2	64.4	800.3	1999.8	341.5	234.1	10.1	30.9	3407.2
Feb	394.0	329.2	64.8	801.5	1995.4	335.7	232.9	9.8	32.1	3406.2
Mar	397.0	332.4	64.6	801.9	1993.0	330.9	239.2	9.5	20.0	3406.6
Apr	399.2	334.8	64.4	798.2	1989.3	330.5	241.1	10.0	27.9	3389.1
May	401.7	337.6	64.1	797.0	1985.0	333.5	242.9	9.5	28.5	3395.8
Jun	404.3	340.3	64.0	798.0	1977.6	333.9	253.0	9.8	13.2	3400.8
Jul	407.0	343.2	63.8	802.3	1974.9	337.3	258.4	10.0	13.3	3396.1
Aug PE	409.2	345.4	63.8	798.0	1972.5	341.1	256.9	9.5	13.6	3391.3

* Includes Money Market Deposit Accounts

** Sum of Columns 4 through 9

Table 1 - Part 2

Federal Reserve Action and Monetary Growth

Date	(11)	(12)	(13)	(14)	(15)	(16)	(17)	(18)
	Adjusted Reserve Ratio	Currency Ratio	Savings & Small Time Deposit Ratio	Large Time Deposit Ratio	Non-deposit Liabl. Ratio	Foreign Deposit Ratio	Treasury Deposit Ratio	Money Multiplier
	(3/10)	(2/4)	(5/4)	(6/4)	(7/4)	(8/4)	(9/4)	(2+4/1)
Jul 91	0.0140	0.4364	3.5622	0.7776	0.3492	0.0160	0.0350	2.7804
Aug	0.0141	0.4361	3.5335	0.7612	0.3511	0.0157	0.0285	2.7828
Sep	0.0141	0.4365	3.5114	0.7472	0.3405	0.0154	0.0447	2.7823
Oct	0.0142	0.4351	3.4757	0.7249	0.3436	0.0151	0.0471	2.7881
Nov	0.0144	0.4304	3.4163	0.6988	0.3420	0.0154	0.0463	2.8048
Dec	0.0147	0.4280	3.3753	0.6803	0.3306	0.0160	0.0405	2.8108
Jan 92	0.0148	0.4237	3.3128	0.6598	0.3221	0.0161	0.0521	2.8301
Feb	0.0153	0.4182	3.2461	0.6387	0.3190	0.0144	0.0389	2.8447
Mar	0.0155	0.4148	3.2011	0.6215	0.3158	0.0140	0.0307	2.8566
Apr	0.0157	0.4147	3.1731	0.6096	0.3057	0.0145	0.0268	2.8571
May	0.0159	0.4110	3.1215	0.5917	0.2969	0.0142	0.0314	2.8717
Jun	0.0159	0.4139	3.1154	0.5828	0.3005	0.0145	0.0376	2.8611
Jul	0.0159	0.4134	3.0698	0.5660	0.2980	0.0151	0.0290	2.8681
Aug	0.0161	0.4116	3.0214	0.5569	0.3060	0.0137	0.0327	2.8743
Sep	0.0166	0.4104	2.9777	0.5430	0.2990	0.0147	0.0411	2.8722
Oct	0.0169	0.4058	2.9183	0.5237	0.2964	0.0144	0.0308	2.8879
Nov	0.0172	0.4027	2.8670	0.5072	0.2920	0.0139	0.0230	2.8991
Dec	0.0174	0.4033	2.8352	0.4973	0.2861	0.0146	0.0269	2.8982
Jan 93	0.0175	0.4031	2.7989	0.4835	0.2757	0.0138	0.0453	2.9026
Feb	0.0175	0.4066	2.7896	0.4793	0.2830	0.0140	0.0404	2.8867
Mar	0.0176	0.4084	2.7691	0.4705	0.2944	0.0135	0.0237	2.8782
Apr	0.0177	0.4094	2.7467	0.4731	0.2931	0.0129	0.0275	2.8768
May	0.0180	0.4031	2.6847	0.4611	0.2847	0.0131	0.0269	2.9007
Jun	0.0180	0.4035	2.6587	0.4535	0.2864	0.0129	0.0348	2.9023
Jul	0.0182	0.4026	2.6217	0.4444	0.2872	0.0133	0.0333	2.9058
Aug	0.0183	0.4030	2.5964	0.4407	0.2889	0.0125	0.0307	2.9051
Sep	0.0185	0.4033	2.5682	0.4353	0.2917	0.0128	0.0367	2.9026
Oct	0.0188	0.4031	2.5431	0.4336	0.2925	0.0126	0.0217	2.8985
Nov	0.0190	0.4019	2.5189	0.4269	0.2957	0.0126	0.0161	2.9021
Dec	0.0190	0.4022	2.5042	0.4242	0.2955	0.0135	0.0268	2.9039
Jan 94	0.0189	0.4063	2.4988	0.4267	0.2925	0.0126	0.0386	2.8888
Feb	0.0190	0.4107	2.4896	0.4188	0.2906	0.0122	0.0400	2.8701
Mar	0.0190	0.4145	2.4853	0.4126	0.2983	0.0118	0.0249	2.8571
Apr	0.0190	0.4194	2.4822	0.4141	0.3021	0.0125	0.0350	2.8382
May	0.0189	0.4236	2.4906	0.4184	0.3048	0.0119	0.0358	2.8243
Jun	0.0188	0.4264	2.4782	0.4184	0.3170	0.0123	0.0165	2.8154
Jul	0.0188	0.4278	2.4615	0.4204	0.3221	0.0125	0.0166	2.8142
Aug PE	0.0188	0.4328	2.4718	0.4275	0.3219	0.0119	0.0171	2.7943

Table 2

Federal Reserve Action and Monetary Growth

(Compound Annual Rates of Change)

This is accounted for by changes in the:

Date	Monetary Growth (M-1)	Federal Reserve Actions (Monetary Base Growth)	Contribution of the Money Multiplier	This is accounted for by changes in the:						
				Adjusted Reserve Ratio	Currency Ratio	Savings & Small Time Deposit Ratio	Large Time Deposit Ratio	Non-Deposit Liability Ratio	Foreign Deposit Ratio	Treasury Deposit Ratio
Jul 91	6.24	7.76	-1.52	-1.40	-1.54	0.60	0.53	0.14	-0.02	0.17
Aug	8.91	7.82	1.09	-1.23	0.59	1.00	0.57	-0.07	0.01	0.22
Sep	6.31	6.51	-0.20	-0.69	-0.65	0.81	0.51	-0.39	0.01	-0.59
Oct	10.46	7.76	2.70	-0.71	1.86	1.05	0.65	-0.09	0.01	-0.07
Nov	16.71	8.62	8.09	-2.88	7.85	2.12	0.92	0.06	-0.01	0.03
Dec	11.58	8.75	2.83	-3.73	3.85	1.46	0.66	0.40	-0.02	0.20
Jan 92	18.03	8.71	9.31	-1.52	7.69	2.46	0.80	0.33	-0.00	-0.45
Feb	21.04	13.82	7.22	-5.67	9.08	2.41	0.76	0.11	0.06	0.47
Mar	12.41	6.92	5.49	-3.90	6.25	1.92	0.73	0.14	0.01	0.35
Apr	8.05	7.79	0.26	25.13	-2.25	-11.89	-5.05	-4.27	0.22	-1.62
May	15.10	8.28	6.82	-2.87	6.56	2.18	0.75	0.37	0.01	-0.19
Jun	0.51	5.10	-4.59	0.19	-4.99	0.26	0.38	-0.16	-0.01	-0.26
Jul	14.81	11.26	3.35	-0.49	0.91	1.85	0.67	0.10	-0.02	0.34
Aug	17.02	14.04	2.98	-3.09	3.73	2.40	0.45	-0.39	0.07	-0.18
Sep	17.21	18.26	-1.05	-8.29	3.30	3.12	0.99	0.50	-0.07	-0.60
Oct	19.68	12.09	7.59	-4.27	7.96	2.53	0.81	0.11	0.01	0.44
Nov	16.15	10.89	5.26	-4.88	6.16	2.54	0.81	0.22	0.02	0.38
Dec	10.34	10.73	-0.39	-0.91	-0.60	0.83	0.26	0.15	-0.02	-0.10
Jan 93	10.25	8.26	1.98	-0.12	0.26	1.55	0.59	0.44	0.03	-0.78
Feb	2.85	9.89	-7.04	-0.82	-6.81	0.50	0.23	-0.39	-0.01	0.27
Mar	5.63	9.41	-3.78	-2.38	-2.97	0.92	0.39	-0.51	0.02	0.75
Apr	8.32	8.97	-0.65	-0.28	-0.76	0.49	-0.06	0.03	0.01	-0.08
May	26.57	14.61	11.95	-4.08	11.98	3.04	0.58	0.41	-0.01	0.03
Jun	10.68	9.95	0.73	0.24	-0.70	1.27	0.37	-0.09	0.01	-0.38
Jul	12.20	10.56	1.64	-1.40	1.21	1.46	0.36	-0.03	-0.02	0.06
Aug	10.00	10.33	-0.33	-1.03	-0.67	1.12	0.16	-0.07	0.03	0.11
Sep	11.49	12.66	-1.17	-1.87	-0.47	1.35	0.26	-0.13	-0.01	-0.28
Oct	9.23	11.08	-1.85	-5.04	0.52	1.63	0.11	-0.06	0.01	0.97
Nov	10.22	8.59	1.63	-5.04	3.75	2.13	0.58	-0.28	-0.00	0.49
Dec	6.66	5.86	0.80	1.15	-0.81	1.10	0.20	0.02	-0.07	-0.80
Jan 94	5.49	12.33	-6.85	1.45	-8.00	0.31	-0.14	0.17	0.05	-0.69
Feb	5.69	14.24	-8.55	-1.27	-8.31	0.53	0.45	0.11	0.02	-0.08
Mar	3.89	9.71	-5.82	-0.26	-6.51	0.22	0.32	-0.40	0.02	0.79
Apr	-1.37	6.80	-8.17	0.10	-7.25	-0.31	-0.06	-0.17	-0.03	-0.45
May	1.71	7.87	-6.16	1.46	-7.31	0.09	-0.24	-0.15	0.03	-0.04
Jun	3.98	8.03	-4.05	-0.29	-4.70	0.61	0.00	-0.61	-0.02	0.95
Jul	7.86	8.37	-0.51	0.11	-0.79	0.29	-0.03	-0.09	-0.00	-0.00
Aug PE	-2.20	6.51	-8.71	-0.15	-7.76	-0.48	-0.33	0.01	0.03	-0.02
1991	8.88	8.28	0.60	-1.23	0.34	0.79	0.49	0.22	0.01	-0.01
1992	14.18	10.66	3.52	-0.88	3.65	0.88	0.20	-0.23	0.02	-0.12
1993-IH	10.72	10.18	0.53	-1.24	0.17	1.30	0.35	-0.02	0.01	-0.03
1993-IIH	9.96	9.84	0.12	-2.20	0.59	1.47	0.28	-0.09	-0.01	0.09
1994-8 Months	3.13	9.23	-6.10	0.14	-6.33	0.16	-0.00	-0.14	0.01	0.06
	-6.83	-0.61	-6.22	2.35	-6.92	-1.31	-0.28	-0.05	0.02	-0.04

Table 3

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

THREE-MONTH MOVING AVERAGES

This is accounted for by changes in the:

Date	Monetary Growth (M-1)	Federal Reserve Actions (Monetary Base Growth)	Contribution of the Money Multiplier	Adjusted Reserve Ratio	Currency Ratio	Savings & Small Time Deposit Ratio	Large Time Deposit Ratio	Non-Deposit Liability Ratio	Foreign Deposit Ratio	Treasury Deposit Ratio
Jul 91	10.35	5.70	4.65	-1.36	3.97	1.13	0.58	0.30	0.02	0.00
Aug	9.32	7.00	2.33	-1.27	1.78	1.05	0.57	0.12	0.01	0.06
Sep	7.16	7.37	-0.21	-1.11	-0.53	0.80	0.54	0.15	-0.00	-0.06
Oct	8.56	7.37	1.20	-0.88	0.60	0.95	0.58	0.08	0.01	-0.14
Nov	11.16	7.63	3.53	-1.42	3.02	1.33	0.70	0.12	0.00	-0.21
Dec	12.91	8.38	4.54	-2.44	4.52	1.54	0.75	0.12	-0.01	0.05
Jan 92	15.44	8.69	6.74	-2.71	6.46	2.02	0.79	0.26	-0.01	-0.07
Feb	16.88	10.43	6.45	-3.64	6.87	2.11	0.74	0.28	0.01	0.08
Mar	17.16	9.82	7.34	-3.70	7.67	2.27	0.76	0.19	0.02	0.12
Apr	13.83	9.51	4.32	5.18	4.36	-2.52	-1.19	-1.34	0.10	-0.27
May	11.85	7.66	4.19	6.12	3.52	-2.60	-1.19	-1.25	0.08	-0.49
Jun	7.88	7.05	0.83	7.48	-0.23	-3.15	-1.31	-1.35	0.07	-0.69
Jul	10.07	8.21	1.86	-1.06	0.83	1.43	0.60	0.10	-0.01	-0.04
Aug	10.71	10.13	0.58	-1.13	-0.12	1.50	0.50	-0.15	0.01	-0.03
Sep	16.28	14.52	1.76	-3.96	2.65	2.46	0.70	0.07	-0.01	-0.14
Oct	17.97	14.80	3.18	-5.22	5.00	2.68	0.75	0.07	0.00	-0.11
Nov	17.68	13.75	3.93	-5.81	5.81	2.73	0.87	0.27	-0.01	0.07
Dec	15.39	11.23	4.15	-3.35	4.51	1.97	0.63	0.16	0.01	0.24
Jan 93	12.24	9.96	2.28	-1.97	1.94	1.64	0.55	0.27	0.01	-0.17
Feb	7.81	9.63	-1.82	-0.62	-2.39	0.96	0.36	0.07	0.00	-0.20
Mar	6.24	9.19	-2.95	-1.11	-3.17	0.99	0.40	-0.15	0.02	0.08
Apr	5.60	9.42	-3.82	-1.16	-3.51	0.84	0.19	-0.29	0.01	0.31
May	13.51	11.00	2.51	-2.25	2.75	1.48	0.31	-0.02	0.01	0.23
Jun	15.19	11.18	4.01	-1.37	3.51	1.60	0.30	0.12	0.00	-0.14
Jul	16.48	11.71	4.78	-1.75	4.17	1.93	0.44	0.10	-0.00	-0.10
Aug	10.96	10.28	0.68	-0.73	-0.05	1.29	0.30	-0.06	0.01	-0.07
Sep	11.23	11.18	0.05	-1.43	0.02	1.31	0.26	-0.08	0.00	-0.04
Oct	10.24	11.35	-1.12	-2.64	-0.21	1.37	0.18	-0.09	0.01	0.27
Nov	10.31	10.77	-0.46	-3.98	1.26	1.70	0.32	-0.16	0.00	0.39
Dec	8.70	8.51	0.19	-2.98	1.15	1.62	0.30	-0.10	-0.02	0.22
Jan 94	7.45	8.93	-1.47	-0.81	-1.69	1.18	0.21	-0.03	-0.01	-0.33
Feb	5.94	10.81	-4.87	0.44	-5.71	0.65	0.17	0.10	0.00	-0.52
Mar	5.02	12.10	-7.07	-0.03	-7.61	0.35	0.21	-0.04	0.03	0.01
Apr	2.74	10.25	-7.52	-0.48	-7.36	0.15	0.24	-0.15	0.00	0.09
May	1.41	8.13	-6.72	0.43	-7.03	-0.00	0.01	-0.24	0.01	0.10
Jun	1.44	7.57	-6.13	0.42	-6.42	0.13	-0.10	-0.31	-0.01	0.15
Jul	4.52	8.09	-3.57	0.43	-4.27	0.33	-0.09	-0.28	0.00	0.30
Aug PE	3.22	7.64	-4.42	-0.11	-4.42	0.14	-0.12	-0.23	0.00	0.31

Table 4

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

Date	Reserve Growth Rate Month to Month	Reserve Growth Rate Three-month Moving Average
Jul 91	5.41	8.12
Aug	6.08	6.79
Sep	3.30	4.93
Oct	8.88	6.09
Nov	20.62	10.93
Dec	21.64	17.05
Jan 92	10.46	17.57
Feb	47.68	26.59
Mar	17.55	25.23
Apr	7.92	24.38
May	16.29	13.92
Jun	-2.97	7.08
Jul	1.10	4.81
Aug	21.20	6.44
Sep	39.70	20.67
Oct	30.66	30.52
Nov	22.62	31.00
Dec	5.61	19.63
Jan 93	0.60	9.61
Feb	6.01	4.07
Mar	7.96	4.85
Apr	1.55	5.17
May	35.66	15.05
Jun	1.99	13.06
Jul	12.29	16.64
Aug	7.12	7.13
Sep	15.23	11.55
Oct	23.77	15.37
Nov	14.61	17.87
Dec	-1.37	12.34
Jan 94	-0.78	4.15
Feb	6.66	1.50
Mar	-2.67	1.07
Apr	-3.94	0.02
May	-4.97	-3.86
Jun	-1.97	-3.62
Jul	-3.36	-3.43
Aug PE	-0.64	-1.99
	1991	
	7.72	
	1992	
	18.15	
	1993-IH	
	8.96	
	1993-IIH	
	11.94	
	1994-8 Months	
	-1.46	
	-13.40	

Source: Federal Reserve Board; Helnemann Economic Research

BUDGET PROGRESS?

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Washington policymakers, still fixated on budget deficits, see great "progress" in the budget. From a peak of \$290 billion in Fiscal Year 1992, the deficit will be approximately \$205 billion in 1994 (which concludes this September) and is projected to fall to approximately \$170 billion in 1995. Thus, excluding net interest outlays, the budget will be in surplus for the first time since 1989.

But when evaluated from other equally important fiscal policy considerations, this progress is illusory. The deficit reduction has been generated by a reversal of the earlier cash-flow outlays for the Savings and Loan bailouts, legislated tax hikes, and stronger economic growth. Spending for entitlement programs continues to rise sharply, while spending for investment-oriented activities and defense shrinks. Tax policy continues to discourage private saving. These policies dampen long-run economic growth. Policymakers leave untouched the structural flaws that are the sources of the fastest growing spending programs. The structural (standardized employment) budget deficit is projected to resume its rise in 1996, even with no new spending programs, and jumps sharply in 1999 when the spending caps on discretionary programs are lifted. And there is a mounting backlog of pending legislation that is potentially very expensive, including health care reform, the crime bill, and welfare reform.

Crucially important to economic performance is how the budget allocates national resources, regardless of whether spending is financed by taxes or borrowing, and how that allocation affects long-run economic growth as well as how it achieves redistributive goals. In this light, progress on the budget is unidimensional and unbalanced.

RECENT BUDGET TRENDS

On the surface, the recent deficit reduction has been impressive. The deficit will be 3.1 percent of GDP in 1994, compared to an average of 4.8 percent in 1991-1992. It is projected to fall below 2.5 percent of GDP in 1995, its lowest level since the late 1970s. This would help stabilize the public debt-to-GDP ratio at approximately 51 percent; this ratio soared from 26.8 percent in 1980 to 44 percent in 1990 and exceeded 50 percent in 1992 for the first time since 1958 (see Chart 1).

But a dissection of the deficit reduction reveals a less impressive pattern—one that has negative implications for economic performance. The largest source of the recent deficit reduction has been the reversal of government spending for the S & L bailouts. Those outlays, which rose to a peak of \$66.1 billion in 1991 as the Resolution Trust Corporation (RTC) acquired assets of failed depository institutions, shifted to negative outlays of \$28 billion in 1993 as these assets were sold (proceeds from the RTC asset sales are counted as negative spending.) More net asset sales by the RTC are expected to generate negative outlays of a lesser magnitude in 1994 and 1995. Excluding deposit insurance, the rise in government spending and deficits from 1988 to 1991, and the subsequent improvement, were much less dramatic.

The continued decline in defense spending has been another source of deficit reduction. With the exception of the Gulf War, defense spending has declined continuously since 1989. Its average annual decline from 1990 to 1993 was slightly less than 1 percent; that pace accelerated to a 4.1 percent decline in 1994. Measured in terms of shares of national resources, these declines have been even more dramatic: since 1989, defense spending has fallen from 26.6 percent to 19.0 percent of total federal spending, and from 5.9 percent to 4.2 percent of GDP.

Net interest outlays have stabilized since 1992, as the lower interest rates since 1990 have temporarily offset the debt service costs of the rising publicly-held debt. However, they will resume rising in 1995; in fact, virtually all of the upward revision of spending projections in the Administration's *Mid-Session Review of the 1995 Budget* (July 1994) were due to the impact of the rising interest rates on net interest outlays.

Meanwhile, spending on domestic programs has continued to soar (see Table 1). From 1990 to 1994, spending on entitlements and other mandatory programs has risen approximately 8.8 percent annually, even faster than in the 1980s. The fastest growth occurred in Medicaid, which has risen at a whopping 19.6 percent rate. All means-tested entitlements, including Medicaid, have risen 15.7 percent annually. This reflects in part the early 1990's recession-related increase in welfare recipients. During this same period, spending on nonmeans-tested entitlements, including social security, Medicare, and other retirement programs, has grown at a 7.1 percent pace, more than double the rate of inflation.

Tax revenue growth has accelerated dramatically in 1994, increasing nearly 10 percent. This surge reflects the tax hikes legislated by Omnibus Budget Reconciliation Act of 1993 (OBRA93) and a sharp pickup in economic growth and taxable incomes. This compares with the 2.8 percent average annual rise from 1990 to 1992, and the 5.7 percent increase in 1993.

THE CURRENT SERVICES BUDGET OUTLOOK

The deficit is projected to recede substantially in 1995. The Administration projects a deficit of \$167 billion, the lowest level since 1989. It projects 7.4 percent growth in revenues—more than twice the rate of inflation—and only 2.3 percent growth of spending. Individual income taxes are projected to rise 8.6 percent, thanks to the tax increases and continued healthy economic growth. The slow spending growth stems from continued declines in defense spending, net asset sales from the RTC, and only 0.7 percent rise in spending on nondefense discretionary programs, which assumes adherence to the OBRA caps. Continued rapid growth in entitlement and other mandatory spending is anticipated. The Congressional Budget Office is even more optimistic, projecting a deficit of \$162 billion.

Under current law, the budget deficit is projected to level off in 1996 and then increase throughout the remainder of the decade. Once again, rising spending is the culprit. In recent decades, revenues have remained in a very narrow range around 18 to 19 percent of GDP. All of the deficit increase has been attributable to spending rising as a share of GDP. Current services tax revenues will remain very close to 19 percent of GDP through the 1990s, while spending will be between 21.5 and 22 percent of GDP. Thus spending rises faster than taxes in dollar terms. Beginning in 1999, when the he OBRA caps on discretionary spending expire, current services projections of deficits rise sharply.

Ironically, the Administration's decision in 1993 to alter the Treasury's debt management strategy and shorten the duration of government debt—essentially betting that short-term interest rates would stay low—may prove costly to taxpayers. The Administration has raised its projections of net interest outlays, and uncertainty about future costs have heightened, particularly as the Federal Reserve pursues a disinflationary monetary policy.

Based on these projections, structural deficits persist. The CBO's standardized-employment deficit, which excludes deposit insurance, remains around 2.5 percent of potential GDP and begin rising late in the decade.

A MORE REALISTIC VIEW

The vastly improved deficit outlook is based on several heroic and unrealistic assumptions about economic policymaking; first, that the increasingly stringent spending caps on discretionary spending imposed by OBRA are adhered to, and second, that none of the pending legislation for

health care reform, welfare reform, or crime prevention are even enacted, or if health care reform becomes law, the Administration's projected cost savings, not the CBO's deficit-widening estimates, are correct. So much for rosy budget forecasts.

Beginning in 1994, OBRA imposed a single cap on the three categories of discretionary spending, i.e., defense, international, and domestic discretionary (from 1991 to 1993, separate caps applied). Spending for these discretionary programs requires action by Congress's appropriation committees, in contrast to spending for entitlements that are automatically paid to beneficiaries that meet certain requirements.

The OBRA spending caps through 1998 become increasingly stringent, and adhering to them will require increasingly restrictive cutbacks by the appropriation committees. This will generate increasingly contentious tradeoffs among the programs vying for the shrinking budget resources. In 1994, the cap was achieved by cuts in defense spending sufficient to offset increases in outlays for domestic programs. The caps require freezing 1995 outlays at 1994 levels and then reducing inflation-adjusted outlays by approximately \$51 billion by 1998. Many of these domestic discretionary programs, including education, training and social services, transportation, income security, and natural resources and the environment, are important and visible. The same, of course, is true of defense. *Accordingly, the probability of legislative slippage in adhering to these spending caps is high.* Also at issue is the potential tradeoff between national security needs and the magnitude of the defense downsizing necessary to achieve budget objectives.

Pending initiatives for health care reform, welfare reform, and crime prevention—all in various stages of legislative consideration—are potential budget-busters. The cost of a health care package is highly uncertain; as evidence, the Administration originally projected its proposal would *save* \$38 billion over 5 years, while the CBO estimated the same proposal would *raise the deficit* by \$67.8 billion. Since then, leading alternative proposals have emphasized universal coverage over cost containment. While the Administration supports leading universal coverage alternatives, its latest budget projections continue to assume the large savings estimated in its earlier optimistic projections.

The leading health care proposals are all open-ended entitlements that would raise the demand for medical services and rely on various kinds of market and nonmarket mechanisms to constrain costs. The cost-containing ability of these mechanisms are at best uncertain, and at worst, ineffective and economically distorting. While leading proposals may minimize projected effects on the budget

deficit, they involve hidden taxes and costs by shifting the burden directly to the private sector. Importantly, whether or not these costs are reflected in the federal budget, they certainly raise the costs of business and employment.

The Administration's crime bill, still facing House-Senate reconciliation, would raise spending an estimated \$33 billion over 5 years if enacted. While well-intended—almost everybody wants lower crime—some of its good provisions are overwhelmed by numerous other provisions that would (re)institute costly urban programs that have failed in the past. The Administration did *not* include the cost of its proposed crime bill in its *Mid-Session* budget projections. The initiative to reform welfare programs is still pending, and its potential budgetary impact is uncertain.

**GOVERNMENT PURCHASES, TRANSFER PAYMENTS, AND TAXES:
IMPLICATIONS FOR RESOURCE ALLOCATION AND ECONOMIC PERFORMANCE**

The mix of government spending and the burden of taxes have both direct and indirect impacts on the allocation of national resources, with important implications for economic performance. Government purchases of goods and services, including defense purchases, nondefense purchases for transportation, infrastructure, natural resources, etc., and state and local purchases for education, police, etc., directly consume resources, making them unavailable for private consumption. In contrast, transfer payments do not directly absorb resources, but instead redistribute claims on resources from taxpayers to beneficiaries. As such, transfer payments, including social security, Medicare, net interest costs, income security programs, etc., are counted as negative taxes in the National Income and Product Accounts.

Whereas purchases directly allocate national resources and affect economic performance, transfer payments have significant indirect economic impacts through their influence on decisions to work, save, and invest. In general, the rising tide of transfers that redistribute income from savers and investors toward consumption-oriented activities have had a significant and cumulative depressing affect on long-run potential growth. This trend of taxing and redistributing income constrains long-run standards of living.

A comparison of two trends, tax receipts minus transfers (net receipts) illustrates the extent of the ongoing shift in the uses of national resources through the government's budget (see Chart 2). Tax receipts net of transfers have continued their long decline as a share of GDP; while gross tax revenues have not changed materially as a percent of GDP, transfer payments have continued to rise rapidly, driven by soaring entitlements and net interest outlays. (The sharp fall of taxes less

transfers relative to GDP in the early 1990s reflected in part the temporary surge in RTC's outlays for deposit insurance). Meanwhile, total government purchases continue to recede, as government purchases for defense have fallen while spending on domestic discretionary programs (infrastructure, science and technology, transportation, natural resources, etc.) have risen.

The implications of these trends are the following: more than 100 percent of the rise in federal spending and deficits has been attributable to the rise in transfers, while the government's direct absorption of private resources has been declining in real terms; taxpayers are receiving fewer and fewer goods and services from the government for the taxes they pay, while a larger portion of their taxes are redistributed through transfer programs; and this redistribution reduces national saving and investment while adding to consumption. Moreover, the increasing reliance on income-based taxes (personal and corporate income taxes and FICA taxes on wage income) further discourages saving and investment.

The budget process itself reinforces these trends, while enactment of pending legislation would add significantly to them. Beginning in 1986, the Budget Control Act (Gramm-Rudman-Hollings) excluded from sequestration social security and other transfer programs, thereby forcing cuts in the investment-oriented discretionary programs. Amended by OBRA93, higher spending now is allowed for entitlement programs if they do not raise deficits (pay-as-you-go), while discretionary programs face increasingly stringent, binding caps on spending. These artificial restrictions reflect and reinforce the deficit bean-counting mentality on federal budgeting that has resulted in a reduction of resources allocated to investment-oriented activities and the ever-growing volume of redistributive transfer payments. This hampers the long-run capacity to grow.

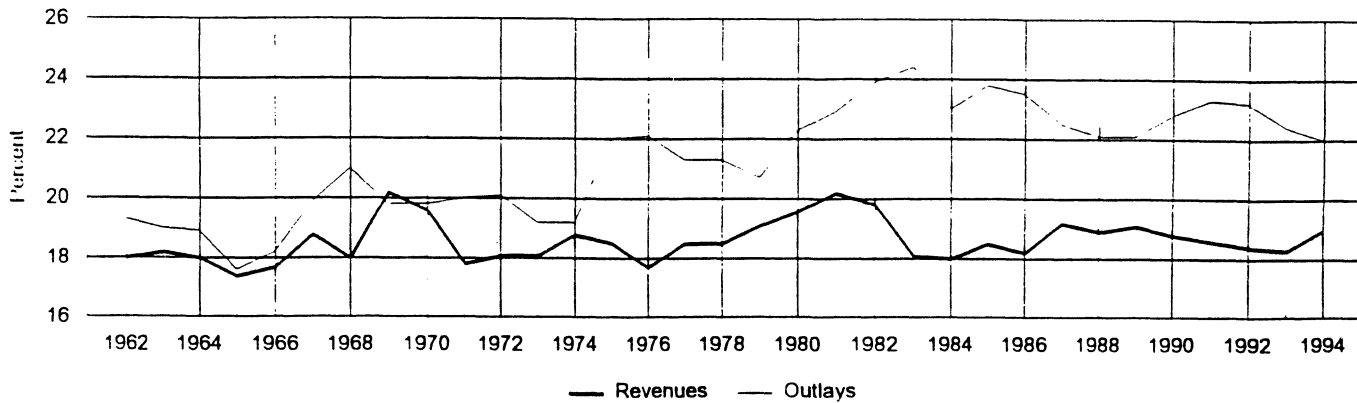
Enactment of health care reform, welfare reform or a crime bill would only add to the rise in transfer payments. Either these legislative initiatives add to the deficit or are financed by taxes, or do not show up in the budget because their costs are shifted directly to the private sector through employer mandated health insurance has no bearing on the general issue of resource allocation or economic performance. Similarly, higher entitlement spending financed by higher taxes (to comply with OBRA's pay-as-you-go provision) is not costless just because it does not raise deficits.

These important issues of resource allocation have taken a back seat to the narrow focus on the budget deficit. While Congress is unwilling to address glaring structural flaws in the fastest growing entitlements, it is more than willing to add expensive and wasteful amendments to pending legislation to raise the probability of enactment. This is not sound fiscal policy, regardless of the temporary favorable deficit trend.

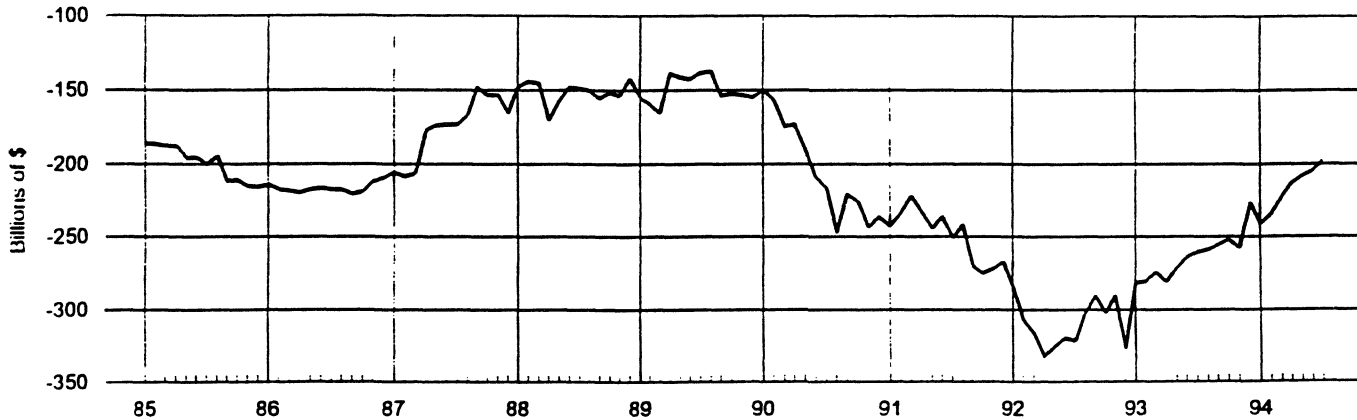
Chart 1

Federal Budget Trends

Federal Spending and Tax Receipts
(Percent of GDP, Fiscal Years)



Federal Budget Deficit
(Sum of past 12 Months)



Publicly-Held Debt-to-GDP Ratio

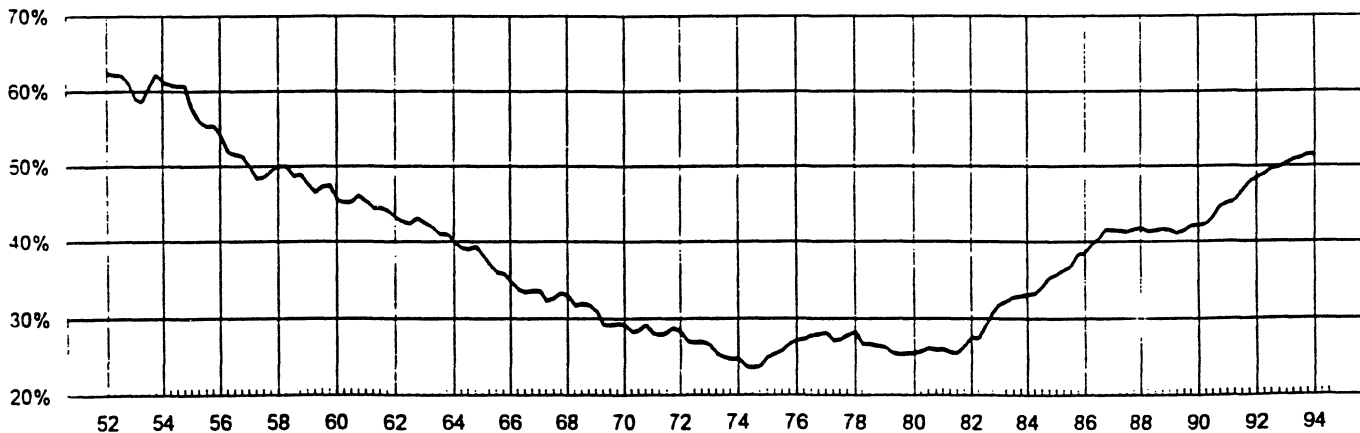


Table 1
The Mix and Growth of Federal Spending
(Fiscal Years)

	1990		1994		1990-1994	
	<u>Level in Bil \$</u>	<u>% of Total</u>	<u>Level in Bil \$</u>	<u>% of Total</u>	<u>Avg. Annual % Change</u>	<u>% Share of \$ Change</u>
Discretionary	501.7	40.1	545	37.2	2.1	20.2
Domestic	182.5	14.6	244	16.6	7.5	28.7
International	19.1	1.5	20	1.4	1.2	0.4
Defense	300.1	24.0	280	19.1	-1.7	-9.4
Mandatory	567.4	45.3	794	54.1	8.8	105.7
Social Security	246.5	19.7	317	21.6	6.5	32.9
Medicare	107.4	8.6	158	10.8	10.1	23.6
Medicaid	41.1	3.3	84	5.7	19.6	20.0
Other Retirement & Disability	59.9	4.8	72	4.9	4.7	5.7
Other ²	112.5	9.0	163	11.1	9.7	23.6
Deposit Insurance	58.1	4.6	-5	-0.3	-	-29.4
Net Interest	184.2	14.7	202	13.8	2.3	8.3
Offsetting Receipts	-58.8	-4.7	-68	-4.6	-3.7	-4.3
Total	1252.7	100.0	1467	100.0	4.0	100.0

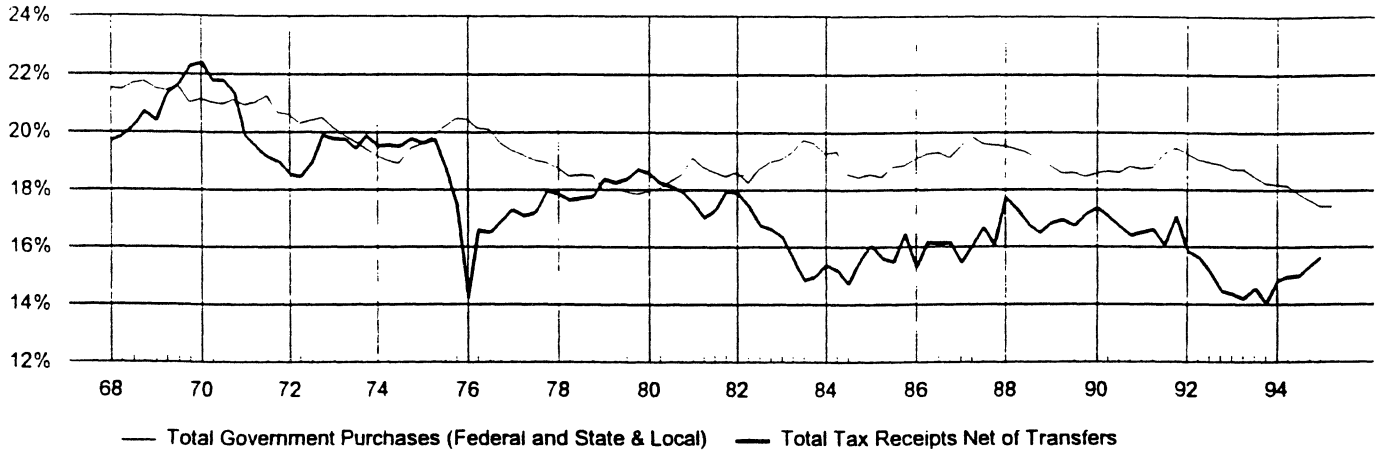
¹ Estimates for FY 1994 are from the Congressional Budget Office, *The Economic and Budget Outlook: An Update*, August 1994.

² Includes food stamps, family support, supplementary security income, veterans pensions, child nutrition, earned income tax credit, student loans, unemployment compensation, farm price supports, and other programs. Most of the increase in outlays in this category occurred in the means-tested programs, which jumped from \$58.8 Bil. in 1990 to a projected \$95 Bil. in 1994. In addition, unemployment compensation increased by approximately \$10 billion.

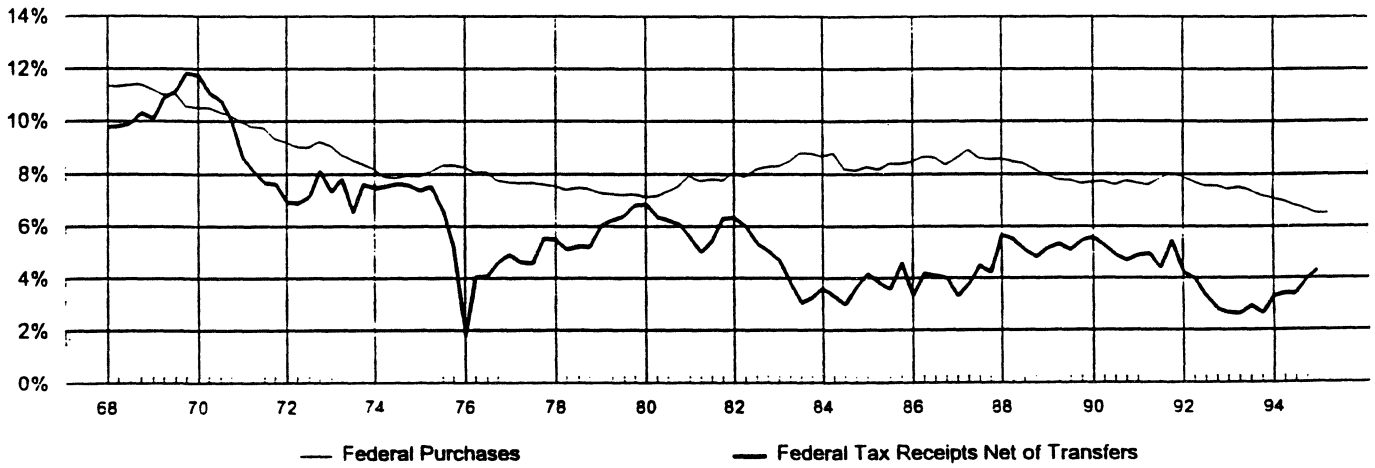
Chart 2

Government Purchases and Tax Receipts Net of Transfer
Percent of GDP

Total Government



Federal Government



September 11-12, 1994

ECONOMIC OUTLOOK

Mickey D. LEVY
Nationsbanc Capital Markets Inc.

The rate of economic growth is beginning to moderate following a period of robust expansion. Real GDP is projected to expand at an approximate 3.0 percent rate in the second half of 1994 and 2.5-3.0 percent in 1995. Inflation is expected to rise modestly, even as economic growth slows. The Federal Reserve's recent anti-inflation policy will constrain inflation pressures and limit the rise in inflation expectations. The structure of the economy remains strong, pointing toward sustained economic expansion, although the government's fiscal and regulatory policies constrain long-run potential growth.

APPROACHING A MORE TYPICAL EXPANSION

As the expansion has matured, it has become more similar to recent cycles. The economy recovered slowly from the April 1991 recession trough, as the many structural adjustments in various sectors, particularly the defense downsizing, inhibited the rate of growth. As a consequence, during the first two years of rebound, cumulative rises in nominal and real GDP, employment, and real disposable income were anemic relative to recent recoveries.

The expansion accelerated in mid-1993. Real GDP grew 4 percent from second quarter 1993 to second quarter 1994, and many key measures of economic performance are starting to catch up with the patterns of recent expansions. Although the expansion is now in its fourth year, its characteristics in the last year have been similar to the early stages of recent recoveries. From second quarter 1993 to second quarter 1994, real domestic demand grew 4.8 percent. Consumption growth of 3.5 percent exceeded the 2.8 percent growth of real disposable income, suppressing the rate of personal saving below 4.0 percent. Business investment advanced robustly (13.2 percent), particularly in information processing equipment. The net export sector has deteriorated and subtracted 0.8 percent from domestic production, as imports of consumer and producer goods have soared with the stronger economic growth.

Analogous to the early stages of recent recoveries, a cyclical jump in productivity suppressed unit labor costs. In the year ending first quarter 1994, productivity in the nonfarm sector jumped

3.1 percent, compared to its 1.0 percent average annual rise in the 1980s. While compensation increases have leveled off about 3.0 percent, unit labor costs actually declined in the second half of 1993 and have increased only 0.7 percent year-over-year.

These developments have contributed to receding inflation and building corporate profits and cash flows. Through Spring 1994, all broad measures of inflation—the CPI, PPI, and GDP deflator—receded gradually; since then, they have begun to tilt up modestly. The widening margins and rising product demand have lifted after-tax operating profits 14.8 percent in that last year.

Since Fall 1993, interest rates have also behaved similarly to recent early-recovery spurts in real economic growth, as the yield curve has flattened modestly with short-term rates rising faster than long-term rates.

Employment has also played catch-up. Whereas the economic rebound through 1993 was attributable primarily to productivity gains, job growth has jumped significantly in 1994 while productivity growth has slowed. So far this year, monthly payroll increases have averaged 269,000 compared to 160,000 in 1993, and the unemployment rate has fallen to 6.1 percent from 6.7 percent a year ago.

DISTINGUISHING CHARACTERISTICS

Several characteristics distinguish this expansion from previous ones, and these distinctions hold the key to future economic performance. The government's fiscal policy has remained restrictive, in sharp contrast to the stimulative fiscal thrust in all recent recoveries. Taxes were raised substantially in 1990 and again in 1993, the latter pushing maximum marginal tax rates above 40 percent. The federal defense downsizing has generated reductions in real government purchases. These trends have significantly reduced the cyclically-adjusted budget deficit.

Another general characteristic of this cycle has been the many noncyclical adjustments, beginning well before the recession, that have affected the growth and mix of output during the recovery. More accentuated than in recent cycles, these adjustments made the recession seem more severe than aggregate statistics indicate, and clearly have inhibited the gains during the subsequent expansion.

Reflecting these factors, the rebound of nominal GDP has been significantly slower than in previous cycles. During the first two years of recovery, nominal GDP grew 5.2 percent annually, in contrast to an average of 9.6 percent in recent cycles. In the last year, nominal GDP has accelerated

to 6.1 percent growth. At the same time, increases in the GDP deflator have fallen slightly. This change in the mix of nominal GDP between real output and inflation has contributed significantly to the recent period of strong economic growth.

One may also argue that the Federal Reserve's move to a tighter monetary policy has been more timely than in previous cycles, when delayed responses to accelerating nominal spending and price pressure allowed inflation to rise significantly. Just as the Fed has tended to ease for too long in expansions, it has invariably followed such periods with overly tight policy, generating recession. While the Fed has tightened aggressively so far in 1994, this followed an overly accommodative stance in 1992-1993. Nevertheless, the Fed now seems committed to lower inflation, has become more aware of the costs of its past mistakes, and has taken appropriate steps to limit any rise in inflation.

THE OUTLOOK FOR ECONOMIC PERFORMANCE AND INFLATION

The pace of domestic demand growth is projected to moderate toward year-end and throughout 1995. The factors underlying this slowdown are the building impact of the monetary tightening and higher interest rates, the higher taxes and restrictive fiscal policies, and the general maturing of the expansion that will bring growth toward its long-run trend.

The Fed's shift toward monetary restrictiveness is clear in the trend of bank reserves and the narrow monetary aggregates. Bank reserves have declined since February and are now at the same level as October 1993. This follows two years of 16.6 percent average annualized growth. M1 growth has slowed similarly, expanding at a 3.0 percent pace since February, while its year-over-year growth has fallen to half of its previous 12 percent rate. The slowdown in the monetary base has been much more modest—it has continued to grow at a 7.5 percent rate—reflecting the persistently rising demand for currency from abroad. Meanwhile, M2 growth has remained very modest, less than 2.0 percent in the last year, and has been decelerating gradually. Associated with this monetary slowdown has been a significant rise in short-term interest rates and a flattening of the yield curve, both symptoms of monetary tightening.

The timing of this monetary restrictiveness on domestic demand is uncertain in part due to the excess liquidity that has been provided previously. Moreover, bank reserves and M1 have been suppressed by the sharp reduction in mortgage refinancing that has accompanied the change in the Fed's posture. At issue is the extent to which the sharp declines in income velocities when the Fed was easing in 1992-1993 will be retraced as the Fed tightens and short-term interest rates rise.

Clearly, however, the shift toward monetary restrictiveness has had a telling financial market response, with a marked shift in the level and term structure of rates and a reallocation of assets among different asset classes. This suggests that some impact on aggregate demand and output is to follow.

To date, the impact of the sizable tax increases on income and capital, as well as the ongoing defense downsizing, has been overwhelmed by the tailwinds of monetary ease. As the monetary restrictiveness absorbs the excess liquidity, the higher taxes may begin to bite into economic activity.

In fact, selected evidence of slower economic growth has begun to merge, although it is measured against the earlier unsustainable spurt of activity. Consumption growth has slowed since the Spring. In particular, automotive sales have receded, although some of this decline has been the result of insufficient inventories. Department store sales have weakened modestly. Surveys of consumer confidence have drifted lower from their peaks, although they remain high. Housing activity is firm, but slightly below Spring levels. Only business investment has continued to rise robustly. As a result, domestic final sales have slowed to a 1.4 percent growth rate in second quarter 1994 from 6.5 percent in fourth quarter 1993. They are projected to *reaccelerate* through most of the remainder of this year, averaging 3.0-3.5 percent, and grow approximately 2.5-3.0 percent in 1995.

The deteriorating trade deficit is expected to stabilize toward year-end and improve in 1995, adding to GDP growth. Import growth is projected to decelerate in response to slower domestic demand growth and the higher relative cost of imports (import prices rose about 10 percent annualized in second quarter 1994, and prices of nonpetroleum imports are beginning to pick up). Exports are expected to accelerate in 1995 from their already rapid pace (real exports grew 7.1 percent in the last year), benefiting from economic recovery in Europe and Japan.

Inflation is projected to increase modestly, even as real economic growth slows. Through 1995, the CPI is projected to accelerate gradually to approximately 3.5-3.75 percent from its current year-over-year pace of 2.8 percent, while the GDP deflator should tend toward 3.0 percent from its present 2.0 percent rate.

To date, several factors have kept inflation low. First, inflation is caused by the excess of nominal spending over productive capacity, not by strong economic growth. Rapid increases in business investment have expanded industrial capacity, while the modest acceleration of product

demand and nominal GDP has constrained the ability of business to raise prices. Accelerating price increases have been limited to selected products in strong demand but these have been offset by slower price increases or outright decline for products in weak demand.

Secondly, strong increases in productivity have offset wage increases to constrain unit labor costs, and labor markets are only selectively tight. Thirdly, on average, increases in nonwage costs of production have remained low as decelerating increases in nonwage compensation (including health and pension benefits) have offset accelerating prices of certain commodities and industrial materials.

But now inflation is tilting modestly upward. Unit labor costs are rising as employment and aggregate hours worked jump and productivity gains abate. In recent months, producer prices have accelerated at both the intermediate and finished goods levels. The recent acceleration in GDP and product demand will allow price increases across a broader array of consumer goods and services. In recent cycles, as expansions have matured, the inflation portion of nominal GDP has risen gradually while real growth has tended toward its long-term trendline. Nominal GDP growth of 5.5-6.0 percent in 1995—a modest slowdown from its recent trend—would generate a rise in the GDP deflator to approximately 3.0 percent while real growth slows to about 2.75 percent. More rapid nominal spending growth would strain industrial and labor capacity and push inflation higher. However, the Fed's recent monetary tightening limits any sustained acceleration of aggregate demand.

THE OUTLOOK FOR INTEREST RATES

Short-term interest rates have risen to reflect the acceleration in economic growth and the associated monetary tightening. The Fed's two recent half-point hikes in the funds rate have increased its inflation-fighting credibility and flattened the yield curve. Thus, a higher portion of interest reflects expected real return and a smaller portion reflects expectations of inflation and other risks. Whereas most of the curve flattening through July occurred in maturities beyond 5 years, the Fed's half-point more in mid-August generated a substantial flattening in the shorter maturities (up to 2 years).

This term structure flattening and the failure of bond yields to rise more significantly, despite the earlier erratic decline in the U.S. dollar, clearly signals the heightened credibility of the Fed. This sets a positive tone for financial markets, limiting the negative impact of inflation pressures.

However, the Fed is expected to raise the funds rate further, to around 5.25-5.5 percent, as it continues to constrain inflation. As long as economic growth remains strong, further curve flattening is likely to occur primarily by short-rate rising.

The present 7.7 percent yield on the long Treasury bond embodies either expectations of stronger potential economic growth or risk of a significant rise in inflation. The former seems unlikely in light of the thrust of fiscal policy, which discourages saving and investment and constrains potential capacity. As the Fed continues to pursue a low inflation objective and economic growth moderates to its long-term trendline, a further curve flattening will occur as bond yields recede towards 7.0 percent. However, this may not occur until 1995, as bond yields remain around 7.5-7.75 percent as they digest modestly higher inflation.

SUSTAINABILITY OF THE EXPANSION

The structure of the economy is solid and points toward sustained expansion, although risks exist. Inflation remains low and the Fed's monetary policy is expected to limit inflation pressures. The significant restructuring of business finances and production processes has eliminated many of the potentially disruptive excesses in the economy. Debt burdens have been lowered. Unit labor costs have been reduced below inflation, generating strong profits and cash flows that provide a base for permanent job gains. Rapid business investment has raised capacity, while inventories are low relative to sales and output. Household balance sheets are vastly improved, as more than half of the 1980's sharp rise in debt burden has been retraced. The defense downsizing is well underway, and its primary impact will be regional and sectoral, and not threatening to the overall expansion. U.S. unit labor costs are at or below those of other industrialized nations, and exports continue to rise, even as major trading partners struggle to recover from recession. Exports are receiving an additional boost from NAFTA and should continue to strengthen with overseas economies, shrinking the trade and current account deficits.

There are no immediate threats to expansion. Given past Fed patterns, the risk of excessive monetary tightening is of some concern. The Fed may target the funds rate too high and in doing so drain real money balances over a sustained period, in an overzealous attempt to slow real growth, maintain its inflation-fighting credibility, or stem a disorderly decline in the U.S. dollar. Responding to the dollar would be particularly bothersome insofar as the recent fall in the currency, amid monetary tightening and a flattening yield curve, seems clearly to be a nonmonetary phenomenon. While the Fed's funds rate targeting is a recipe for monetary policy excesses and recent money growth has slowed sharply, the previous accommodative policy provides a cushion.

The recent thrust of fiscal policy—tax increases, cuts in defense purchases, an ongoing reallocation of spending toward consumption-oriented entitlements and away from investment-oriented activity, as well as the systematic tax bias against saving—has not unhinged the recovery and is unlikely to do so. It does, however, reduce long-run potential growth. Similarly, enactment of potentially costly pending legislation for health care reform, the crime bill, or welfare reform, may change the mix of output, but its short-term impact on economic growth would likely be minor relative to its cumulative impact on long-run potential output.

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ECONOMIC AND FINANCIAL PERSPECTIVES

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NATIONSBANC CAPITAL MARKETS, INC.

SHADOW OPEN MARKET COMMITTEE
WASHINGTON, D.C.

SEPTEMBER 12, 1994

S N A P S H O T												
QUARTERLY DATA	Levels				Quarterly % Change (annualized)				Yr-to-Yr % Change			
	1993		1994		1993		1994		1993		1994	
	III	IV	I	II	III	IV	I	II	III	IV	I	II
Nominal GDP	6359.2	6478.1	6574.7	6685.5	3.8%	7.7%	6.1%	6.9%	5.2%	5.0%	5.4%	6.1%
GDP	5139.4	5218.0	5261.1	5310.2	2.7%	6.3%	3.3%	3.8%	3.0%	3.1%	3.7%	4.0%
Domestic Demand	5225.8	5300.2	5365.1	5423.1	4.0%	5.8%	5.0%	4.4%	3.9%	3.9%	4.5%	4.8%
Final Sales	5126.5	5207.2	5235.7	5253.9	3.2%	6.4%	2.2%	1.4%	2.8%	3.0%	3.5%	3.3%
Domestic Final Sales	5212.8	5289.4	5339.7	5366.7	4.5%	6.0%	3.9%	2.0%	3.8%	3.9%	4.4%	4.1%
Disposable Personal Income	3708.4	3747.8	3779.2	3804.7	0.8%	4.3%	3.4%	2.7%	2.0%	0.5%	3.3%	2.8%
Consumption	3472.2	3506.2	3546.3	3558.6	3.9%	4.0%	4.7%	1.4%	3.4%	3.0%	3.8%	3.5%
Residential Investment	211.0	224.5	229.9	234.0	9.4%	28.2%	10.0%	7.3%	7.2%	8.1%	9.3%	13.4%
Business Investment	597.9	627.2	643.6	657.9	12.2%	21.1%	10.9%	9.2%	12.6%	16.0%	14.9%	13.2%
Inventory Investment	13.0	10.8	25.4	56.3	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Government Purchases	931.8	931.5	919.9	916.3	1.1%	-0.1%	-4.9%	-1.6%	-0.7%	-1.0%	-0.7%	-1.4%
Exports	595.3	625.2	619.6	642.7	-3.2%	21.7%	-3.5%	15.8%	2.5%	5.8%	5.2%	7.1%
Imports	681.6	707.4	723.6	755.6	7.4%	16.0%	9.5%	18.9%	10.0%	12.4%	11.9%	12.8%
Current Account	(c) -27.9	-30.6	-31.9	NA	-2.3	-2.7	-1.3	NA	-9.2	-6.2	-12.1	NA
GDP Deflator	123.7	124.1	125.0	125.9	1.0%	1.3%	2.9%	2.9%	2.1%	1.8%	1.7%	2.0%
Employment Costs (Private)	118.9	119.9	120.7	121.8	3.4%	3.4%	2.7%	3.7%	3.7%	3.6%	3.3%	3.3%
Unit Labor Costs (Non-Farm)	137.7	136.9	137.9	139.1	-1.2%	-2.3%	3.0%	3.5%	1.3%	0.6%	0.3%	0.7%
Productivity (Non-Farm)	115.8	117.2	118.0	117.2	4.3%	4.9%	2.8%	-2.7%	1.7%	1.9%	3.1%	2.3%
Compensation (Non-Farm)	159.4	160.4	162.8	163.1	2.8%	2.5%	6.1%	0.7%	3.0%	2.5%	3.4%	3.0%
Corporate Profits A/T	(a) 288.9	310.2	299.4	321.6	1.4%	7.4%	-3.5%	7.4%	23.0%	17.1%	9.7%	12.9%
Operating Profits A/T	(a) 323.6	342.4	324.1	345.9	7.4%	5.8%	-5.3%	6.7%	35.6%	20.6%	14.6%	14.8%
Net Cash Flow	(a) 540.6	565.5	572.2	582.5	2.9%	4.6%	1.2%	1.8%	12.2%	13.9%	12.6%	10.9%
MONTHLY DATA	Levels				Monthly % Change				12 Month % Change			
	May-94	Jun-94	Jul-94	Aug-94	May-94	Jun-94	Jul-94	Aug-94	May-94	Jun-94	Jul-94	Aug-94
Purchasing Managers Index	57.7	57.5	57.8	56.2	0.0%	-0.3%	0.5%	-2.8%	13.6%	17.8%	16.8%	13.8%
Non-Farm Payrolls	(b) 112.951	113.334	113.585	113.764	252	383	251	179	2.4%	2.7%	2.7%	2.8%
Manufacturing Payrolls	(b) 18.009	18.044	18.045	18.077	2	35	1	32	-0.1%	0.3%	0.4%	0.7%
Unemployment Rate	(c) 6.0	6.0	6.1	6.1	-0.4	0.0	0.1	0.0	-0.9	-0.9	-0.7	-0.6
Average Workweek (sa)	34.8	34.6	34.7	34.5	0.3%	-0.6%	0.3%	-0.6%	0.3%	0.6%	0.6%	-0.3%
Avg. Hourly Earnings (sa)	11.09	11.08	11.11	11.13	0.4%	-0.1%	0.3%	0.2%	2.6%	2.5%	2.7%	2.5%
Total Vehicle Sales, incl. LT Trucks	14.6	14.4	13.7	NA	-3.4	-1.3	-5.0	NA	2.3	4.4	-0.0	NA
Domestic Unit Auto Sales	7.1	6.9	6.5	7.4	-4.1%	-2.9%	-6.2%	14.8%	2.7%	1.9%	-1.7%	10.1%
Industrial Production	116.3	116.9	117.2	NA	0.3%	0.5%	0.3%	NA	5.7%	5.9%	5.7%	NA
Capacity Utilization	83.7	83.9	83.9	NA	0.0%	0.2%	0.0%	NA	3.3%	3.5%	3.2%	NA
PPI	119.9	120.4	120.6	121.2	0.2%	0.4%	0.2%	0.5%	0.2%	0.8%	1.2%	2.1%
PPI Ex. Food & Energy	137.2	137.1	137.1	137.2	0.4%	-0.1%	0.0%	0.1%	0.4%	0.6%	0.5%	1.9%
CPI	147.7	148.1	148.6	NA	0.2%	0.3%	0.3%	NA	2.4%	2.8%	2.8%	NA
CPI Ex. Food & Energy	156.3	156.7	157.0	NA	0.3%	0.3%	0.2%	NA	2.8%	2.9%	2.9%	NA
Retail Sales	183.4	184.9	184.8	NA	-0.0%	0.8%	-0.1%	NA	6.6%	7.3%	6.6%	NA
Housing Starts	1491	1351	1415	NA	1.4%	-9.4%	4.7%	NA	20.1%	9.1%	13.7%	NA
Permits	1357	1316	1337	NA	-1.7%	-3.0%	1.6%	NA	21.9%	17.3%	14.4%	NA
Federal Budget Surplus/Deficit	(d) -32.1	14.9	-33.2	NA	4.9	3.8	6.4	NA	-208.3	-204.5	-198.2	NA
Durable Goods Orders	149.4	151.2	144.8	NA	1.4%	1.2%	-4.3%	NA	17.8%	14.3%	12.6%	NA
Manufacturing Orders	277.4	279.8	273.3	NA	0.8%	0.8%	-2.3%	NA	11.7%	9.5%	9.1%	NA
Personal Income (\$87)	5655.7	5663.0	5692.9	NA	0.4%	0.1%	0.5%	NA	5.2%	5.6%	6.3%	NA
Consumption (\$87)	3558.7	3570.1	3562.8	NA	0.3%	0.3%	-0.2%	NA	3.5%	3.4%	2.9%	NA
Personal Saving Rate	(c) 3.9	4.0	NA	NA	0.0	0.1	NA	NA	-0.7	-0.1	NA	NA
Leading Economic Indicators	101.3	101.5	101.5	NA	0.1%	0.2%	0.0%	NA	3.3%	3.5%	3.7%	NA
Total Business Inventories	885.2	889.8	NA	NA	1.2%	0.5%	NA	NA	3.5%	3.9%	NA	NA
Inventory/Total Sales	(c) 1.41	1.41	NA	NA	0.01	0.00	NA	NA	-0.04	-0.04	NA	NA
International Trade	(c) -9.5	-9.4	NA	NA	-1.0	0.1	NA	NA	-4519	-1716	NA	NA
3 Month Bill	(c) 4.30	4.29	4.50	4.61	0.47	-0.01	0.21	0.11	1.28	1.12	1.38	1.49
2 Year Note	(c) 5.97	5.93	6.13	6.18	0.42	-0.04	0.20	0.05	1.99	1.77	2.06	2.18
10 Year Note	(c) 7.18	7.10	7.30	7.24	0.21	-0.08	0.20	-0.06	1.14	1.14	1.49	1.58
30 Year Bond	(c) 7.41	7.40	7.58	7.49	0.14	-0.01	0.18	-0.09	0.49	0.59	0.95	1.17
DJIA	3708.0	3737.6	3718.3	3797.5	1.3%	0.8%	-0.5%	2.1%	6.6%	6.4%	5.4%	5.6%
S&P 500	450.90	454.83	451.40	464.24	0.8%	0.9%	-0.8%	2.8%	1.3%	1.5%	0.9%	2.2%
U.S. Dollar (FRB)	92.79	91.60	89.08	89.28	-1.7%	-1.3%	-2.8%	0.2%	2.8%	-0.2%	-5.8%	-5.4%
Yen/\$	104	103	98	100	0.3%	-1.2%	-4.0%	1.5%	-6.0%	-4.5%	-8.6%	-3.7%
DM/\$	1.66	1.63	1.57	1.56	-2.5%	-1.8%	-3.7%	-0.2%	3.1%	-1.7%	-8.6%	-7.7%
M1	1142.9	1146.4	1153.7	NA	0.2%	0.3%	0.8%	NA	7.0%	6.5%	6.2%	NA
M2	3595.2	3587.9	3601.9	NA	0.1%	-0.2%	0.4%	NA	2.1%	1.7%	1.9%	NA
Bank Reserves	59910	59708	59819	59532	-0.7%	-0.3%	0.2%	-0.5%	5.6%	4.7%	3.9%	2.6%
C&I Loans & Non-Financial CP												
Consumer Credit	838.7	849.9	855.5	NA	1.4%	1.3%	0.7%	NA	12.3%	13.0%	12.9%	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

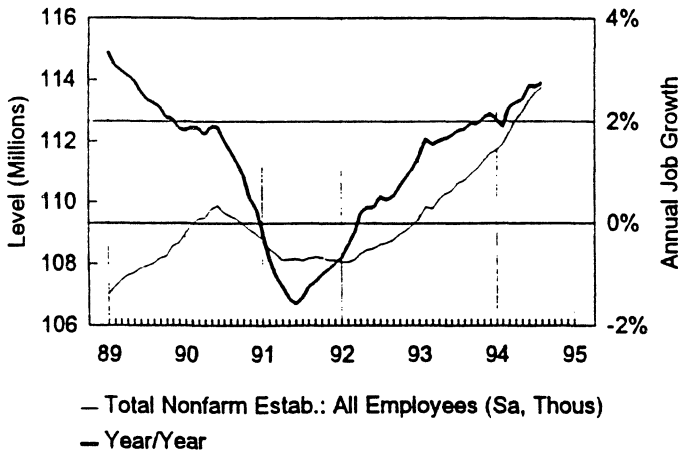
09/09/94

September 11-12, 1994

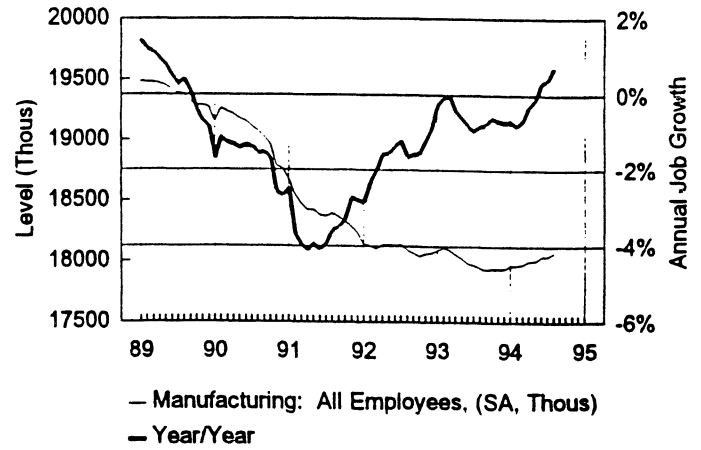
Chart 1

Selected Indicators: Employment and Earnings

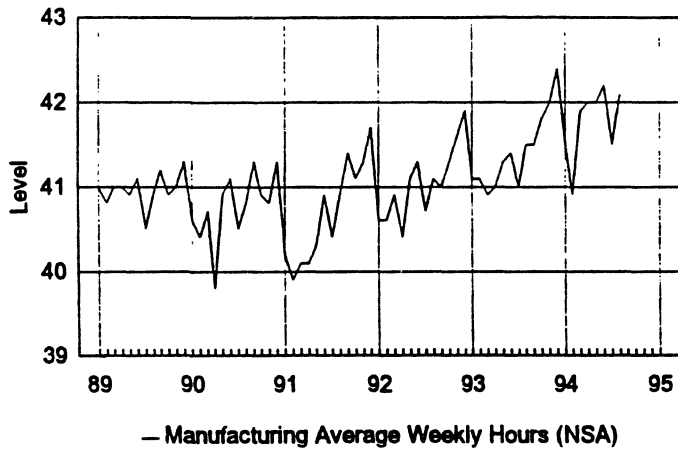
Non-Farm Payroll Employment



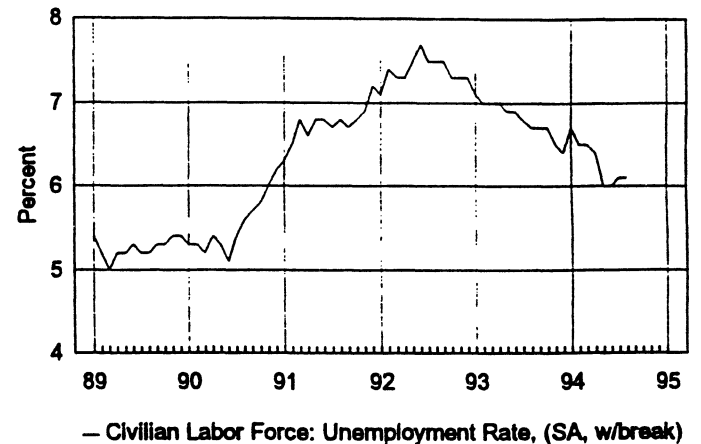
Manufacturing Jobs



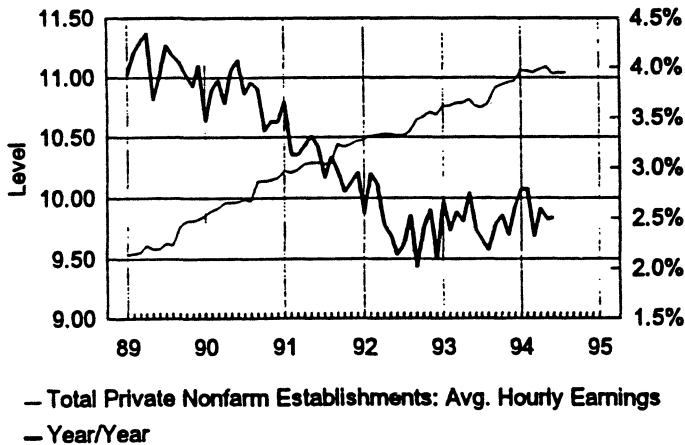
Average Workweek in Manufacturing



Unemployment Rate



Average Hourly Earnings



Employment/Population Ratio

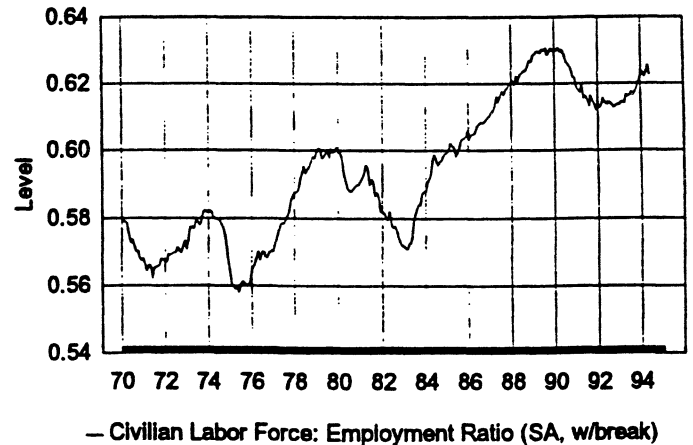
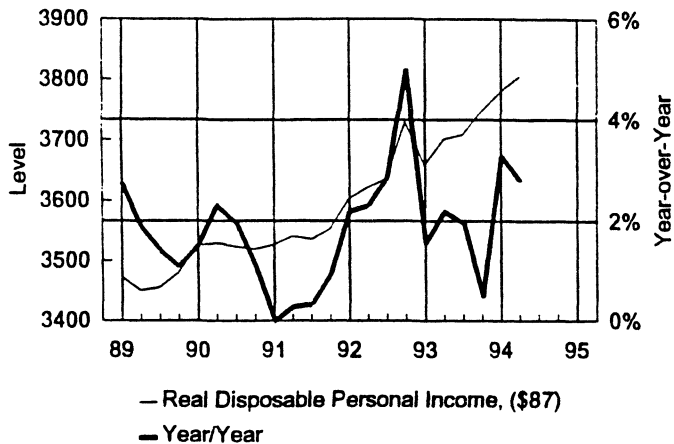


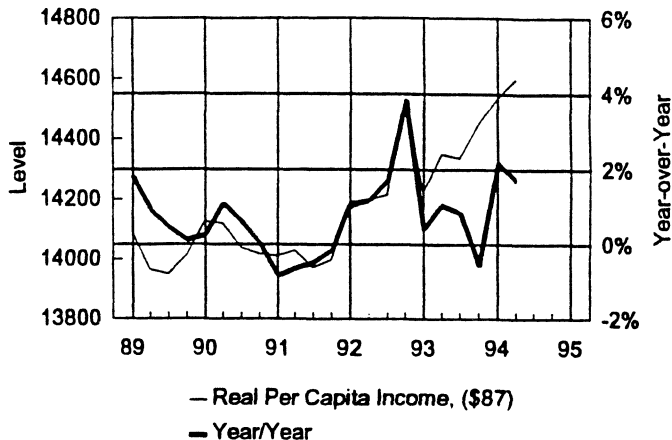
Chart 2

Selected Indicators: Income and Profits

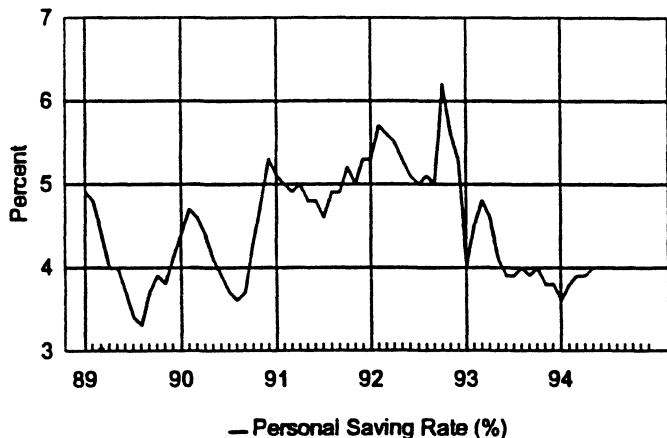
Real Disposable Personal Income



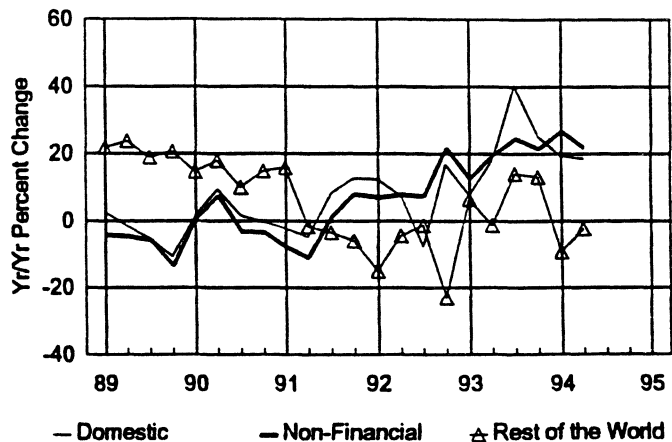
Real Per Capita Income



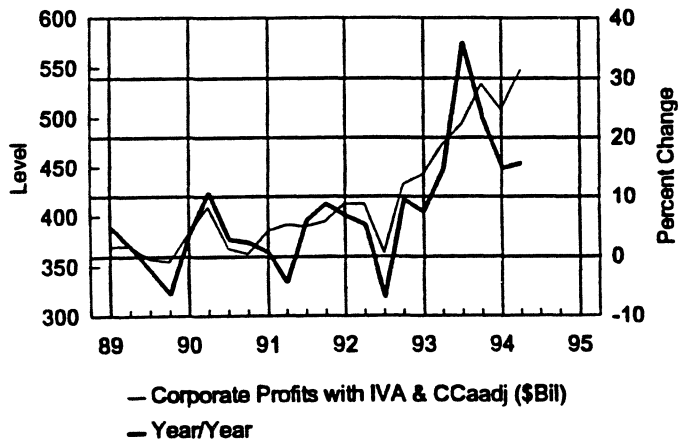
Personal Saving



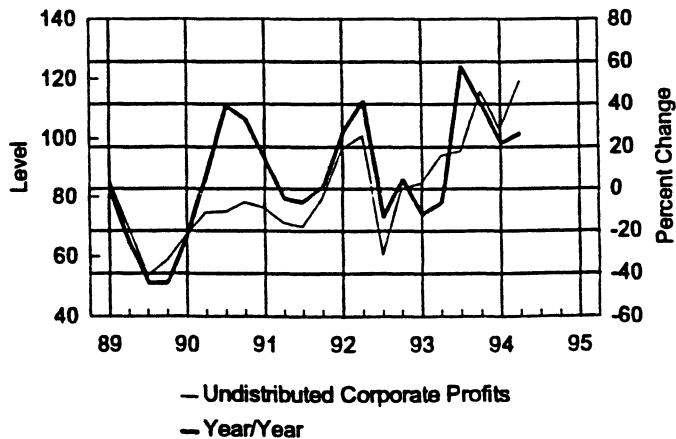
The Mix of Profits



Corporate Profits



Undistributed Corporate Profits

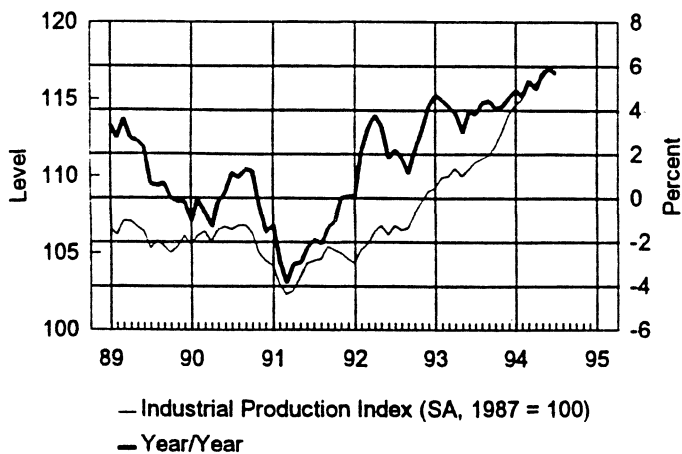


September 11-12, 1994

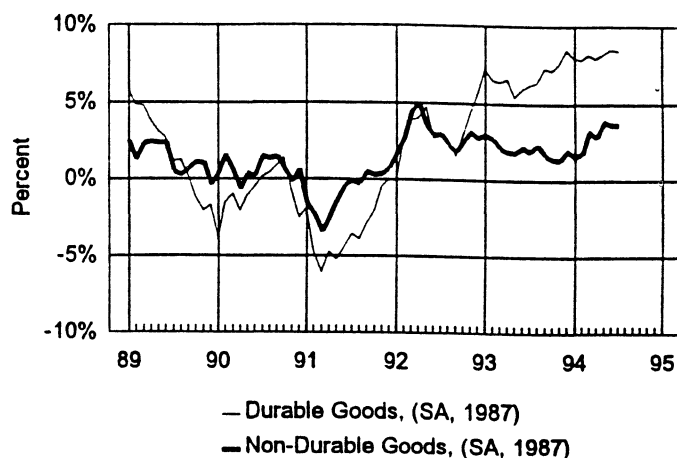
Chart 3

Indicators of Production

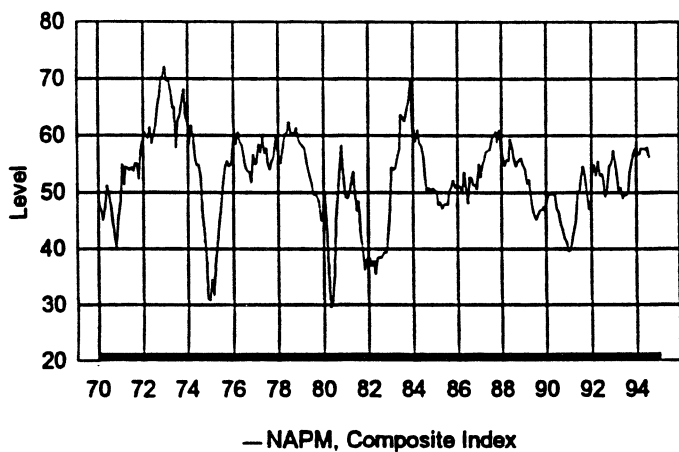
Industrial Production



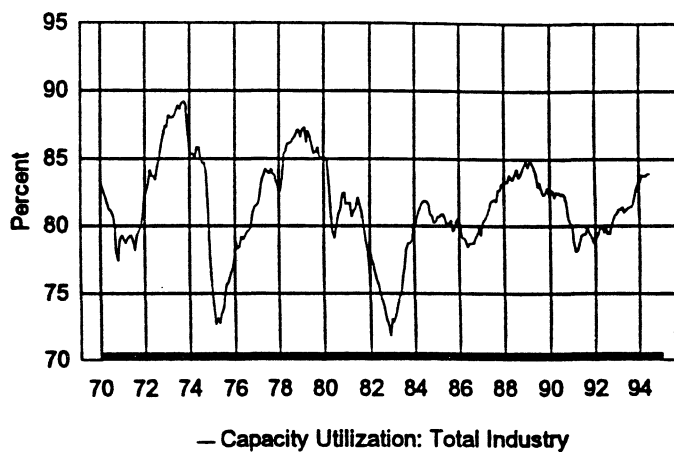
Industrial Production: Durable & Non-Durables



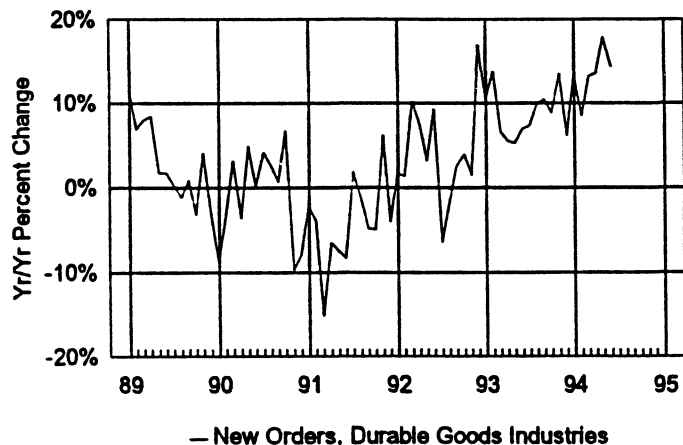
NAPM - Composite Index



Capacity Utilization



Durable Goods Orders



Aggregate Hours Worked

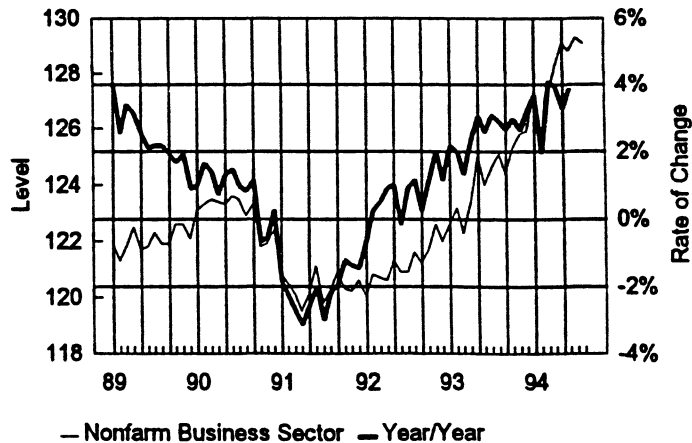
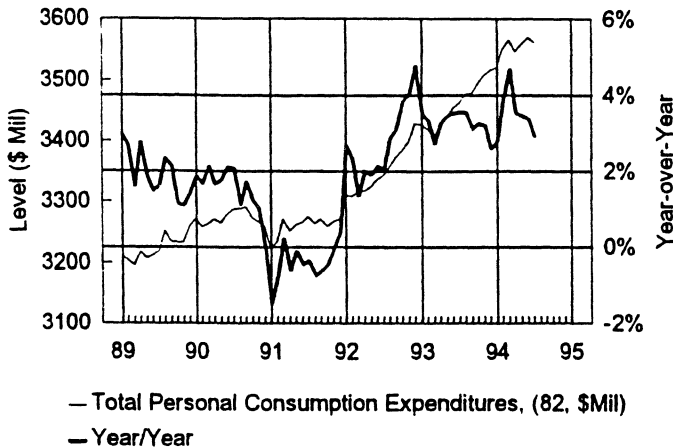


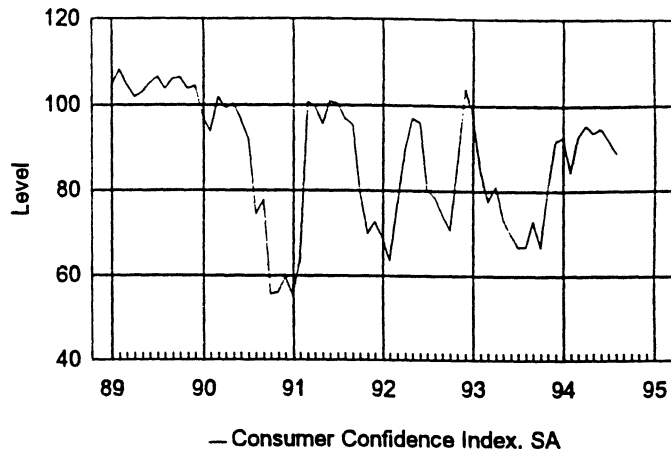
Chart 4

Selected Indicators: Consumption

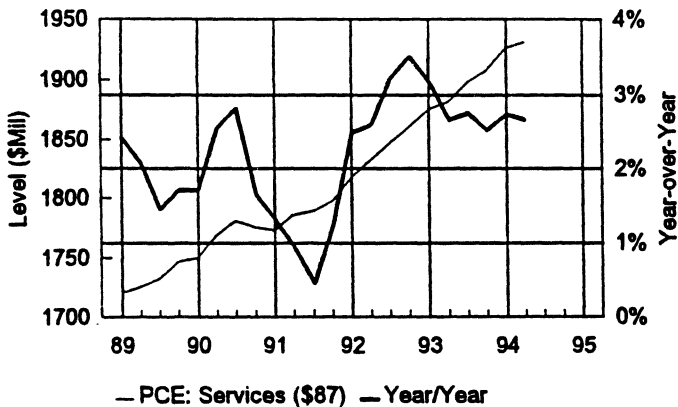
Real Consumption



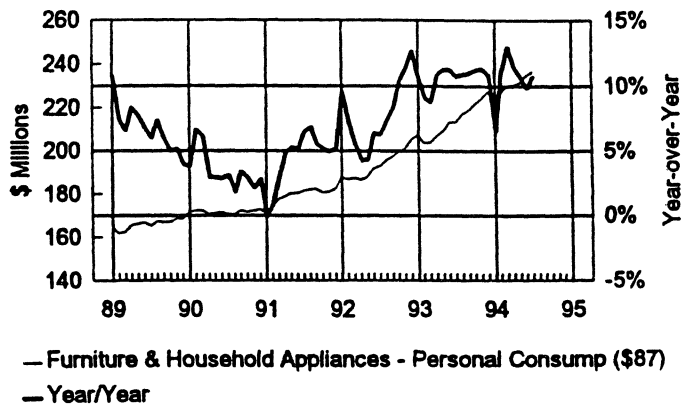
Consumer Confidence Index



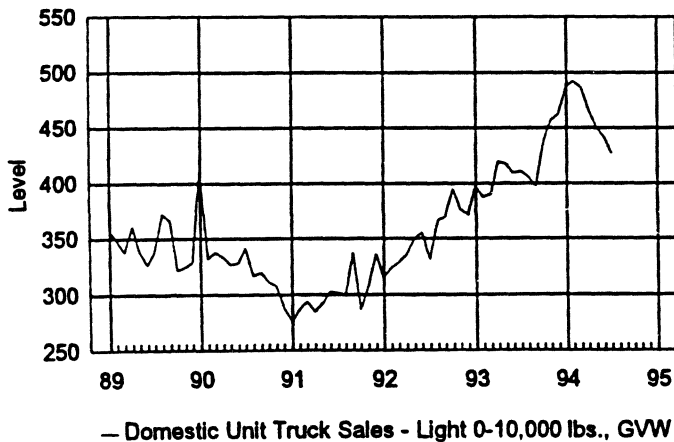
Real Personal Consumption Expenditures Services



Real Consumption of Furniture & Household Appliances



Light Truck Sales



Retail Auto Sales

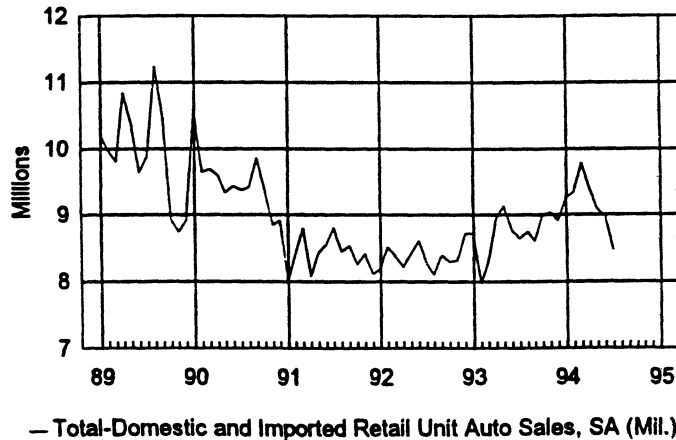
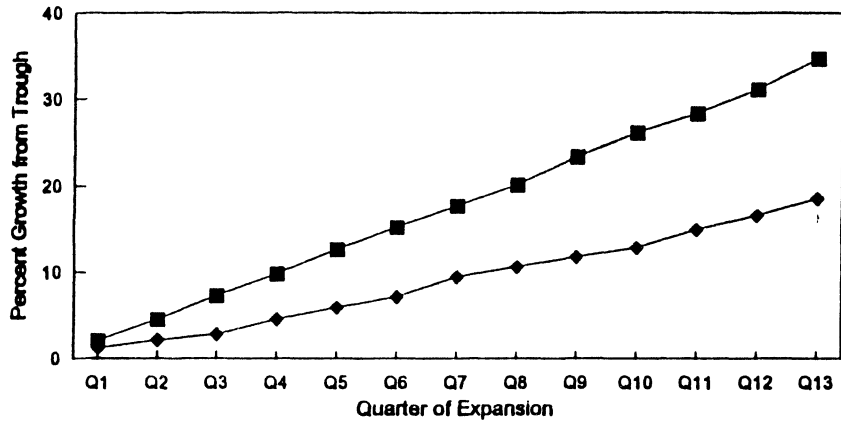


Chart 4A

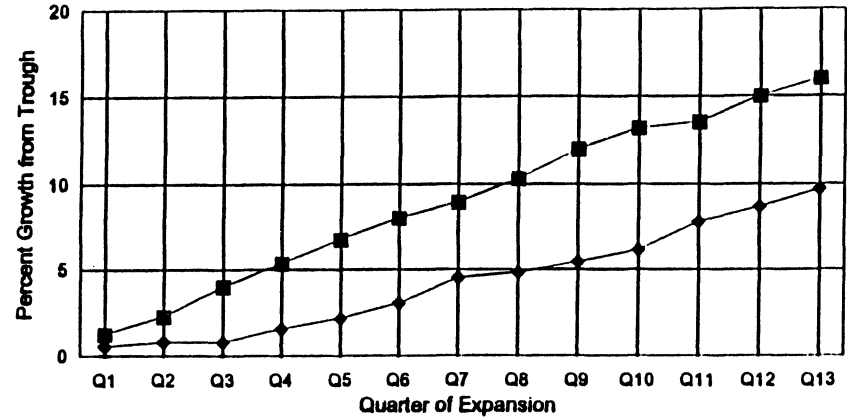
The Current Expansion in Perspective

Nominal GDP



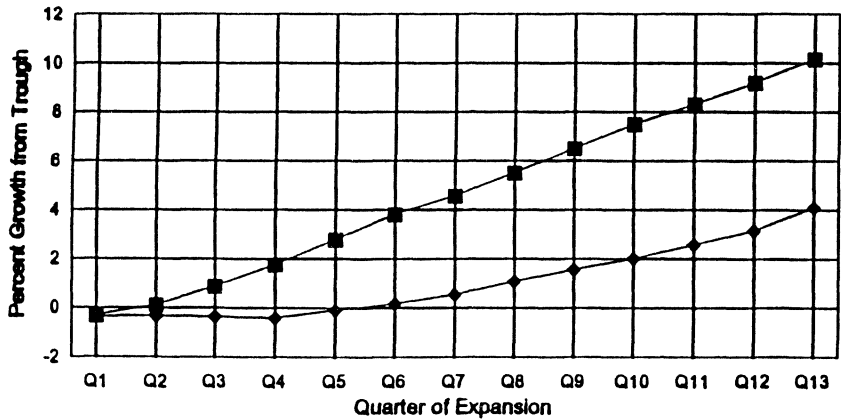
■ Average of Four Previous Expansions ◆ Current Expansion

Real GDP



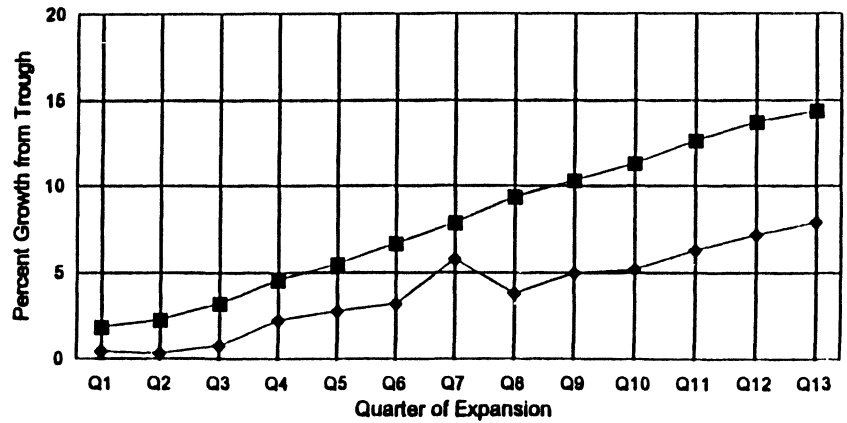
■ Average of Four Previous Expansions ◆ Current Expansion

Employment



■ Average of Four Previous Expansions ◆ Current Expansion

Real Disposable Income



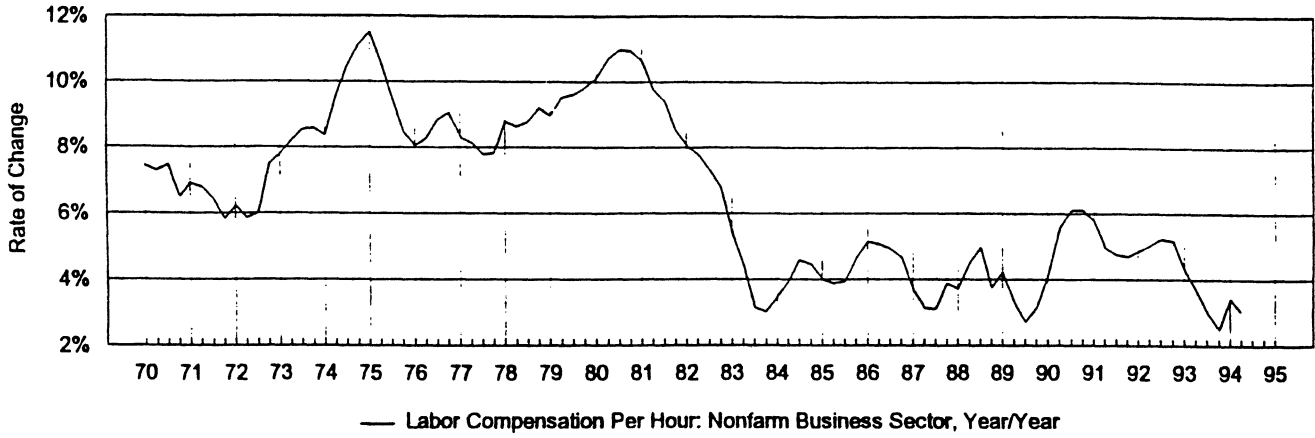
■ Average of Four Previous Expansions ◆ Current Expansion

September 11-12, 1994

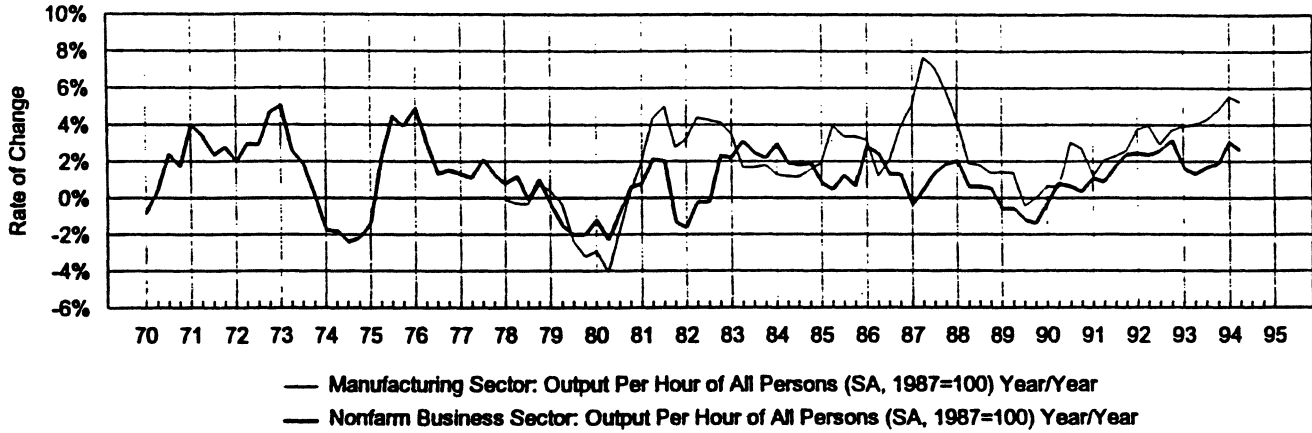
Chart 5

Compensation, Productivity and Unit Labor Costs

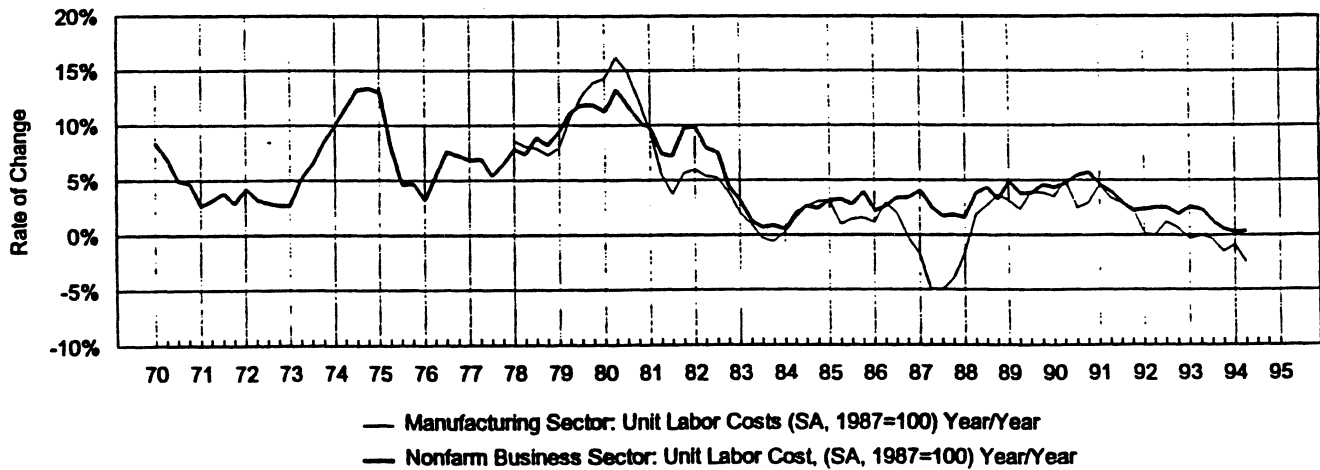
Compensation



Productivity



Unit Labor Cost Inflation

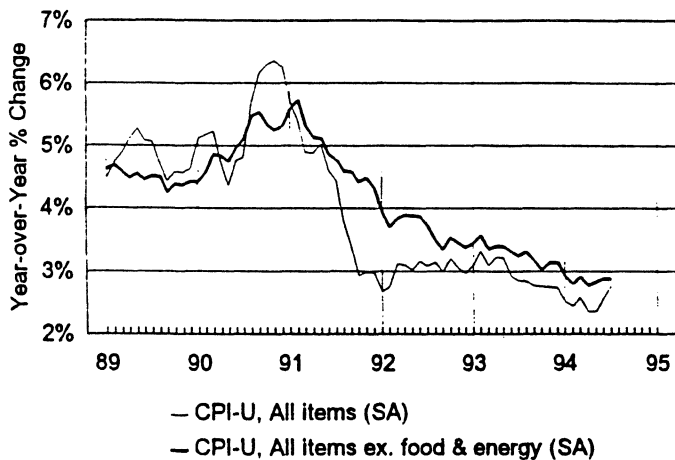


September 11-12, 1994

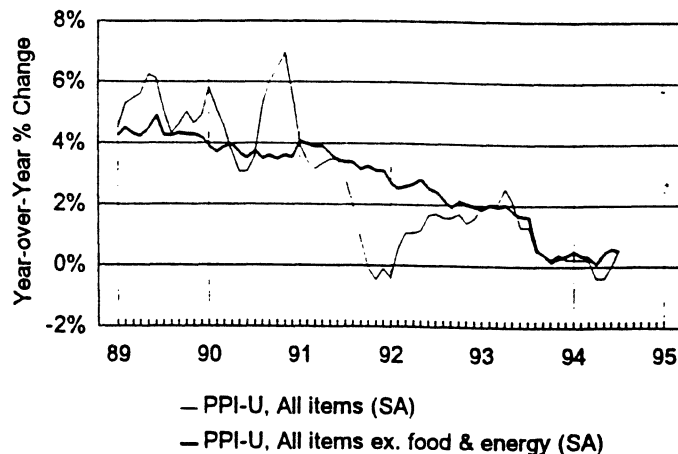
Chart 6

Selected Indicators of Inflation

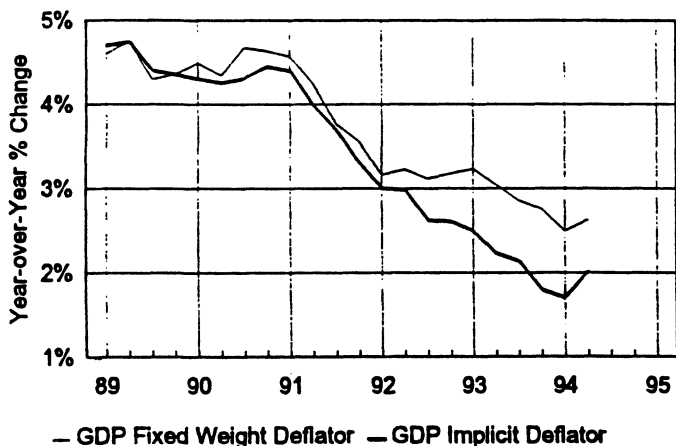
Consumer Price Index



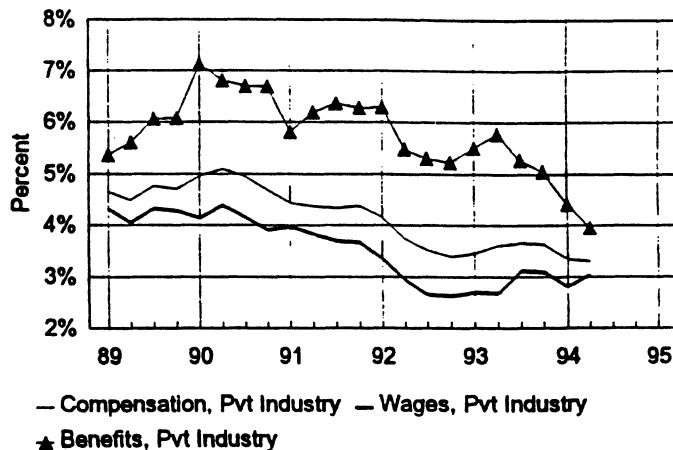
Producer Price Index



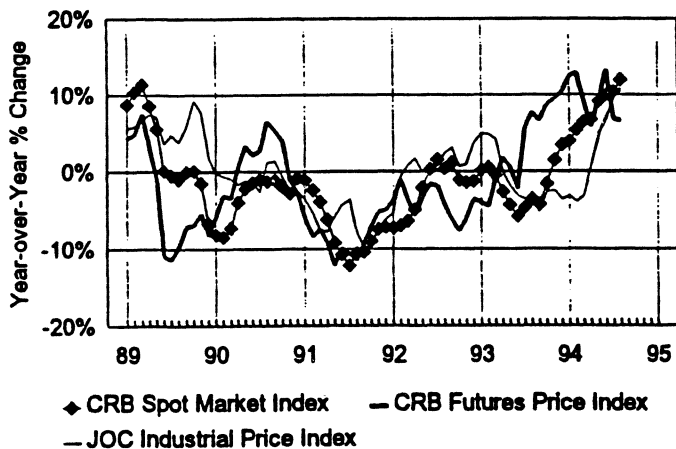
GDP Deflators



Employment Costs



Commodity Prices



NAPM: Survey of Prices

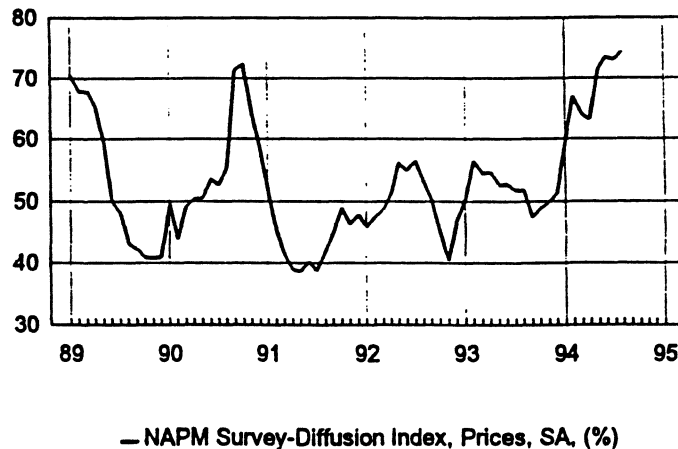


Table 1

Federal Reserve Objectives and Monetary Policy

Federal Reserve Objectives and Actual Performance Selected Economic Variables, Percent Change

	Central Tendency Forecasts			Actual Performance
	Q4:93 - Q4:94		Q4:94 - Q4:95	
	Feb. Forecast	July Forecast	July Forecast	
Real GDP	3% - 3.25%	3% - 3.25%	2.5% - 2.75%	4.0% yr/yr; 3.6% in 1st half of 1994
CPI Inflation	about 3%	2.75% - 3%	2.75% - 3.5%	2.8% yr/yr; (2.7% since 1993:IV)
Nominal GDP	5.5% - 6%	5.5% - 6%	5% - 5.5%	6.1% yr/yr; (6.5% since 1993:IV)

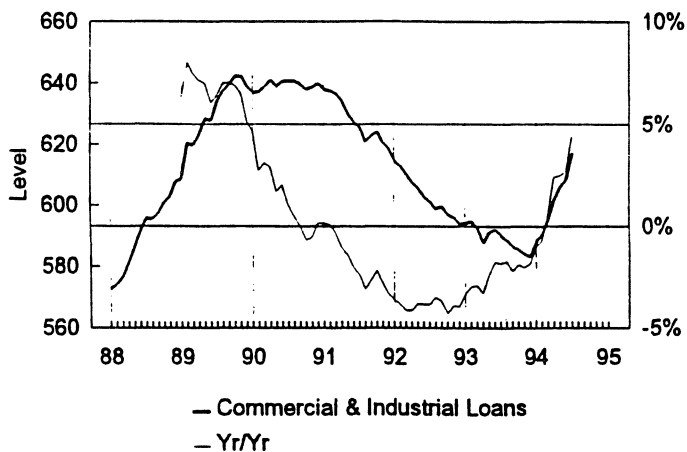
The Fed's Money Supply Targets and Actual Trends

	Money Growth Targets			Annualized % Change		Yr/Yr
	Q4:93 - Q4:94		Q4:94 - Q4:95	Last 3 Months	Last 6 Months	
	Feb. Target	July Target	Target			
Bank Reserves	not targeted		-	-2.5	-4.0	2.6
M1	not targeted		-	4.5	3.6	6.2
M2	1-5	1-5	1-5	1.1	1.6	1.9
M3	0-4	0-4	0-4	1.7	0.4	1.4
Debt	4-8	4-8	3-7	5.1	5.3	5.4

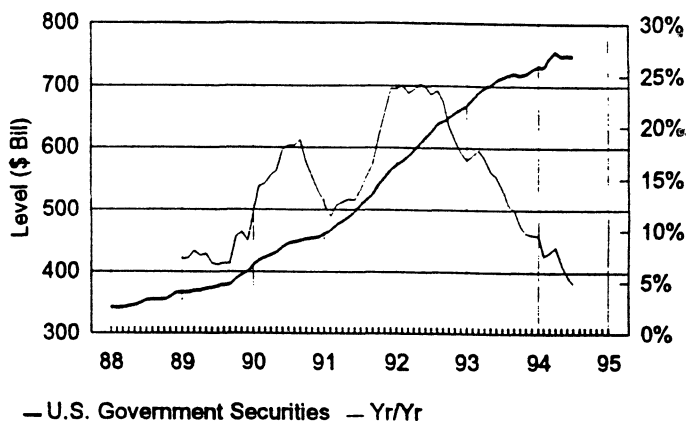
Chart 7

Bank Credit Conditions

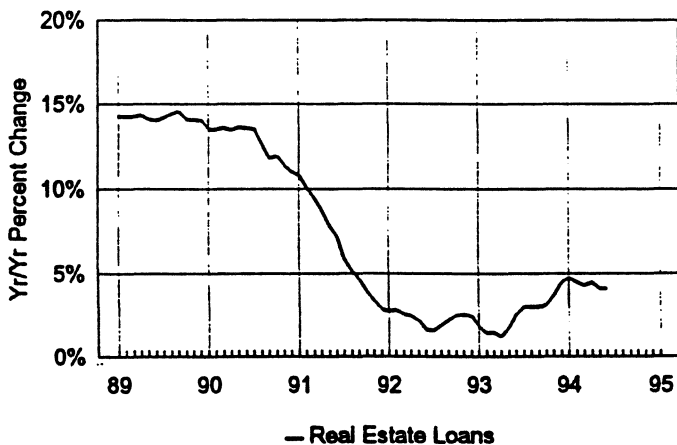
Commercial & Industrial Loans



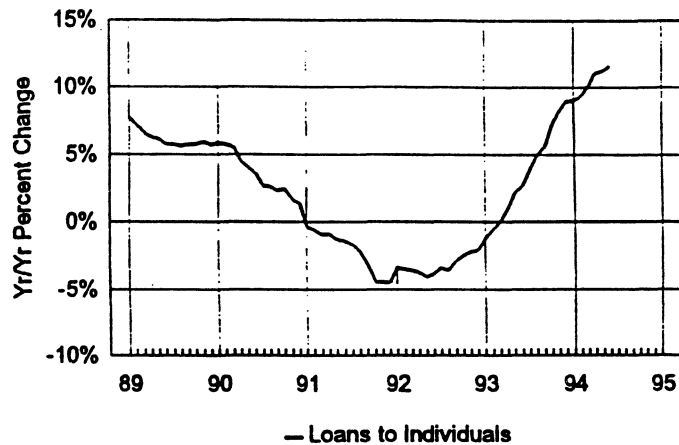
U.S. Government Securities held at Commercial Banks



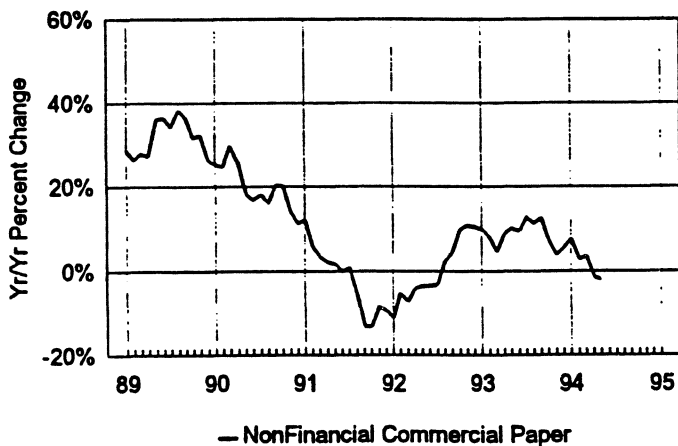
Real Estate Loans



Loans to Individuals



NonFinancial Commercial Paper



Small Time Deposits

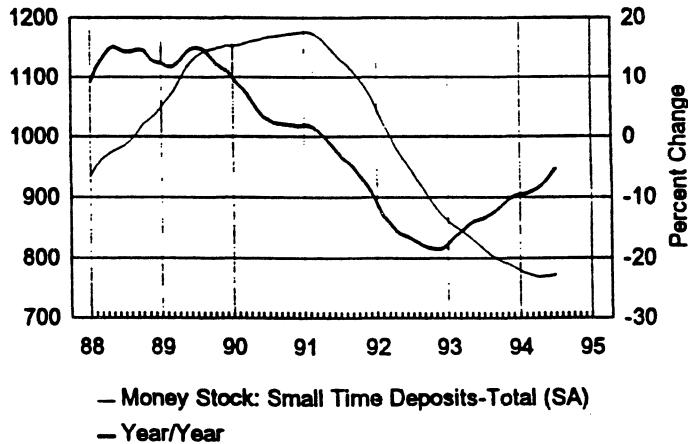
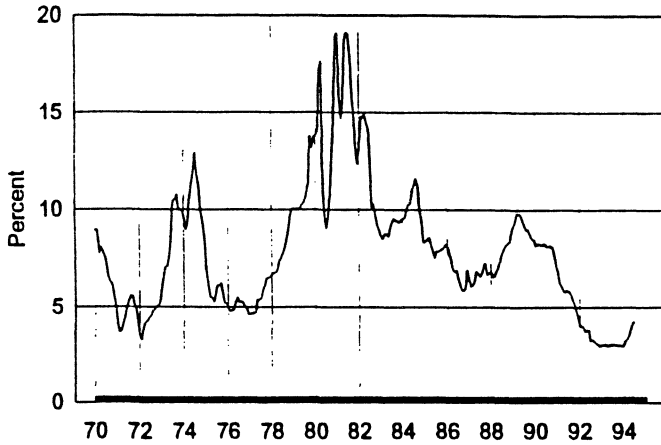


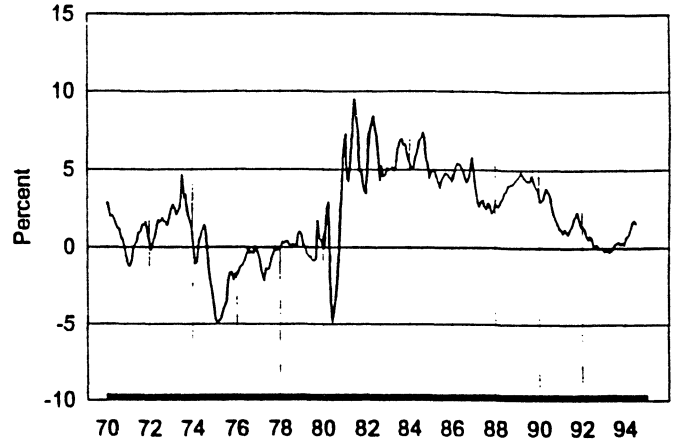
Chart 8

Selected U.S. Interest Rates

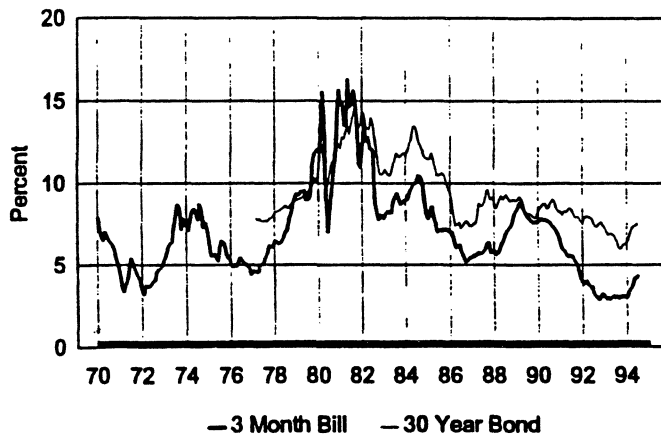
Federal Funds Rate



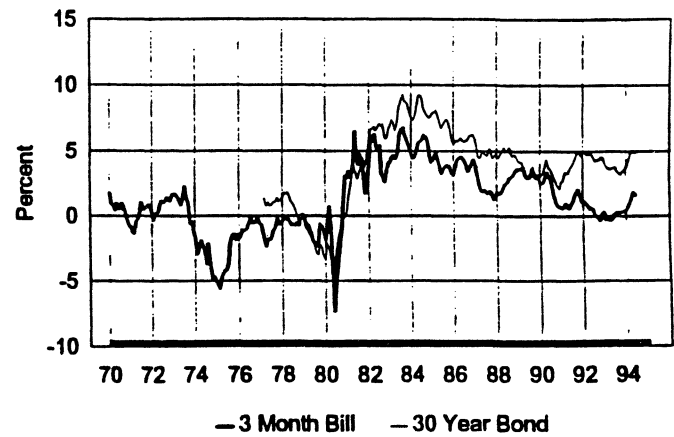
Inflation-Adjusted Federal Funds Rate



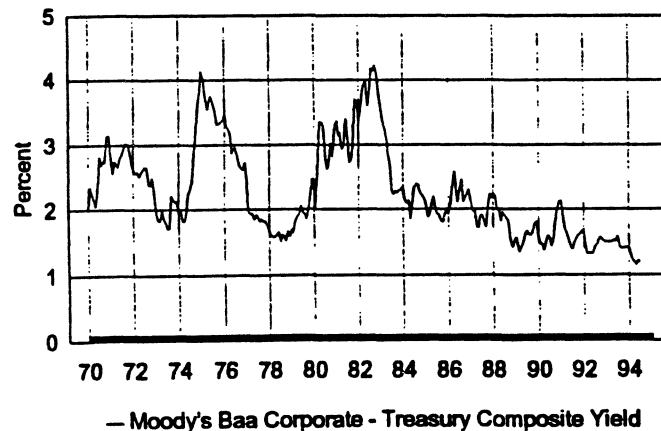
Treasury Yields



Inflation-Adjusted Treasury Yields



Corporate Spread over Treasuries



Treasury Yield Spread

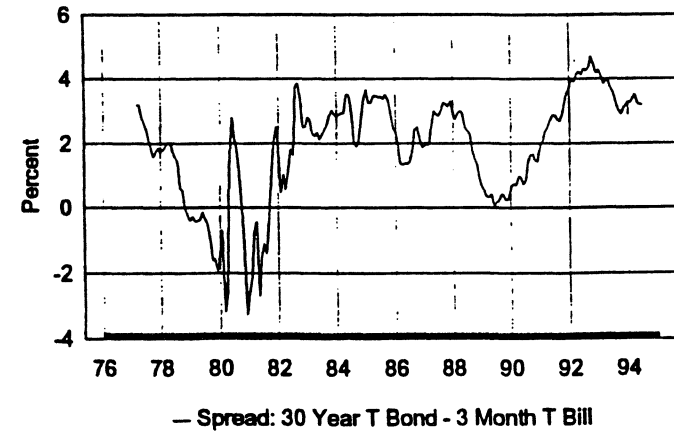
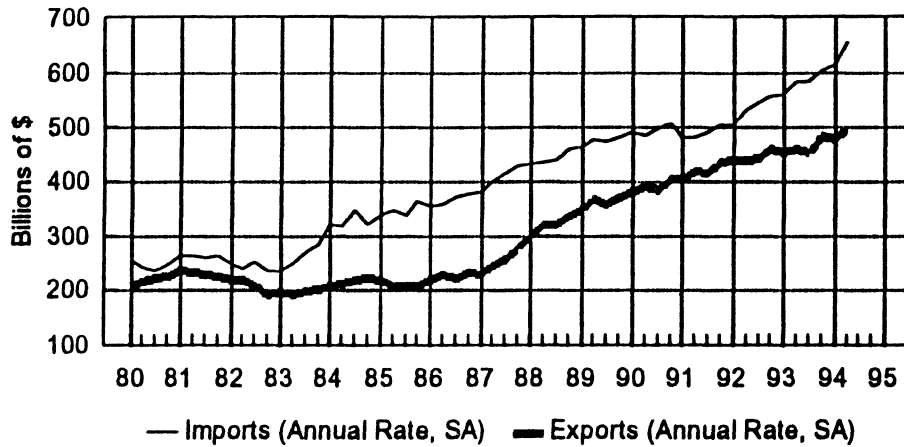


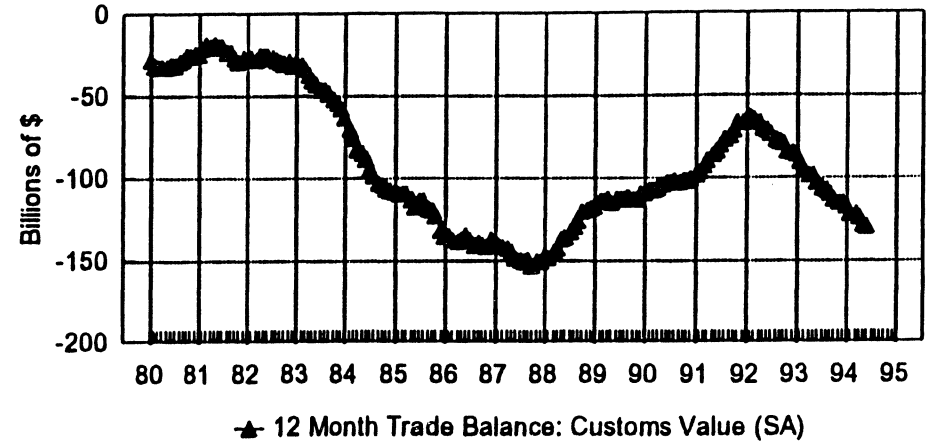
Table 2

Trends in International Trade and Capital Flows

Trends in Imports & Exports



Merchandise Trade Deficit



September 11-12, 1994

58

U.S. Bilateral Merchandise Trade Flows

NSA, Bil \$, Annual Rate

	Q2:91			Q2:94		
	Imports	Exports	TradeBalance	Imports	Exports	TradeBalance
Canada	95.2	90.8	-4.4	130.8	118.8	-12.0
Mexico	31.6	34.4	2.8	48.4	50.4	2.0
Japan	83.6	48.4	-35.2	113.6	52.0	-61.6
China	16.0	6.4	-9.6	35.6	10.0	-25.6
European Union	86.0	107.2	21.2	111.6	101.6	-10.0
OPEC	32.0	18.8	-13.2	31.6	16.8	-14.8
Latin America	59.6	59.2	-0.4	82.8	85.6	2.8
Asia (NICS)	56.0	45.6	-10.4	68.0	57.6	-10.4

U.S. International Trade & Capital Flows

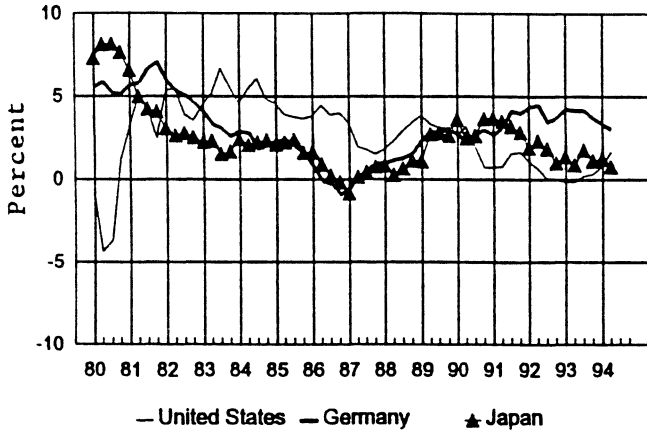
	Current Account	Capital Account	Financed Privately	Financed by Central Banks	% Financed by Central Banks
1980	\$2,316	(\$28,854)	(\$31,035)	\$2,181	(7.6%)
1981	5,031	(31,113)	(25,801)	(5,312)	17.1
1982	(11,438)	(29,917)	(22,414)	(7,503)	25.1
1983	(44,461)	24,644	25,000	356	(1.4)
1984	(99,769)	79,017	84,494	(5,477)	(6.9)
1985	(125,381)	101,960	109,757	(7,797)	(7.7)
1986	(151,203)	121,294	87,354	33,940	28.0
1987	(167,099)	171,539	115,998	55,541	32.4
1988	(128,197)	140,902	102,092	38,810	27.5
1989	(102,815)	49,744	65,275	(15,531)	(31.2)
1990	(91,747)	51,829	17,772	34,057	65.7
1991	(6,943)	46,620	20,757	25,863	55.5
1992	(67,886)	84,993	41,886	43,107	50.7
1993	(103,895)	82,799	12,802	69,997	84.5

The first four columns are in millions of dollars.

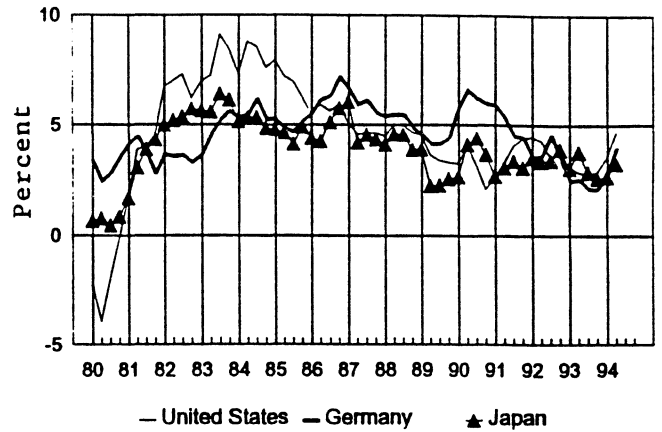
Chart 9

Selected International Financial Trends

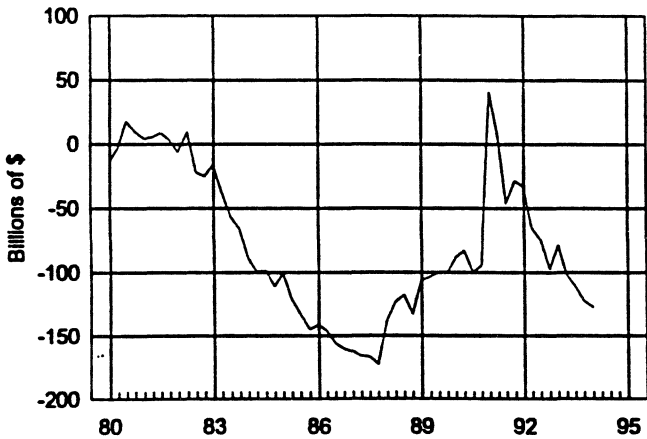
Inflation Adjusted Short-term Interest Rates



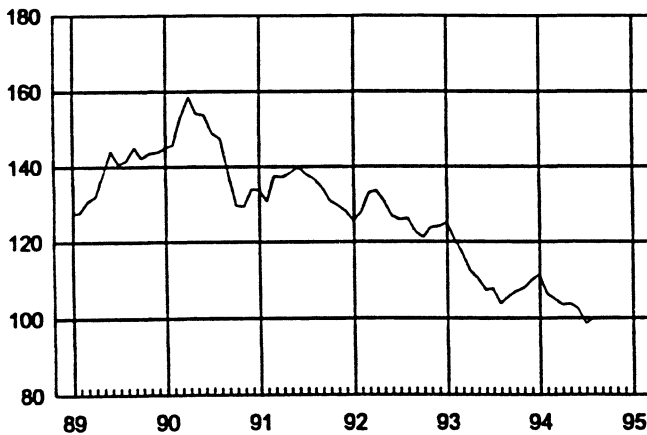
Inflation Adjusted Long-term Interest Rates



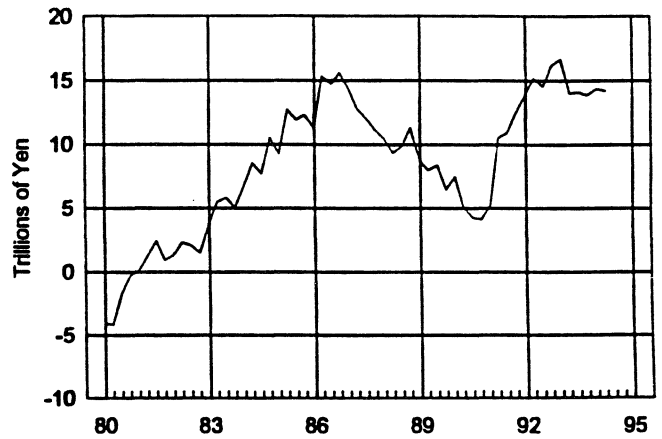
The U.S. Current Account Deficit



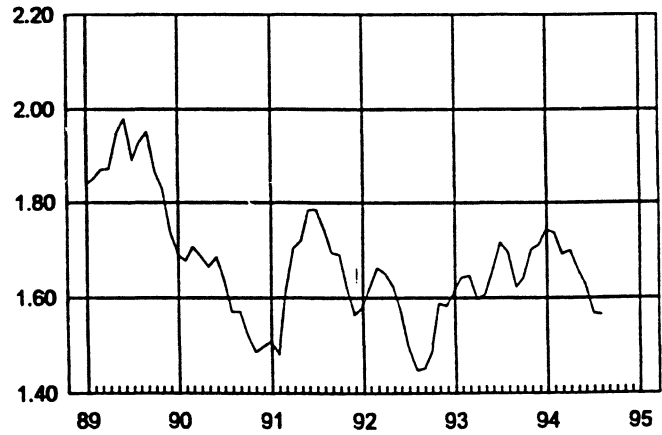
Yen/\$



Japan Current Account Surplus



DM/\$



September 11-12, 1994

M2 AND BASE GROWTH

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We often differ about ease and tightness because some rely more on M2 growth and others on base growth. The chart, labelled U.S. performance, compares the steady state rate of inflation implied by the following rule:

$$m_t = (y^* - v^*)_{t-1}$$

where m is the four quarter growth rate of base or M2, y^* is the 12 quarter moving average of real output growth, and v^* is the 12 quarter moving average of the relevant velocity growth.

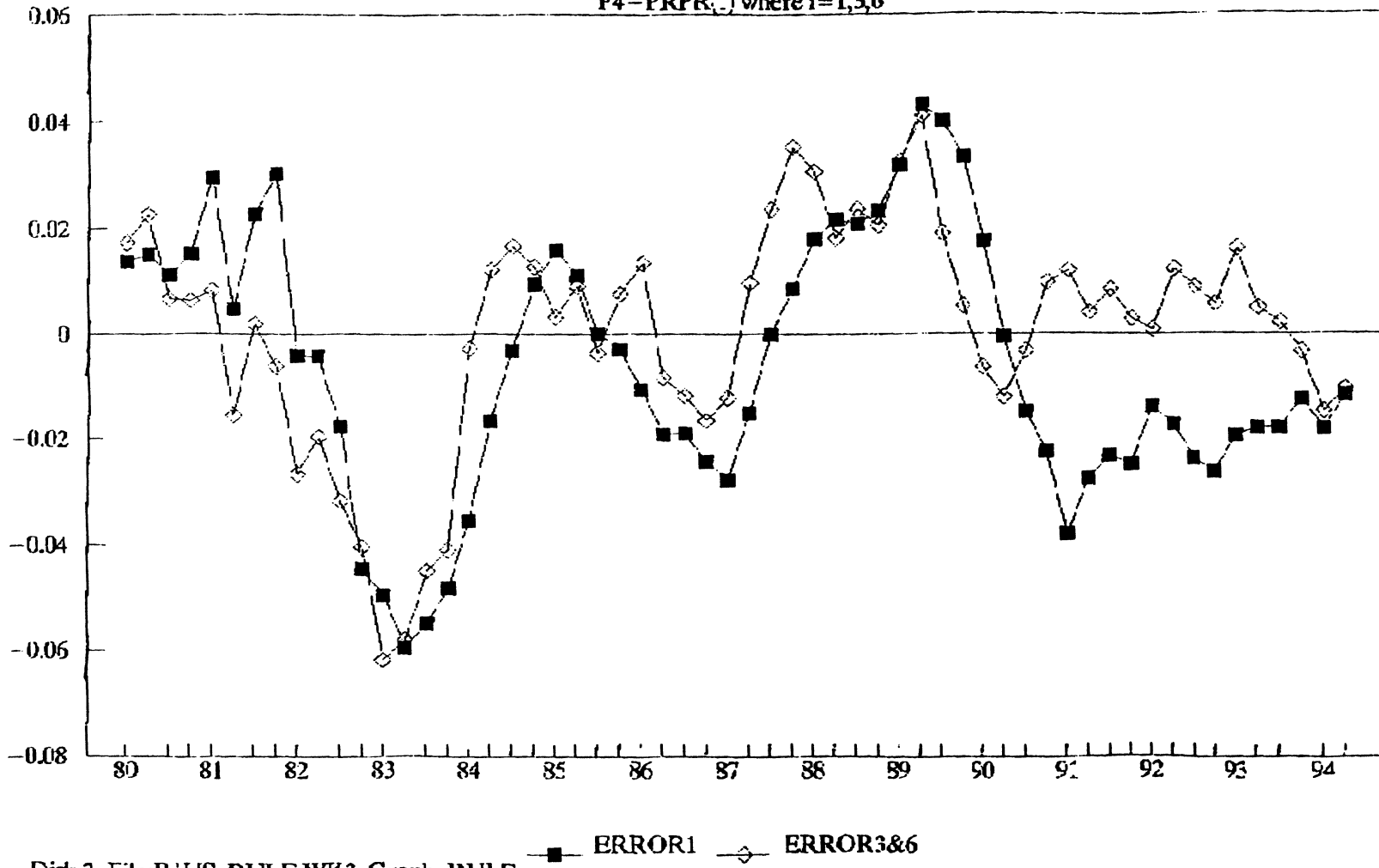
The predicted inflation, PRPR1, uses the base. PRPR3 (or 6) uses M2 growth. The black dots are 4 quarter rates of change of the deflator.

The chart suggests that the two again give very similar forecasts. The errors terms on the following chart show that this has been true more often than not. (Errors are differences between actual inflation and predicted.) The recent divergence, from 1990 to 1993, has now gone away. Both predictions are for approximately 2.5 percent inflation as a steady state result of growth and accumulation of cash balances at recent rates.

The Error Terms -- US

$P4 - PRPR$ where $i=1,3,6$

September 11-12, 1994

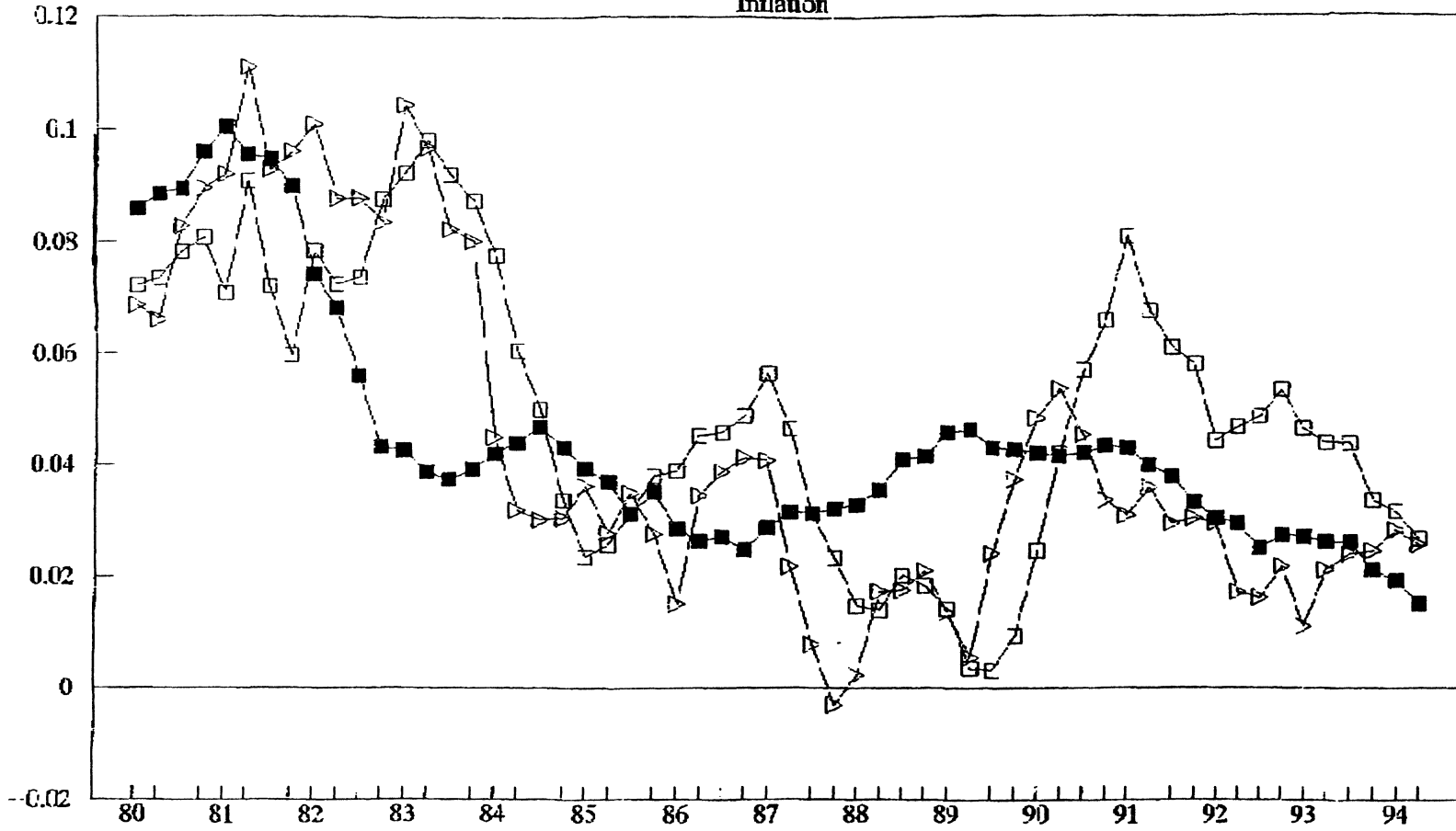


Disk 2: File:B:\US_RULE.WK3 Graph: RULE

The U.S. Performance

Inflation

Shadow Open Market Committee



Actual Price Level Growth PRPR1 PRPR3&6
Disk 2: File:BA\RULE1919.WK3 Graph: INFLATION

September 11-12, 1994

A NOTE ON RECENT U.S. PRODUCTIVITY GROWTH

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U.S. productivity growth has risen over the last several years, creating hopes that the longer-run performance of the U.S. economy is improving. A simple calculation makes clear how important this issue is: if productivity growth had continued after 1973 at the same rate as from 1947 to 1973, productivity today would be 51 percent greater than it actually is. If the number of hours worked were the same, GDP would be 51 percent larger than it actually is. The United States could deal with its many problems a lot more easily if GDP were that much larger.

Figure 1 provides an overview of U.S. productivity performance since 1947; the upward bend of the productivity line since 1990 show up clearly. Some questions:

- How solid is the evidence that productivity growth has risen?
- What are the implications of changes in productivity growth for monetary policy.

As for the first question, the evidence is not at all solid. Analysis of productivity is bedeviled by measurement problems and the difficulty of sorting out long-run changes from short-run cyclical patterns. Zvi Griliches, in his presidential address to the American Economic Association last January, emphasized the importance of data limitations in tracking productivity changes and understanding their causes.

Economists have not been very successful in explaining what has happened to the economy during the last two decades, nor have they been able to agree on what should be done about it. I will argue that data and measurement difficulties may in fact be a major source of this failure. This point will be made not to provide us with an alibi, but rather to temper the pretentiousness of some of our pronouncements and to urge us toward the more mundane task of observation and measurement.¹

It seems unlikely that mismeasurement can explain the decline in productivity growth of the magnitude experienced after 1973, but smaller changes, such as the rise in productivity growth over the last few years, might be partly or even mostly due to changes in measurement techniques. The basic problem is that the division of total dollars spent on goods between quantities and prices is highly suspect for many products. For complex products, with changing characteristics and quality,

measurement of output (and therefore also price per unit of output) is subject to enormous conceptual and practical difficulties. These problems are most severe in service industries, which have been increasing as a share of total GDP.

Putting measurement issues aside, interpreting recent developments is difficult because productivity has pronounced cyclical pattern. Over the business cycle, firms adjust output more quickly than they adjust labor input. During a cyclical contraction, output falls more quickly than employment and hours worked (as reported in official statistics, anyway), and so output per hour—labor productivity—falls, or rises more slowly than normal. During cyclical expansions, firms increase output more rapidly than hours of labor input, and so labor productivity rises.

The conventional wisdom is that the U.S. economy is now operating at or close to full employment, given the structure of the labor market and size of the capital stock. The table shows the annual rate of productivity growth from one cycle peak to the next and from each cycle peak to 15 quarters after the cycle peak. If we knew the economy were now at a cyclical peak, we would compare peak-to-peak productivity growth to see how the recent growth rate compares to previous peak-to-peak growth rates. However, the growth rate of productivity over the 15 quarters from the last cycle peak to 1994:I probably overstates the peak-to-peak growth rate. From Figure 1 and the table, it is clear that productivity growth usually slows markedly in the quarters before the cycle peak. For example, the growth rate of productivity from the cycle peak in 1981:III to the cycle peak in 1990:III was 1.06 percent, but the growth rate over the 15 quarters from 1981:III to 1985:II was 1.37 percent. Comparing 15-quarter periods after cycle peaks, it is true that productivity growth over the 15 quarters after the last cycle peak was higher than for any peak since the one in 1969, and that is indeed a welcome development.

Some analysts have also taken heart from the improved performance of manufacturing productivity, which shows up clearly in Figure 2. (The BLS series on manufacturing productivity begins in 1977.) The problem with interpreting this series is that many manufacturing firms have been restructuring by contracting out services. Service employees such as janitors and lawyers within manufacturing firms are counted as manufacturing employees, but when manufacturing firms contract out janitorial and legal services these same individuals are counted in the service sector where measurement of output is extremely difficult. Thus, the improvement in manufacturing productivity may be totally spurious.

The rate of productivity growth has little direct implication for monetary policy. The Federal Reserve's primary responsibility is maintenance of low inflation. *Given* the rate of money growth, higher productivity growth will yield lower inflation. However, the Fed does not implement its monetary policy by fixing the rate of growth of money.

The Fed's current approach to policy is to raise interest rates in response to actual or incipient pressures toward higher inflation. Higher productivity growth might show up in less apparent pressure toward higher inflation, as measured by early warning signs of inflation itself. A more important influence on monetary policy is likely to be Fed attitudes toward the rate of growth of real GDP. If real GDP seems to be growing "too" rapidly, given the Fed's estimates of productivity growth and labor force growth, then the Fed will implement more restrictive policy actions. If underlying productivity growth is really higher than the Fed's estimates, then the more restrictive policy will prevent the economy from growing as rapidly as it could in the short run. Conversely, if productivity growth is lower than the Fed's estimates, the policy will inadvertently be less restrictive than it should be, and inflation will rise.

The Fed is, I believe, well aware of the dangers of trying to depend too much on uncertain estimates of long-run productivity growth, and so is unlikely to base its policy on these estimates to any significant extent. As the figures and table make clear, productivity growth varies so much in the short run that any change in long-run productivity performance will not be clear for some years.

As a final note, it is interesting that the slowdown in productivity growth after 1973—a slowdown that now seems so obvious from Figure 1—was not generally accepted as a long-run change until late in the 1970s. In the *Economic Report of the President* for 1977, the Council of Economic Advisers lowered its estimate of productivity growth.² This new estimate, however, was not without controversy. In early 1977, in a Brookings Panel paper, George L. Perry argued that the evidence for a trend break in productivity growth was unclear.³ He believed that 1974, a year of sharp productivity decline, was very unusual, and he employed a dummy variable for that year in his statistical analysis. When the Brookings Panel next took up the issue, in 1979, there was no longer any doubt that productivity growth had declined substantially.⁴

This experience with judging productivity growth in the mid 1970s should serve as a warning to policymakers today. Recent productivity growth does seem to be higher than before, but tying policy in any close way to estimates of productivity growth is hazardous.

NOTES

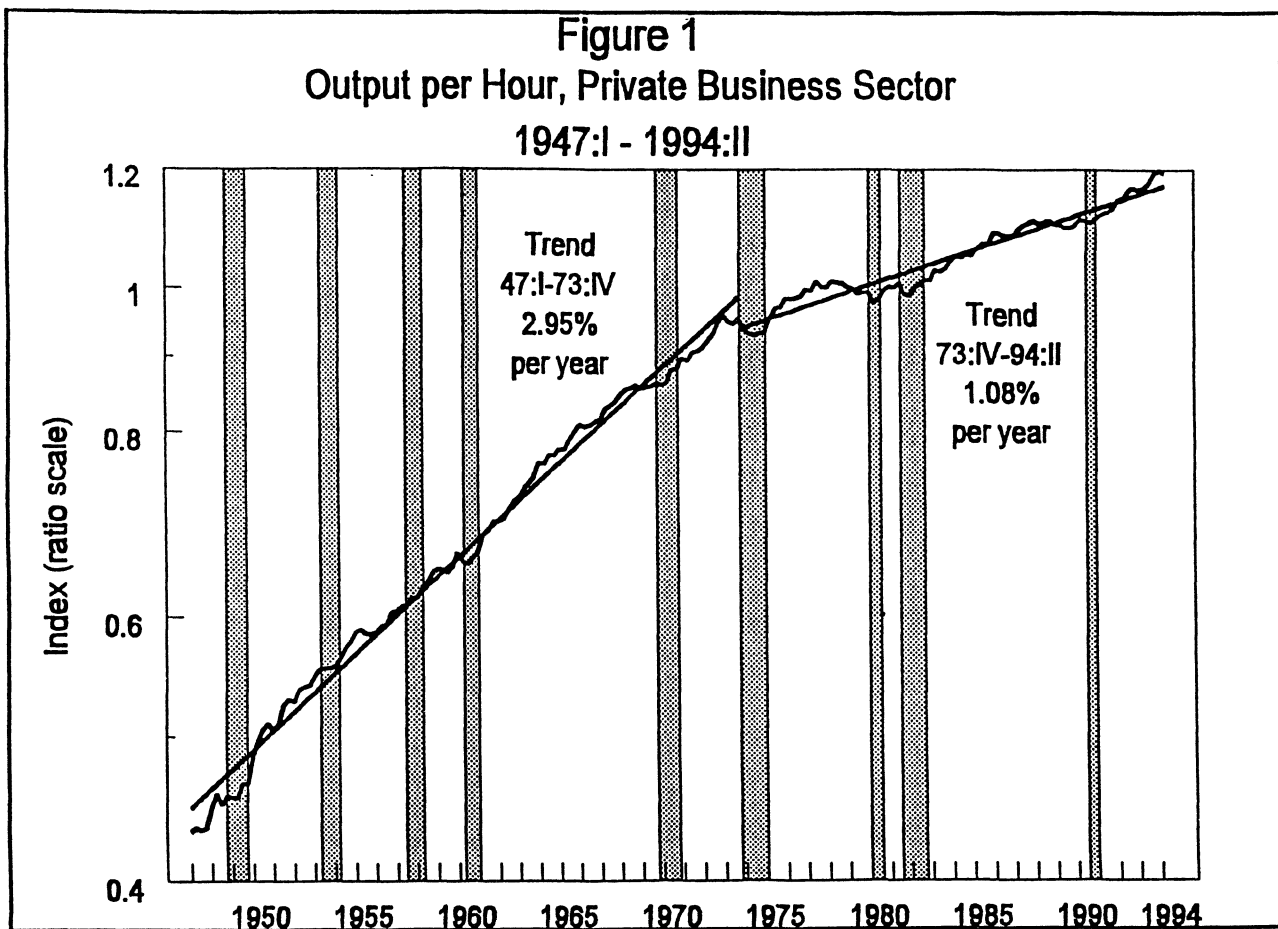
*I thank Data Resources, Inc. for providing access to its data bank, from which I drew the data for the figures and tables.

¹*American Economic Review* 84 (March 1994), p. 10.

²See especially pages 45-46, 52-56 in the *1977 Economic Report*, which was the final Report by the Greenspan Council. The CEA reduced its estimates of productivity growth to 2.0 percent, which in the event was too high.

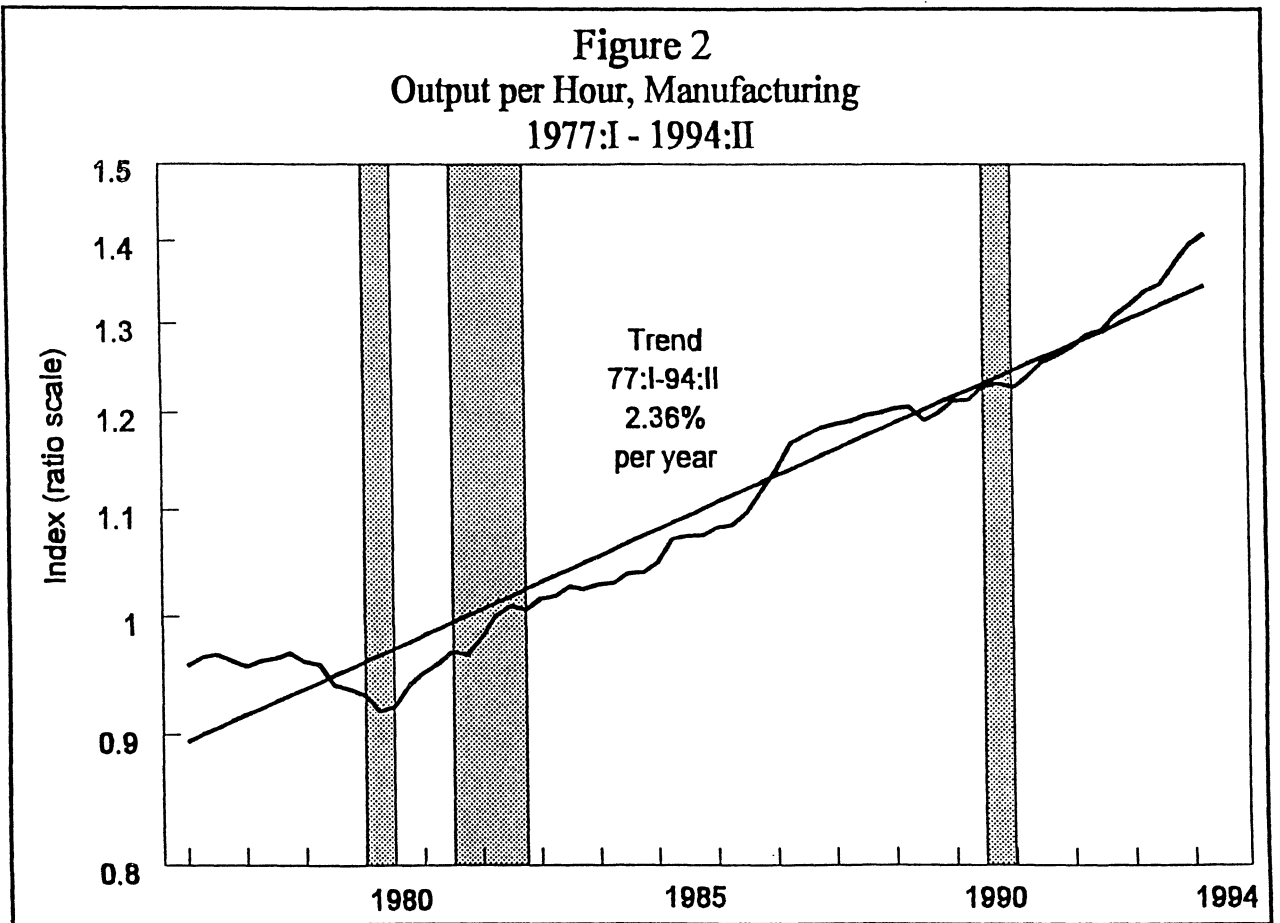
³"Potential Output and Productivity," in Arthur M. Okun and George L. Perry, eds., *Brookings Papers on Economic Activity* 1977:1, 11-47. (See especially pp. 34-38).

⁴J.R. Norsworthy, Michael J. Harper, and Kent Kunze, "The Slowdown in Productivity Growth: Analysis of Some Contributing Factors," and Peter K. Clark, "Issues in the Analysis of Capital Formation and Productivity Growth," in Arthur M. Okun and George L. Perry, eds., *Brookings Papers on Economic Activity* 1979:2, 387-431.



Productivity Growth Rate (percent per year)				
Cycle Peak to Cycle Peak			Cycle Peak to Cycle Peak Plus 15 Quarters	
Period	Number of Quarters	Growth Rate	Period	Growth Rate
48:IV-53:II	18	4.24	48:IV-52:III	4.40
53:II-57:III	17	2.35	53:II-57:I	2.40
57:III-60:II	11	2.42	57:III-61:II	2.89
60:II-69:IV	38	2.92	60:II-64:I	4.08
69:IV-73:IV	16	2.51	69:IV-73:III	2.45
73:IV-80:I	25	0.64	73:IV-77:III	1.52
80:I-81:III	6	1.00	80:I-83:IV	1.03
81:III-90:III	36	1.06	81:III-85:II	1.37
			90:III-94:II	2.02

Figure 2
Output per Hour, Manufacturing
1977:I - 1994:II



September 11-12, 1994

RECENT BEHAVIOR OF M2

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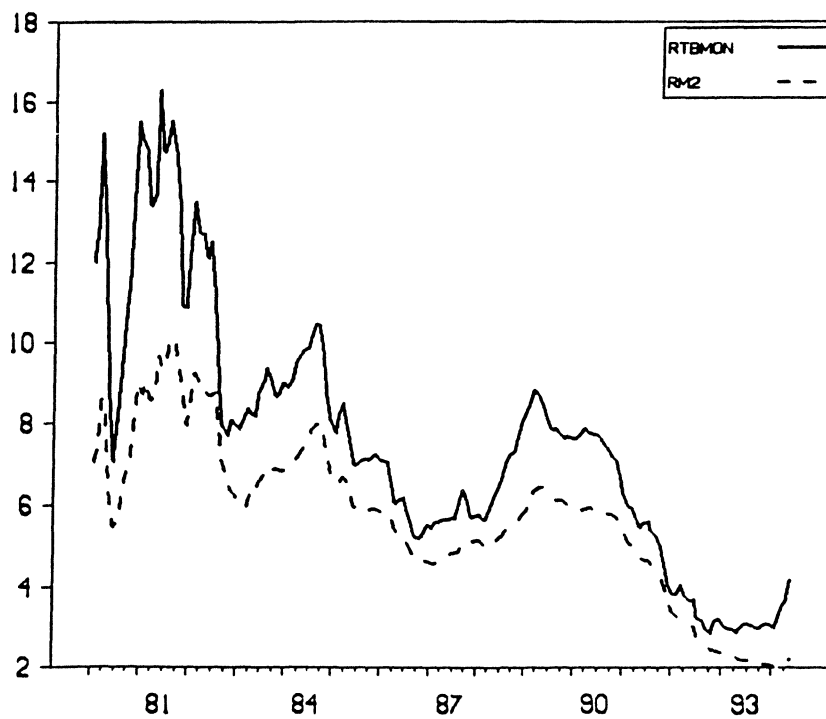
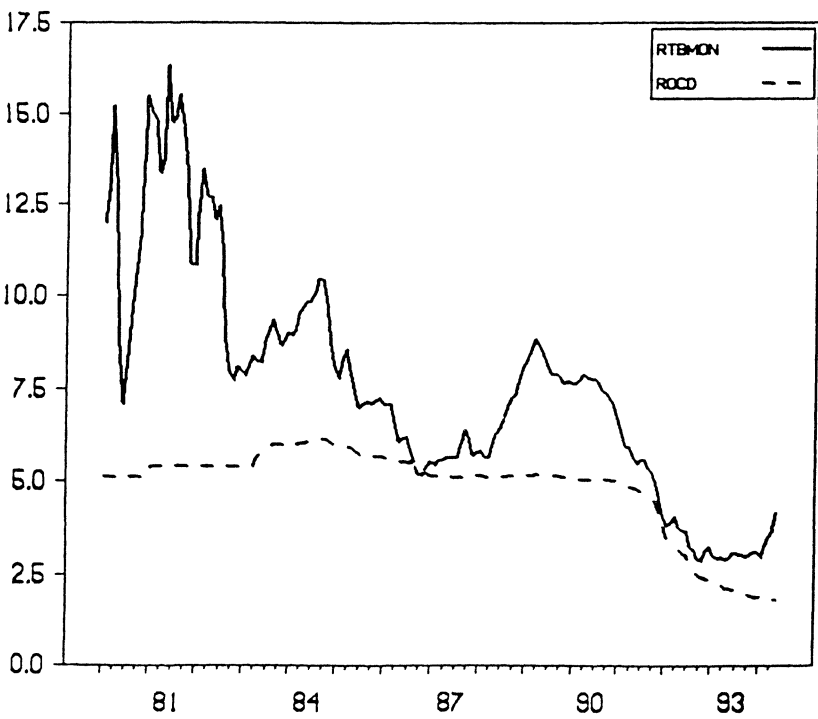
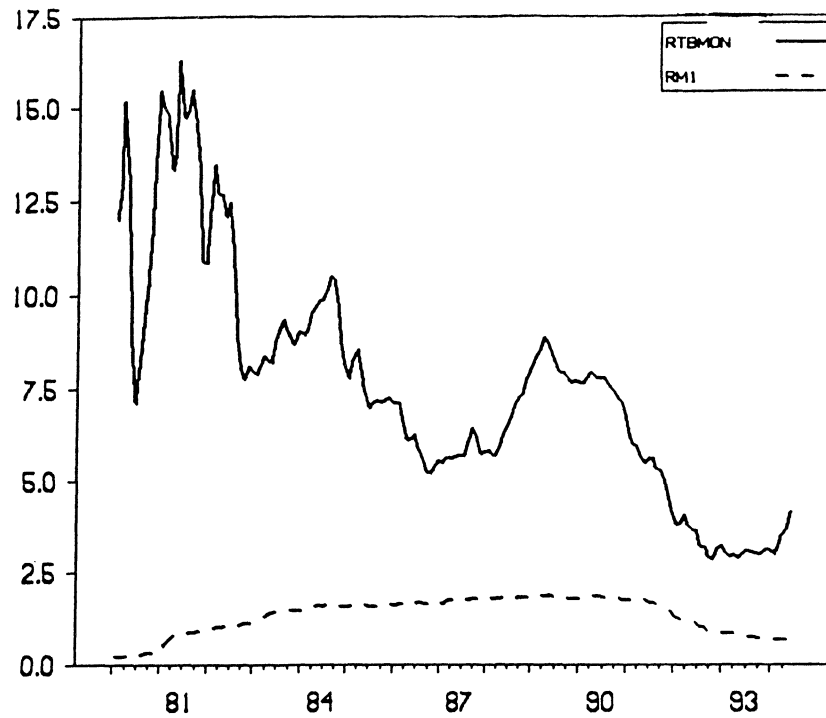
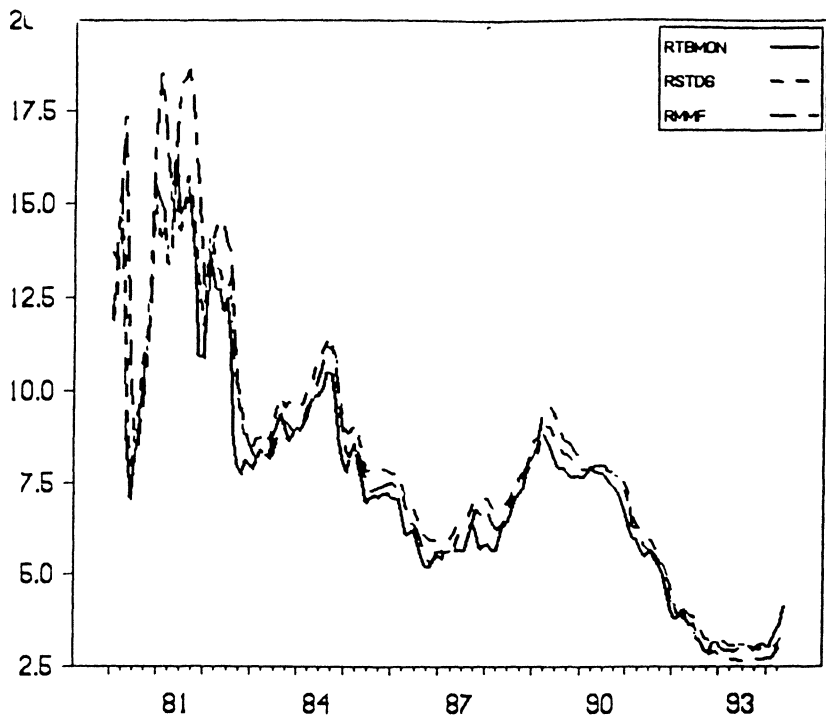
Two years ago I commented on the then mysterious behavior of M2 since early 1991. It was noted that the slow growth of M2 principally was attributable to the decline in small time deposits. One hypothesis then current was that this decline was associated with the thrift crisis; indeed Chairman Greenspan cited that explanation in his testimony to Congress. I proposed an alternative hypothesis, namely "that the recently observed behavior of small time deposit balances is a normal portfolio adjustment in response to the prevailing structure of interest rates, and would have occurred regardless of the severity or existence of the thrift crisis." I also suggested that further reductions in the fed funds rate in an effort to stimulate M2 growth were likely to be futile; that a more productive approach, if higher growth in M2 was desired would be to increase the funds rate target.

The Fed maintained the three percent funds rate target until February, 1994. From September, 1992 through February, 1994, the outstanding stock of small time deposits continued to fall from 911.0 billion to 774.5 billion, or by 16.2 percent. During the same period of time, savings deposits increased from 1160.3 billion to 1220.9 billion, or 5.1 percent. Savings deposits were almost constant from the middle to the end of 1993. Money market mutual funds reached a peak in mid 1991 then declined until early 1993 and remained almost unchanged throughout the rest of the year.

After the Fed increased the funds rate target, starting in February, 1994, the behavior of these three components of M2 changed dramatically. Two months later small time deposits reached a trough, and have risen in each of the following three months for which data are presently available. Outstanding money market mutual funds jumped by about 3.7 percent from March to April, 1994 and have remained at the higher level since. In contrast, savings deposits reached a peak of 1221.9 billion in March, 1994 and have fallen each following month to 1202.2 billion in July, 1994, a decline of about 1.6 percent.

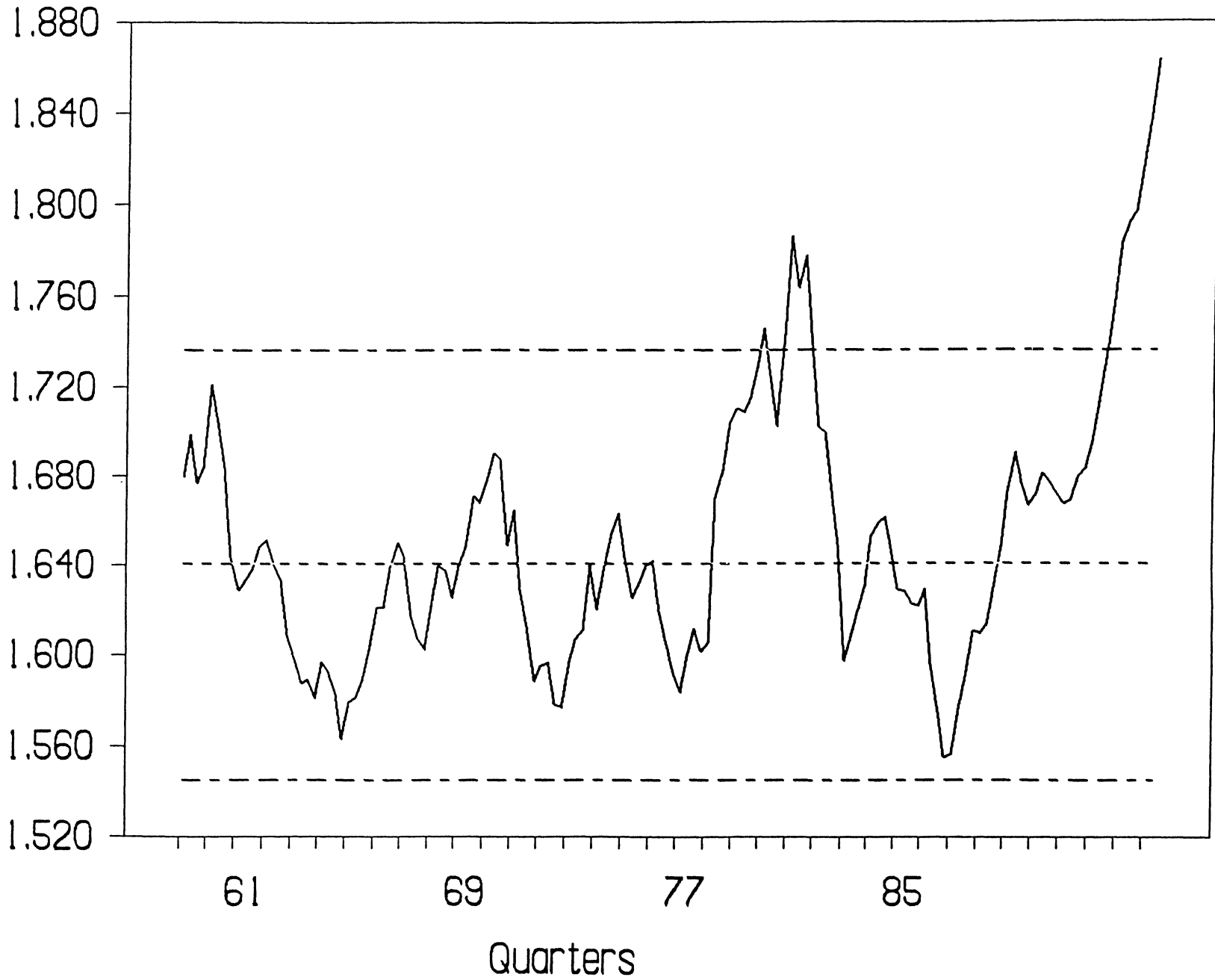
All of these reactions appear consistent with the hypothesis that the "peculiar" behavior of M2 resulted from predictable portfolio adjustments to the existing term structure of interest rates. Available data indicate that CD rates and money market mutual fund rates have moved up sharply with short-term market rates (see Figure). In contrast, average savings deposit rates appear to be quite stable in the 2.5 percent range. Given the latest increase in the funds rate target, it is likely

that money market mutual funds rates and small time deposit rates will again rise (if they have not already done so by the time that we meet). My prediction is that growth in money market mutual funds and small time deposits will accelerate, though if saving deposit rates continue to exhibit the sluggishness that characterizes their historical behavior, then it is likely that this component of M2 will continue to exhibit negative growth in the near future. The net outcome of such portfolio adjustments is that M2 growth will likely increase above recent past levels, but explosive growth is not likely. M2 velocity, which has risen sharply in recent years (see attached figure) is likely to remain at historically high levels in the immediate future.



M2 Velocity, 59:1 - 94:2

September 11-12, 1994



MYTHS IN THE REPORT OF THE BRETTON WOODS COMMISSION

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National Bureau of Economic Research

A 43-member commission, convened by Paul Volcker and co-chaired by three international bankers, has published a nine-page report—Bretton Woods; Looking to the Future—on the occasion of the fiftieth anniversary of the original Bretton Woods Conference. Later this year the commission will publish a volume including a staff review of its deliberations and a set of some 20 odd papers prepared by individuals as background for, but not endorsed by, the commission.

The commission was convened to review the Bretton Woods system and its institutions and "to ask whether the present multilateral economic arrangements are up to the challenges ahead, and to what extent they may need reform." It looks ahead but also looks back, and what the commission offers are myths about the past and present.

My report organizes the commission's recommendations under two main headings: international monetary reform and the IMF, international development assistance and the World Bank Group. I limit my comments to the report's observations about exchange rates and its international monetary reform recommendations.

In reviewing the Bretton Woods system, the report's verdict on the IMF is that, "It was effective in this role for both the industrial and the developing countries in its first two and a half decades." A contradictory view, at least with respect to the industrial countries, has been expressed (Dornbusch, 1993): "In relations among the industrial countries, the IMF has been patently unsuccessful. In the immediate postwar period, the Fund could not get itself to accept the European Payments Union and as a result was left on the sidelines. It never recovered except for a brief moment in the management of sterling crises. Since then the Fund has not been doing any better."

In reviewing the post-Bretton Woods period, the report deplors the absence of a "sustained coherent approach to exchange rate management." The critique of existing arrangements states: "Financial market volume and volatility have increased. Exchange rates have become sensitive and their movements sometime extreme. . . There have been prolonged periods of misalignment among the major currencies." The conclusion is that "the costs of extreme exchange rate misalignment and volatility are high."

No paper is referenced as evidence for extreme volatility, prolonged periods of misalignment, and high costs. In fact volatility has not interfered with an increase in the volume of international trade. The core of the case for exchange-rate management and for target zones, however, is the concern about misalignment. No specific cases are mentioned, and the report provides no clue on how exchange rates consistent with the fundamentals will be determined, or how credibility of fixed rates or target zones will be maintained if capital movements are not restricted. If costs are the issue, why did the commission not assess the costs of exchange rate management?

The report compares the reduction in long-term growth in the major industrial countries from about 5 percent a year under Bretton Woods to about 2.5 percent a year since the early 1970s, and concludes that "the loss of exchange rate discipline has played a part" in accounting for the decline. Again no evidence supports this assertion.

Exchange-rate arrangements did not cause Bretton Woods period prosperity. In the first place, monetary and fiscal expansion accompanying full-employment policies worked until the public caught on that increased spending produced price increases at the expense of output and employment gains. In the second place, international trade grew thanks to GATT successes in reducing tariffs. These were the important cause of Bretton Woods period prosperity.

To achieve more satisfactory performance, the report recommends "better international policy coordination aimed at stabilizing exchange rates." Before that can happen, however, the major industrial countries need to strengthen their fiscal and monetary policies for "greater overall macroeconomic convergence." This, according to the commission, is the first of two steps to international monetary reform. The second step is "a more formal system of coordination, involving firm and credible commitments, to support these policy improvements and avoid excessive exchange rate misalignments and volatility."

The report refers to "firm commitments," "coherent and credible" commitments, "explicit and clear" commitments by major industrial country governments to "respond appropriately to changes in international economic conditions with adjustments in macroeconomic policies and with currency intervention." Intervention is to be limited to the dollar, the deutschmark, and the yen. In view of the recent disarray in the EMS where, commitments notwithstanding, Germany failed to "respond appropriately," what is the basis for the commission's recommendation? It seems to be empty rhetoric.

In the commission's view, the central role in implementing monetary reforms should be played by the IMF. It proposes restoring the Fund to its original focus on international monetary issues, after having been diverted to provision of longer term assistance to developing countries, thus duplicating World bank functions, and to structural transformation of the former communist countries.

There is no detailed discussion, however, of the monetary reforms nor of their implementation. Instead, the report merely urges the IMF to concentrate on short-term macroeconomic stabilization, but does not make clear whether these stabilization efforts are to be directed to developing and transforming economies or to the industrialized economies or both. Executive Directors are to guide IMF management and "at the same time exert influence on their own countries."

The report suggests that IMF quota shares need to be reallocated in line with members' relative economic importance, that the IMF should be less secretive, and should seek close ties with the new World Trade Organization. It defends the Fund against charges that its conditions for financing are harsh, but acknowledges that criticisms of the IMF "sometimes influence the attitude of member governments toward the IMF in destructive ways."

The Bretton Woods Commission report is a reliable account neither of the Bretton Woods experience and of its aftermath nor a usable blueprint for introducing a future fixed rate exchange rate regime, if that is what the commission longs for. Its advice for renewing the IMF is bland.

REFERENCE

Dornbusch, Rudiger, 1993, "Comment." In A Retrospective on the Bretton Woods System, M.D. Bordo and B. Eichengreen (eds.). Chicago: University of Chicago Press, 102.