

University of Rochester
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Business Administration

**BRADLEY POLICY
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CENTER**

**SHADOW OPEN MARKET COMMITTEE
(SOMC)**

Policy Statement and Position Papers
March 2-3, 1997
PPS 97-01

Public Policy Studies
Working Paper Series

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SHADOW OPEN MARKET COMMITTEE

The Shadow Open Market Committee met on Sunday, March 2, 1997 from 2:00 p.m. to 6:30 p.m. in Washington, DC.

Members of the SOMC:

Professor Allan H. Meltzer; Graduate School of Industrial Administration; Carnegie Mellon University; Pittsburgh, Pennsylvania 15213 (412-268-2282 phone, 412-268-7057 fax, am05@andrew.cmu.edu); American Enterprise Institute; Washington, DC (202-862-7150 phone)

Mr. H. Erich Heinemann; Heinemann Economic Research; Division of Brimberg & Co.; 7 Woodland Place; Great Neck, NY 11021-1034 (516-466-3893 phone, 516-466-3872 fax)

Dr. W. Lee Hoskins, Chairman and CEO; Huntington National Bank; 41 S. High Street; Columbus, Ohio 43287 (614-480-4239 phone, 614-480-5485 fax)

Dr. Mickey D. Levy, Chief Financial Economist; NationsBanc Capital Markets, Inc.; 7 Hanover Square, New York, New York 10004 (212-858-5545 phone, 212-858-5741 fax, mlevy@ncmi-ny.com)

Dean Charles I. Plosser; William E. Simon Graduate School of Business Administration and Department of Economics; University of Rochester; Rochester, New York 14627 (716-275-3316 phone, 716-275-0095 fax, plosser@mail.ssb.rochester.edu)

Professor William Poole; Department of Economics; Brown University; Providence, Rhode Island 02912 (401-863-2697 phone, 401-863-1970 fax, williampoole@brown.edu)

Professor Robert H. Rasche; Department of Economics; Michigan State University; East Lansing, Michigan 48823 (517-355-7755 phone, 517-432-1068 fax, rasche@pilot.msu.edu)

Dr. Anna J. Schwartz; National Bureau of Economic Research; 50 E. 42nd Street; New York, New York 10017-5405 (212-953-0200/ext. 106 phone, 212-953-0339 fax, aschwar1@email.gc.cuny.edu)

SOMC POLICY STATEMENT SUMMARY

WASHINGTON, DC, March 3—The Shadow Open Market Committee today called on the Federal Reserve “to reduce inflation to zero.” The SOMC warned the Fed not to meddle with the stock market. “The central bank should not adjust monetary policy to affect stock market valuations.”

The SOMC, a group of academic and business economists who comment regularly on public policy, said the Clinton Administration was wrong in its views about inflation.

“The *1997 Economic Report of the President* is mistaken when it argues that the costs of reducing inflation to zero exceed the benefits. The experience since 1991 illustrates that the alleged trade-off is unreliable. Moreover, the ... report ignores the fact that the benefits of zero inflation are permanent while any short-term loss of output is temporary.”

The SOMC, which meets in March and September, was founded in 1973 by Professor Allan H. Meltzer of Carnegie-Mellon University and the late Professor Karl Brunner of the University of Rochester.

The SOMC recommended that “growth of the monetary base should not exceed 2 percent this year.” In the year ended February, the monetary base—bank reserves and currency—grew approximately 5.4 percent. Achieving its policy recommendation, the SOMC said, “will require a near-term increase in the Federal funds rate target.”

The committee said the current upswing in business—now “71 months old, more than 60 percent longer than the average postwar expansion”—“shows no sign of dying of old age or exploding into an inflationary boom.”

The SOMC also attacked President Clinton’s budget for fiscal year 1998. “The President’s budget promises balance in 2002. Even if it could be achieved, balance in 2002 is a hollow accomplishment. The budget would be out of balance in 2003 and subsequent years. Unless much more is done to reduce spending, the budget deficit would rise year after year to record peacetime levels.

“Everyone who has looked seriously at the budget problem knows that the long-term problem cannot be solved without reducing spending for pensions and health care. A responsible government would begin to address these long-term problems now, when changes can be phased in gradually. The President’s budget not only fails to address these long-term problems, it adds to them by expanding old programs and introducing new ones.”

“The Republican leadership has apparently decided to act as if the President’s budget is a responsible start on a plan for fiscal balance. If the President agrees to more capital gains tax reduction, the Republican leadership appears willing to accept spending increases and potentially large new spending programs. Neither party mentions near-term spending reduction.”

SHADOW OPEN MARKET COMMITTEE

Policy Statement

March 3, 1997

Inflation has fallen slowly. Predictions that low unemployment must be followed by rising inflation have been proved wrong. Inflation and unemployment have fallen together in this expansion. As we have written repeatedly, the unemployment rate is an unreliable guide to inflation.

The current expansion is 71 months old, more than 60 percent longer than the average postwar expansion. The expansion shows no sign of dying of old age or exploding into an inflationary boom. This experience should be put to rest the idea that expansions “run out of steam” or that inflation is inevitable. But it raises an important question: Why is this cycle different?

A DIFFERENT POLICY

Higher inflation accompanies lower unemployment only if monetary policy accommodates excess spending. Until recently, monetary policy has not encouraged rapid growth in spending. Partly by chance and partly by explicit decision, the Federal Reserve did not reproduce the pattern of rapidly rising money growth and spending typical of the 1965-1980 period. Instead, monetary policy tightened in 1994 following an acceleration in money growth. The Federal Reserve should build upon its achievement by continuing disinflationary policy.

The current expansion started slowly. Many observers criticized the Federal Reserve because the slow pace of recovery contributed to rising unemployment. These criticisms were wrong; they ignored the longer-term benefits of moderate, disinflationary Federal Reserve policy that prolonged the expansion while reducing inflation. Contrary to the Council of Economic Advisers, lower inflation did not exact a cost in higher unemployment or lower output since 1991.

Chart 1 compares the acceleration of monetary policy in three long expansions—1961-69, 1982-90, and the current expansion. The chart shows the difference between the 12-month growth rate of the monetary base—bank reserves and currency—and growth of the base in the last twelve months before the expansion began.

The three cycles are strikingly different. The monetary base accelerated in the 1960s as did spending and inflation. When inflation began to rise, monetary policy became more expansive. In 1969, the Federal Reserve reversed its course, bringing the expansion to an end.

Growth of the monetary base rose and fell several times during the 1980s expansion. The trend of base money growth declined as did the rate of inflation. At the end of that decade, base growth rose, as did inflation. In the 1980s the base accelerated modestly, and the rate of inflation fell.

The most recent cycle shows that policy on average has been disinflationary. There is some sign of acceleration in the base at the end of the period.

Chart 2 repeats the comparison for accelerations of M_2 . The details differs, but the thrust is similar. The 1960s show substantial acceleration from the pre-expansion period. The 1980s show less acceleration on average. The recent acceleration is more marked for M_2 than for the base and suggests that inflation will begin to increase if growth of these monetary aggregates remains high.

Chart 3 shows the monthly unemployment rate for the same periods. Differences between the three periods are small. Unemployment reached a lower level in the 1960s, but it is now generally understood that the lower rate was unsustainable, and unemployment has not returned to that rate.

The charts suggest a simple answer to the question: Why is inflation lower? The single, most important difference, we believe, is money growth has been slower.

MONETARY POLICY

Since the fall of 1996, all of the monetary aggregates have either accelerated or achieved stable growth at a substantially higher level. If monetary growth continues at current levels, spending and inflation will rise.

At our last meeting, we urged the Federal Reserve to reduce the growth rates of the monetary base and other monetary aggregates to achieve zero inflation. We repeat that recommendation and add another: Reduce money growth both to prevent inflation from rising and to end inflation. Growth of the monetary base should not exceed 2 percent this year. This policy will require a near-term increase in the Federal funds rate target.

Our recommendation to the Federal Reserve is to reduce inflation to zero. The central bank should not adjust monetary policy to affect stock market valuations.

The *1997 Economic Report of the President* is mistaken when it argues that the costs of reducing inflation to zero exceed the benefits. The experience since 1991 illustrates that the alleged tradeoff is unreliable. Moreover, the Council's report ignores the fact that the benefits of zero inflation can be made permanent while any short-term loss of output is temporary.

THE BOSKIN COMMISSION'S REPORT

Economists have known for many years that the Consumer Price Index overstates the rate of inflation. Actual inflation is lower than reported inflation as measured by the CPI. The main issue is the size of the overestimate.

The members of the Boskin Commission are highly qualified economists. Their report places the overestimate at 1.1 percent a year.

Over time, a 1.1 percent error has a large effect on spending, the budget deficit, measurement of productivity and income. Mismeasurement of inflation distorts our knowledge about the economy, benefits some and penalizes others. People with pensions indexed to the CPI, including all social security recipients, receive excess compensation for inflation. If the 1.1 percent estimate is correct, indexed wage and spending programs are about 30 percent higher than they would have been with accurate adjustment.

We share the Boskin Commission's view that the CPI should accurately reflect the cost of living. We do not believe that the President or Congress should decide on the size of the adjustment. The judgment is technical, not political. It would be a mistake to make a political decision about how much to adjust the CPI.

We believe that Congress should appropriate money and fix a deadline for a decision on the proper size of the adjustment. The Bureau of Economic Analysis (BEA) in the Commerce Department has recently revised its price and output series. It has the technical competence and professional standing to evaluate the work of the Boskin Commission and decide on the best way to adjust the CPI. BEA or some other technically proficient group should be adequately financed to render this judgment. Adjustment of the CPI should not be used as the solution to the long-term Social Security problem. Congress and the President must agree on a structural adjustment.

THE BUDGET

The President's budget promises balance in 2002. Even if it could be achieved, balance in 2002 is a hollow accomplishment. The budget would be out of balance in 2003 and subsequent years. Unless much more is done to reduce spending, the budget deficit would rise year after year to record peacetime levels.

Under the President's proposal, outlays increase \$250 billion in the next four years. The projected deficit is larger in 1999 than in 1996. Reductions in the deficit begin in 2000; much of the reduction is achieved either by tightening price controls on doctors and hospitals or by selling assets.

Everyone who has looked seriously at the budget problem knows that the long-term problem cannot be solved without reducing spending for pensions and health care. A responsible government would begin to address these long-term problems now, when charges can be phased in gradually.

The President's budget not only fails to address these long-term problems, it adds to them by expanding old programs and introducing new ones. The Republican leadership has apparently decided to act as if the President's budget is a responsible start on a plan for fiscal balance. If the President agrees to more capital gains tax reduction, the Republican leadership appears willing to accept spending increases and potentially large new spending programs. Neither party mentions near-term spending reduction.

We have long favored fundamental tax reform, emphasizing lower rates and a broader tax base, for the purpose of raising economic growth and reducing administrative complexity. Neither political party has proposals consistent with these objectives.

MEDICARE, MEDICAID, AND SOCIETY SECURITY

Governments cannot deliver health care; that requires doctors, nurses, hospitals, and pharmaceuticals. All government can do is redistribute the cost of health care and change the demand for and supply of services.

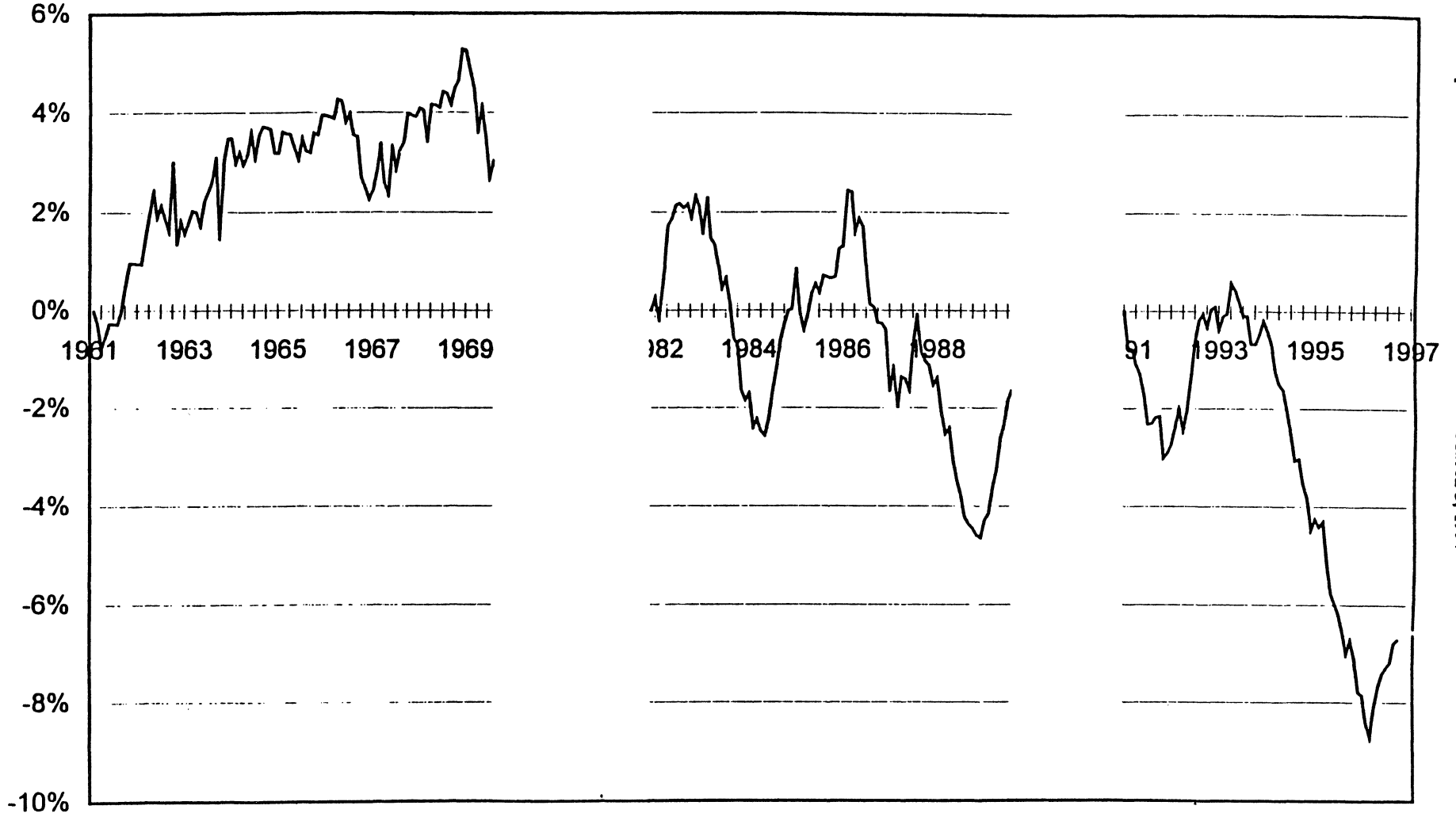
As in all redistribution, some pay more and others benefit. But, government intervention in health care also distorts the pricing and use of medical services. The distortions impose large costs on all of us by separating payment from procurement. Neither patients nor providers have reason to care much about costs.

Congress should completely reform Medicare and Medicaid by removing the principal causes of the distortions. Most health care should be privately financed and privately provided. Some redistribution to the poor should continue to provide a minimum health standard. Universal catastrophic health insurance should support people facing very large expenditures. Price controls and tax exemption for health insurance should end.

Social Security faces a longer-term problem than is faced by Medicare and Medicaid. Yet the problem is real and cannot be ignored. The sooner we, as a nation, address these problems, the less painful and more equitable will be the adjustment.

The Advisory Council on Social Security could not agree on appropriate reform. None of their proposals is appealing; a successful solution does not require massive government involvement. A desirable reform would give individuals the choice between an actuarially sound government program and private management of retirement funds.

Chart 1: Acceleration in Monetary Base from Previous Trough*

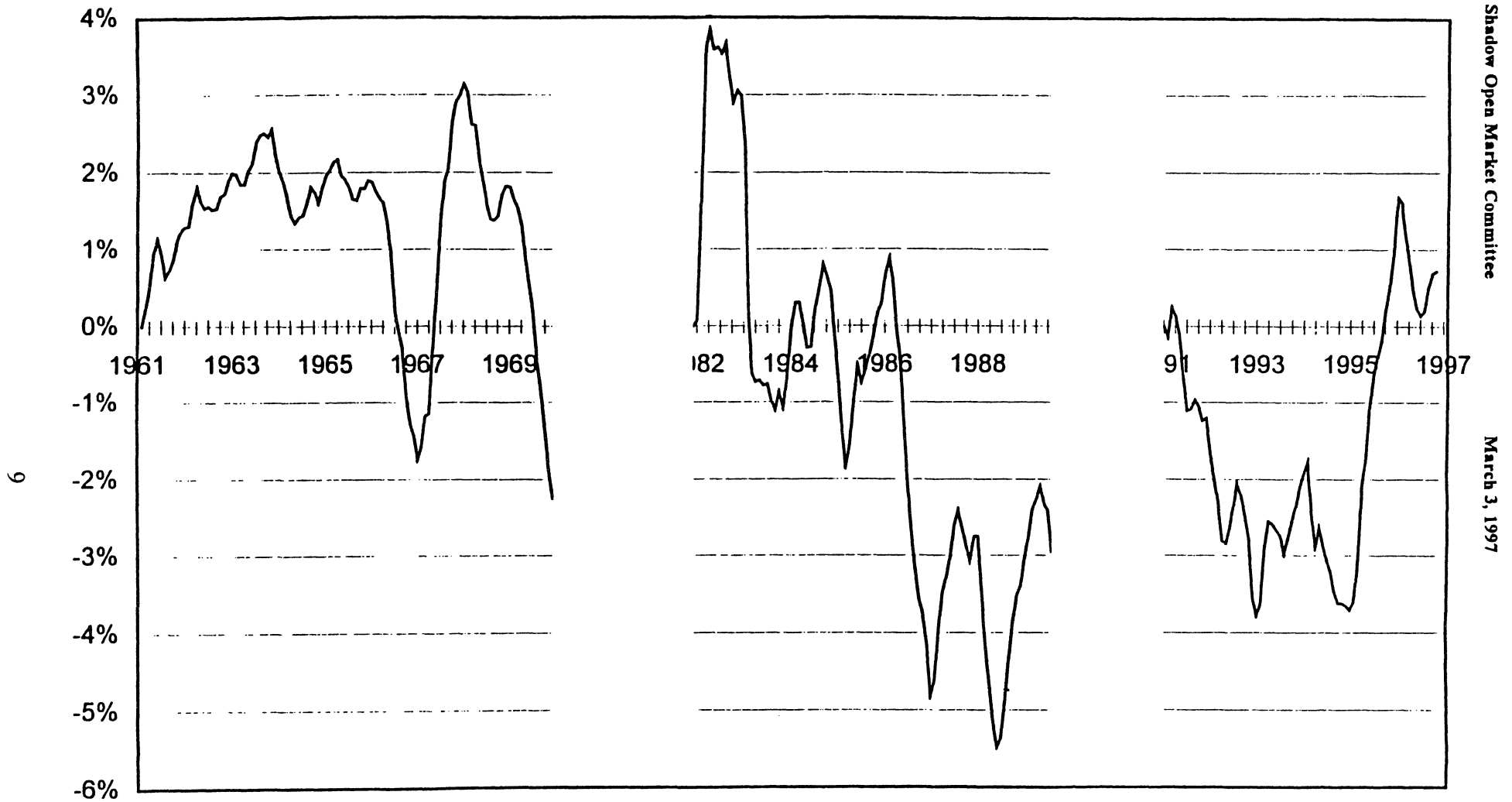


Shadow Open Market Committee
March 3, 1997

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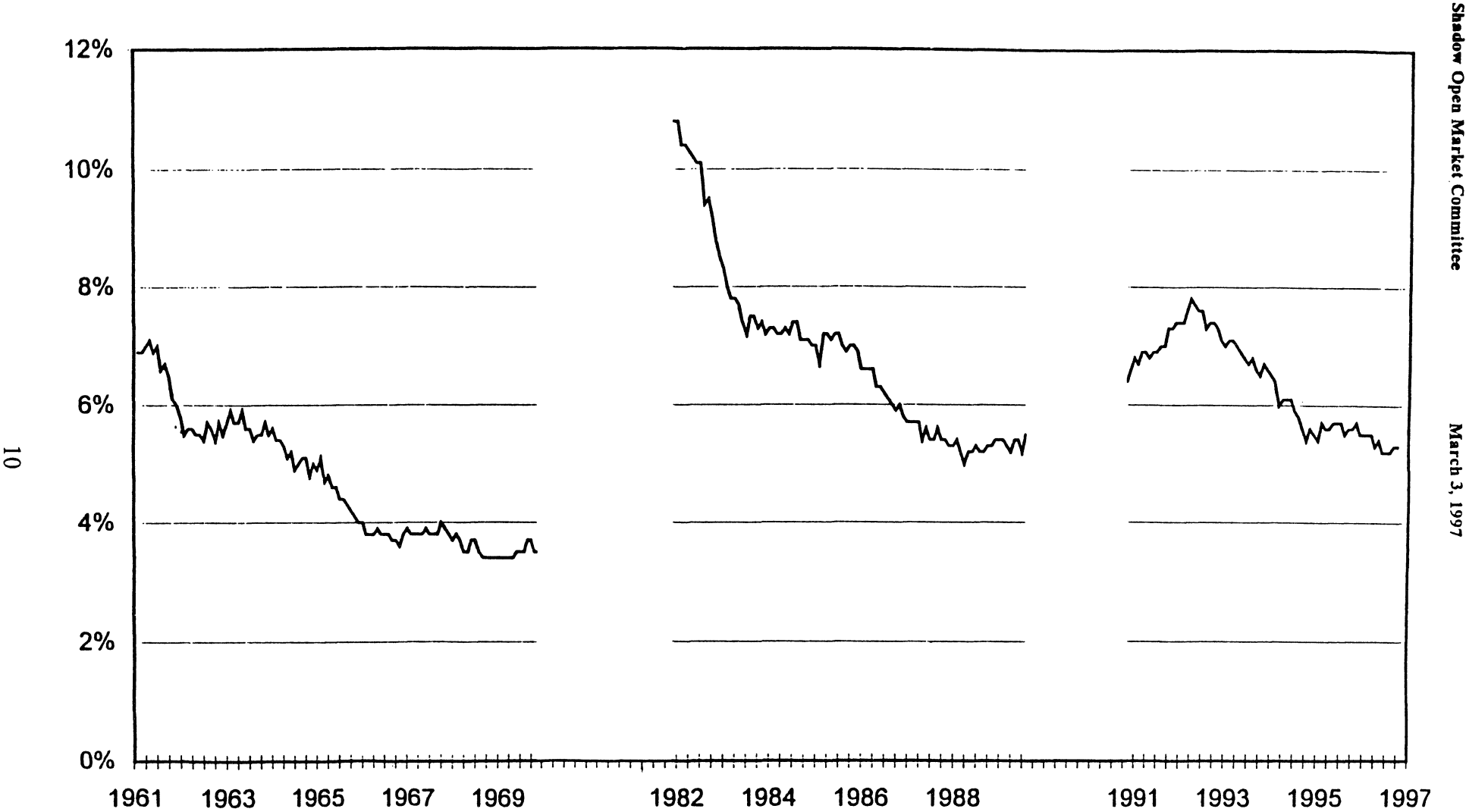
* Difference between 12-month moving average of monetary base growth and 12-month moving average of monetary base growth in month of preceding business cycle trough

Chart 2: Acceleration of M₂ from Previous Trough *



* Difference between 12-month moving average of M₂ growth and 12-month moving average of M₂ growth in month of preceding business cycle trough

Chart 3: Monthly Unemployment



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NOTES ON THE ECONOMY

H. Erich HEINEMANN
Heinemann Economic Research
Division of Brimberg & Co.

Federal Reserve Chairman Alan Greenspan cautioned Congress last week about “the sharp rise in equity prices during the past two years.” He conceded that it was possible that “something fundamentally new about this current period” could keep Wall Street on an escalator indefinitely. However, he noted that “history is strewn with visions of such ‘new eras’ that, in the end, have proven to be a mirage.”

We warned bluntly that “another recession will doubtless occur some day owing to circumstances that could not be, or at least were not, perceived by policymakers and financial market participants alike.” The business cycle, he said, had not been repealed.

As in 1990, prior to the last recession, Mr. Greenspan seems determined to fulfill his own prophecy. “Given the lags with which monetary policy affects the economy,...” he said, “we cannot rule out a situation in which a preemptive policy tightening may become appropriate before any sign of actual higher inflation becomes evident.”

Though Mr. Greenspan would deny it, I believe there is ample evidence that monetary policy is now sufficiently tight to push the economy into a recession. Any further tightening would likely result in a deeper, longer downturn than otherwise and increase the risk of an inflationary monetary policy in 1998 or 1999.

Since January 31, 1996 the Federal Reserve System has fixed overnight interest rates at about 5.25 percent. The Fed’s intention when it set this target was to promote “a slight easing of monetary policy.” In practice, things did not turn out as Mr. Greenspan intended.

Total bank reserves, the raw material for the money supply, have declined in the past year, even after adjusting for distortions created by so-called retail sweep accounts. Meanwhile, the real effective exchange rate of the U.S. dollar has increased and the dollar price of gold has collapsed. These are all classic symptoms of tight money.

As important, sweep-adjusted reserves fell at an annual rate of 0.13 percent during the 36-month period ended in January, a record low growth rate. This is tight money. By

contrast, the three-year rate of reserve growth peaked close to 14 percent in 1993. A similar drop in reserve expansion from 1987 through 1990 set the stage for the last recession. Retail sweeps are computer-driven manipulations of personal checking accounts that banks use to lower the amount of non-interest-bearing reserves they keep on deposit at Federal Reserve banks.

The sharp slowdown in monetary expansion over the last three years has already resulted in a parallel deceleration in total spending and a severe profit squeeze in the retail and service industries. Advance estimates by the Commerce Department show that corporate profits declined in the fourth quarter. Since profits were up a lot in big companies, this suggests that profits of small firms were sharply lower.

This is crucial because small retail and service companies have created roughly three-quarters of all net new jobs in the private sector over the past decade and 70.55 percent over the half century since World War II. As in 1990, when retail and service hiring stops, the overall economy will go into reverse.

Fiscal policy is also tight. Washington—which keeps its books by an archaic set of accounting rules that no sensible business would ever use—continues to be obsessed with achieving a “balanced” federal budget. In reality, the Treasury’s operating accounts (revenues minus outlays except for net interest) already have a huge surplus.

This measure, the best yardstick of the government’s impact on the economy, was in the black by \$107 billion in 1996—a record in dollar terms and the highest in a generation as a percentage of gross domestic product (1.4 percent). That’s a positive swing of more than \$200 billion since President Clinton took office. However, investors should beware. Operating surpluses in the Treasury budget have preceded every recession since World War II.

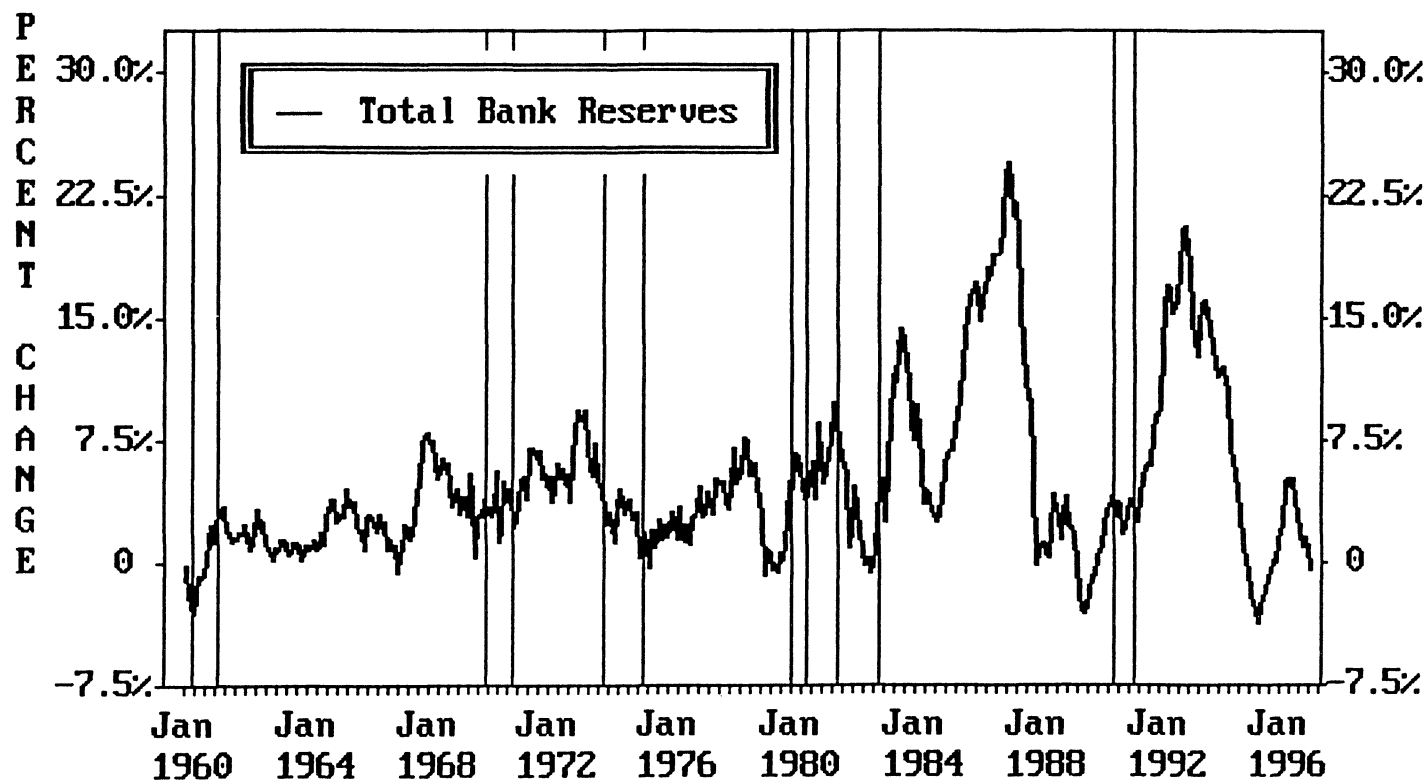
Consumers normally buy big-ticket durable goods—for instance, automobiles and appliances—with borrowed money. Consumer spending for durables accounted for almost 17 percent of the overall expansion of the economy in the past six years, well above the 9.6 percent average during previous expansions.

Against this background, commercial banks have started to limit the availability of consumer credit partly in reaction problems that borrowers have encountered in

servicing their debts. Delinquency on bank consumer loans, particularly credit card loans, has increased substantially over the past two years. At finance companies that are subsidiaries of automakers, loan delinquency rates rose to very high levels. Across the country a record of more than 1 million individuals filed for bankruptcy last year.

The party line at the Federal Reserve is that the surge in Wall Street will offset excessive consumer debt and leave the economy largely unaffected. I'm not so sure. The four-way whammy of tight money, tight fiscal policy, dwindling profit margins that undercut incentives to hire and debt-burdened consumers has tipped the economy into recession in the past. It will do so again.

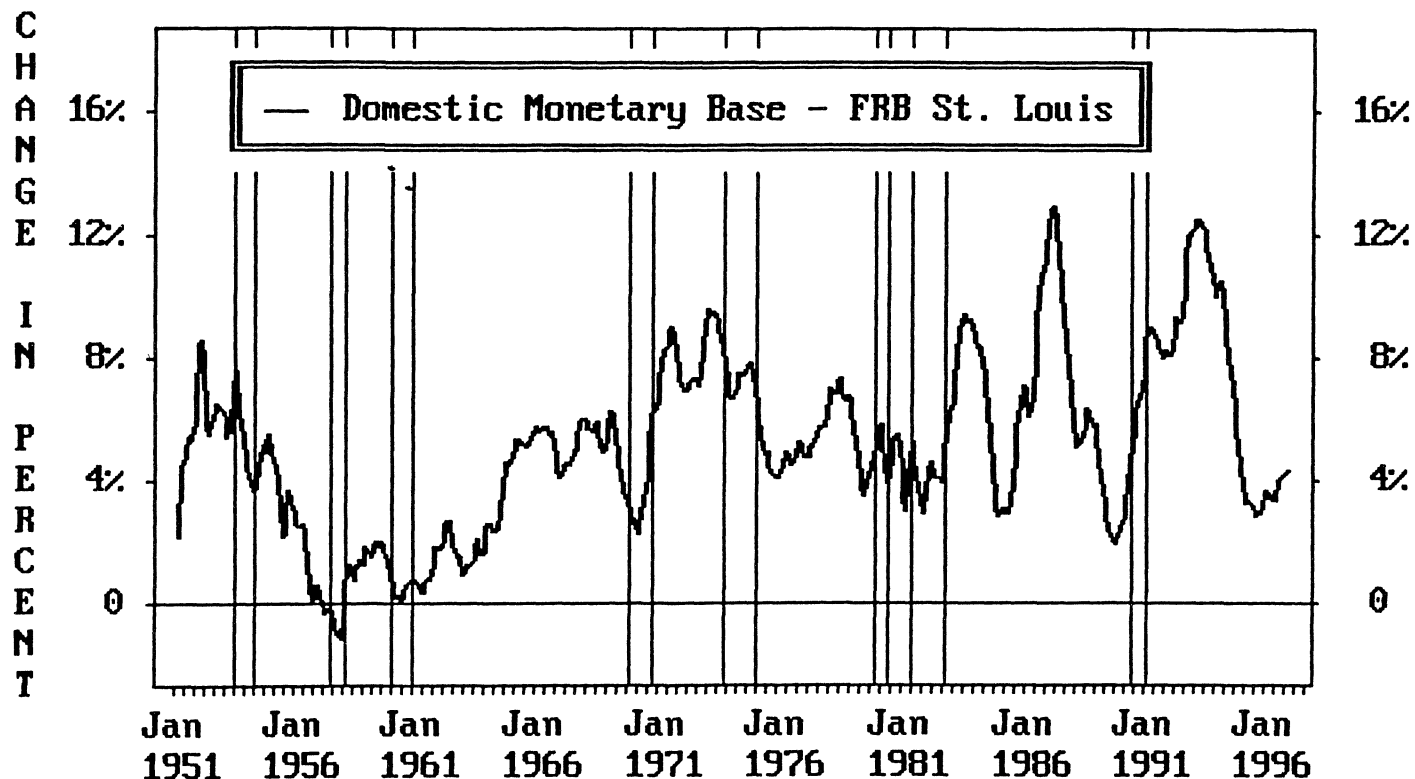
CYCLICAL CHANGES IN THE GROWTH OF BANK RESERVES



Notes: The chart shows yearly percent changes in total bank reserves, adjusted for reserve requirement changes and retail sweep activity. FRB data, seasonally adjusted in current dollars. The vertical lines show recessions.

Sources: Haver Analytics; Heinemann Economic Research

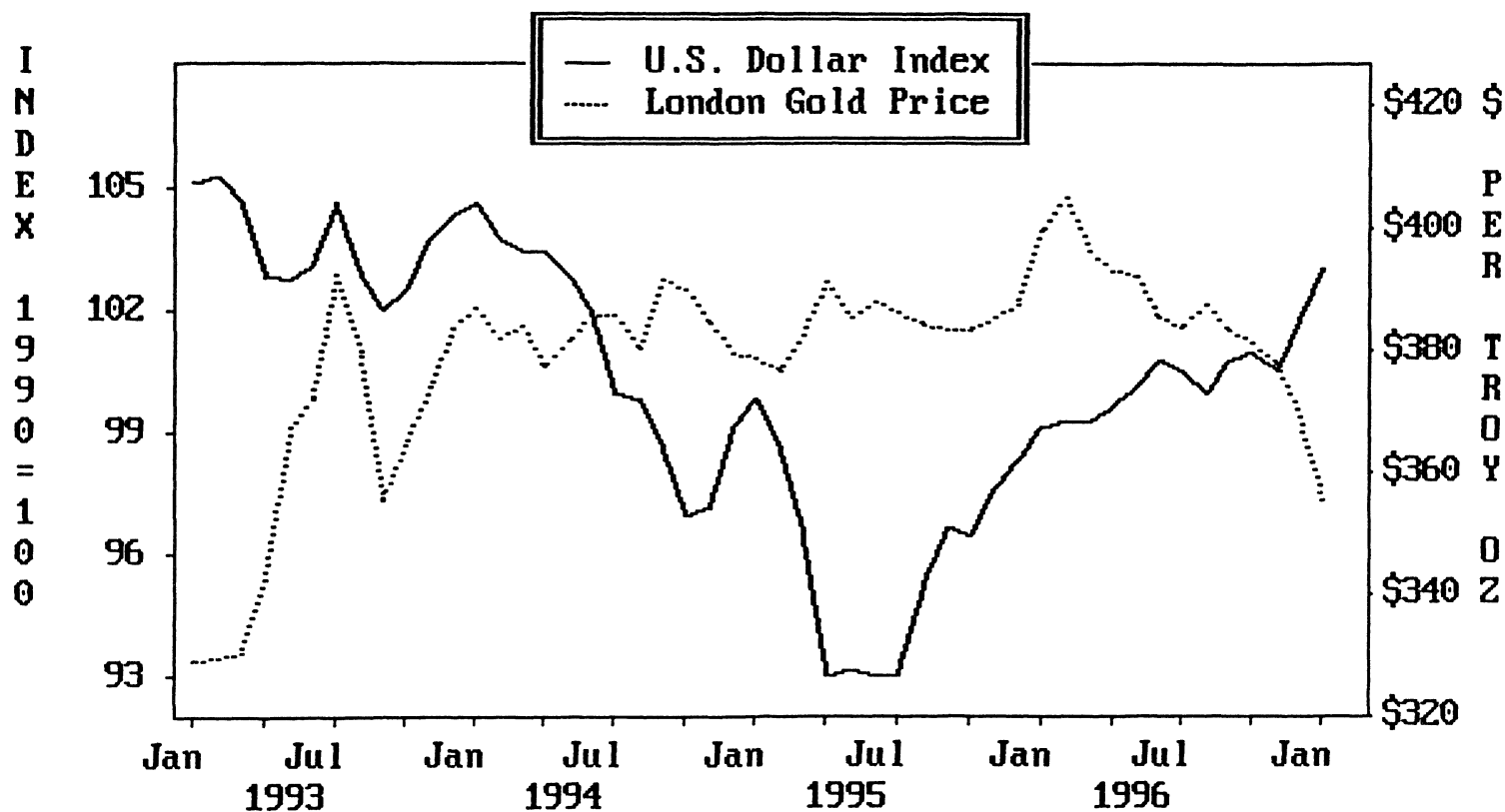
CYCLICAL SWINGS IN FEDERAL RESERVE POLICY



Notes: The chart shows annual changes in the monetary base (FRB St. Louis) minus U.S. currency held abroad plus an adjustment for the effect of retail sweep activity. Current dollars. The vertical lines show recessions.

Sources: Haver Analytics; Heinemann Economic Research

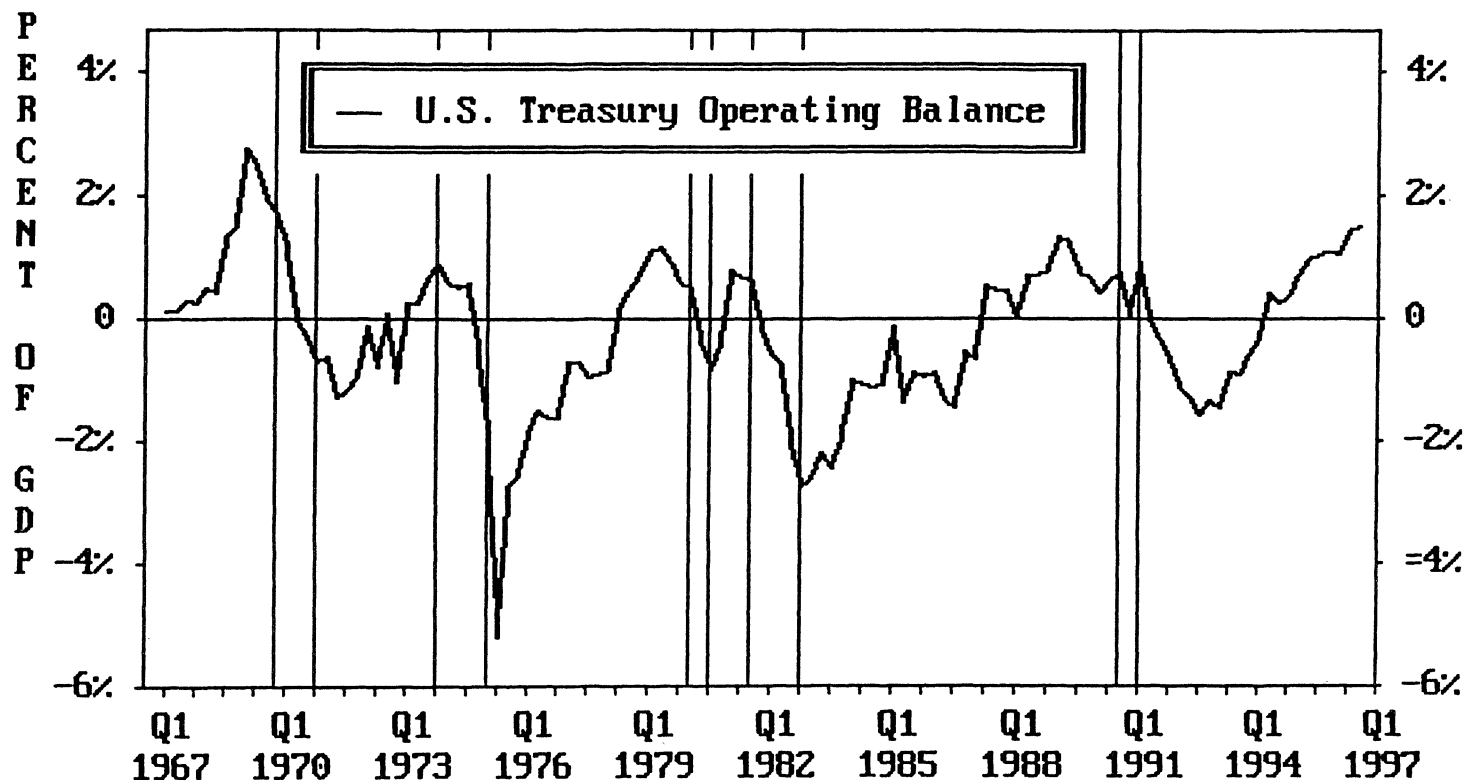
THE DOLLAR IS UP AND GOLD IS DOWN



Notes: The chart shows the J.P. Morgan real effective exchange rate index for the U.S. dollar (1990=100, left scale, line) and the U.S. dollar price of gold in London (right scale, dot).

Sources: Haver Analytics; Heinemann Economic Research

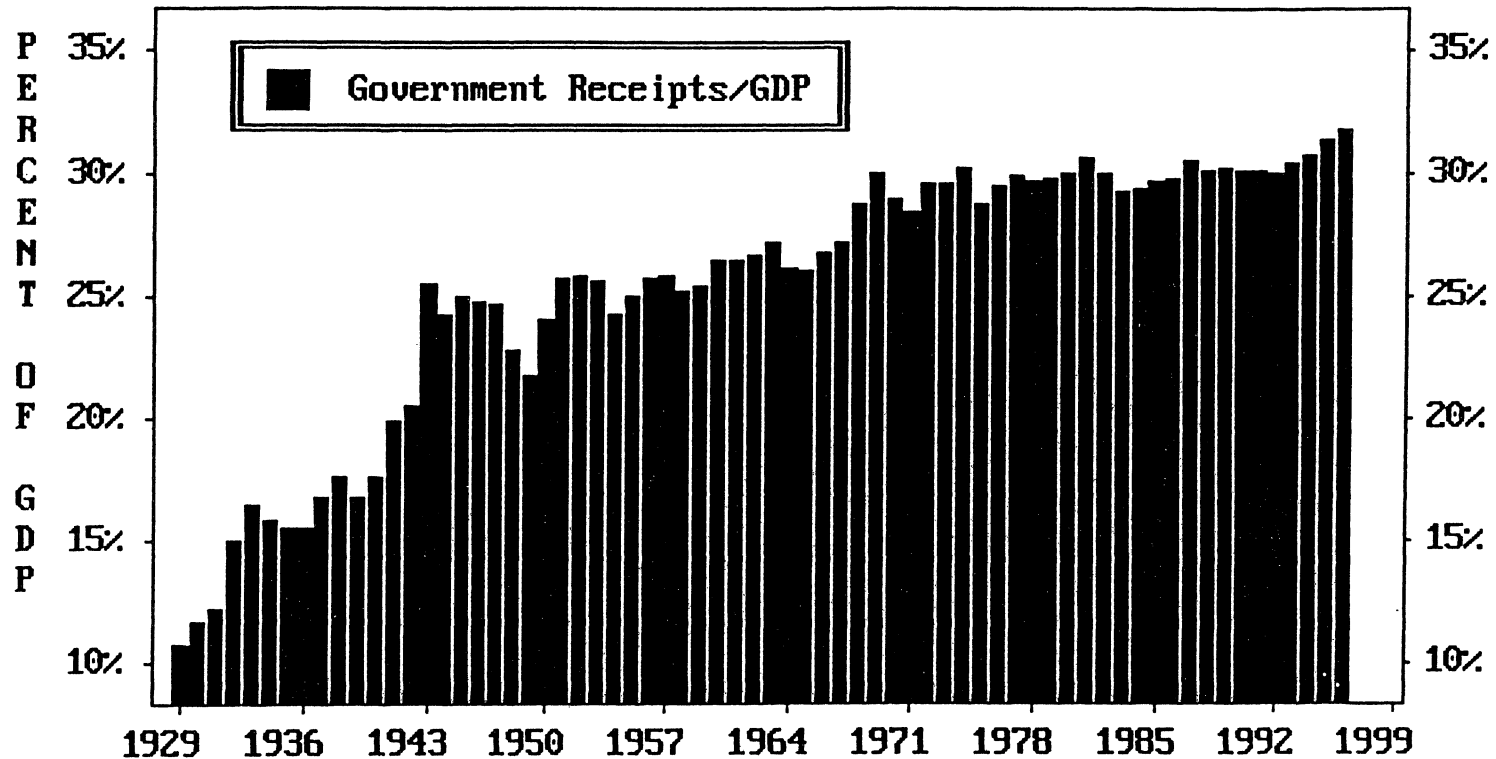
CYCLICAL CHANGES IN THE TREASURY'S OPERATING BUDGET



Notes: The chart shows the U.S. Treasury's operating balance (revenues minus outlays except net interest) as a percent of gross domestic product. NIPA basis in current dollars, SAAR. The vertical lines show periods of recession.

Sources: Haver Analytics; Heinemann Economic Research

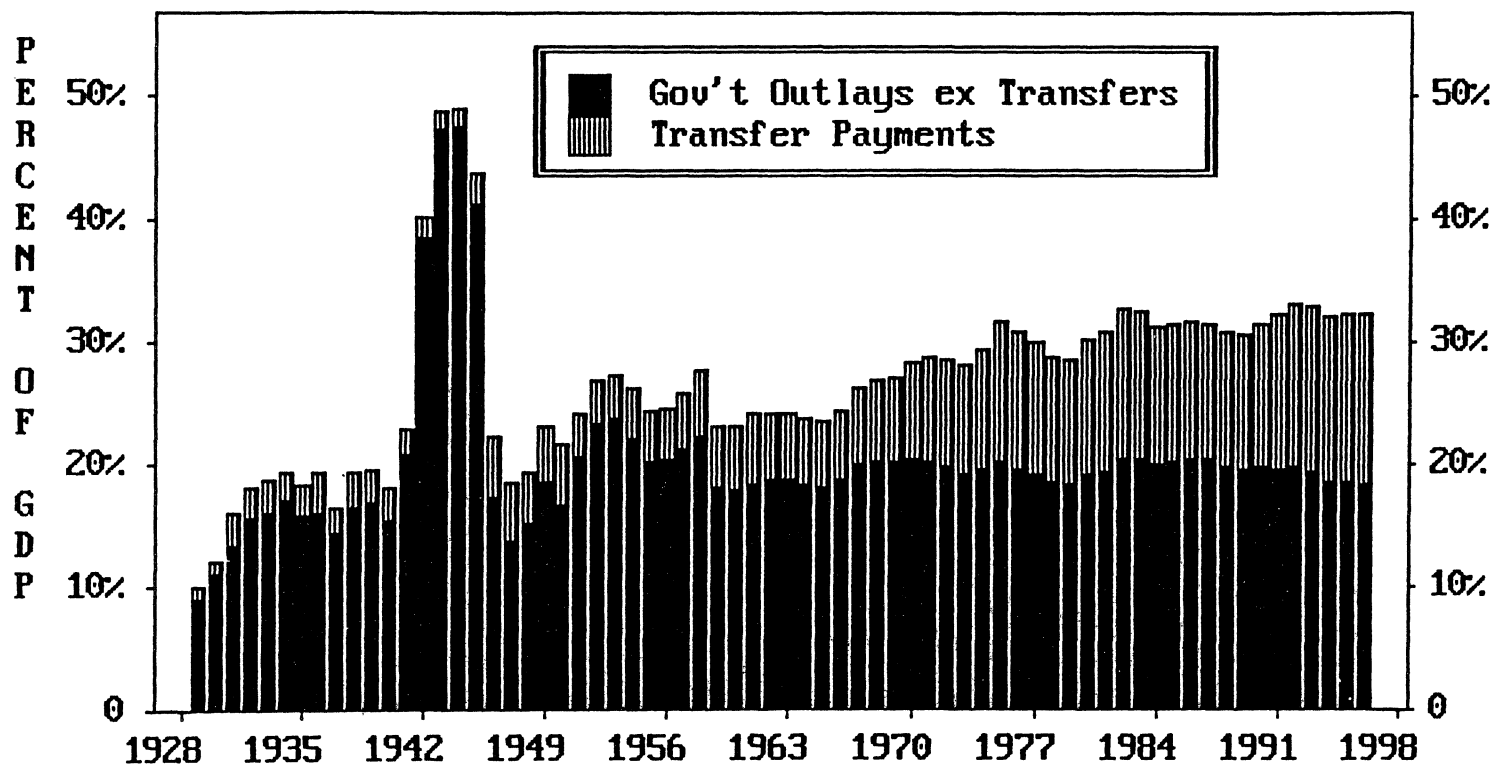
THE LONG-TERM TREND IN TOTAL TAXES



Notes: The chart shows total receipts by federal, state and local governments as a percent of GDP. In current dollars, net of federal grants-in-aid. The datum for 1996 is the average for the first three quarters.

Sources: Haver Analytics; Heinemann Economic Research

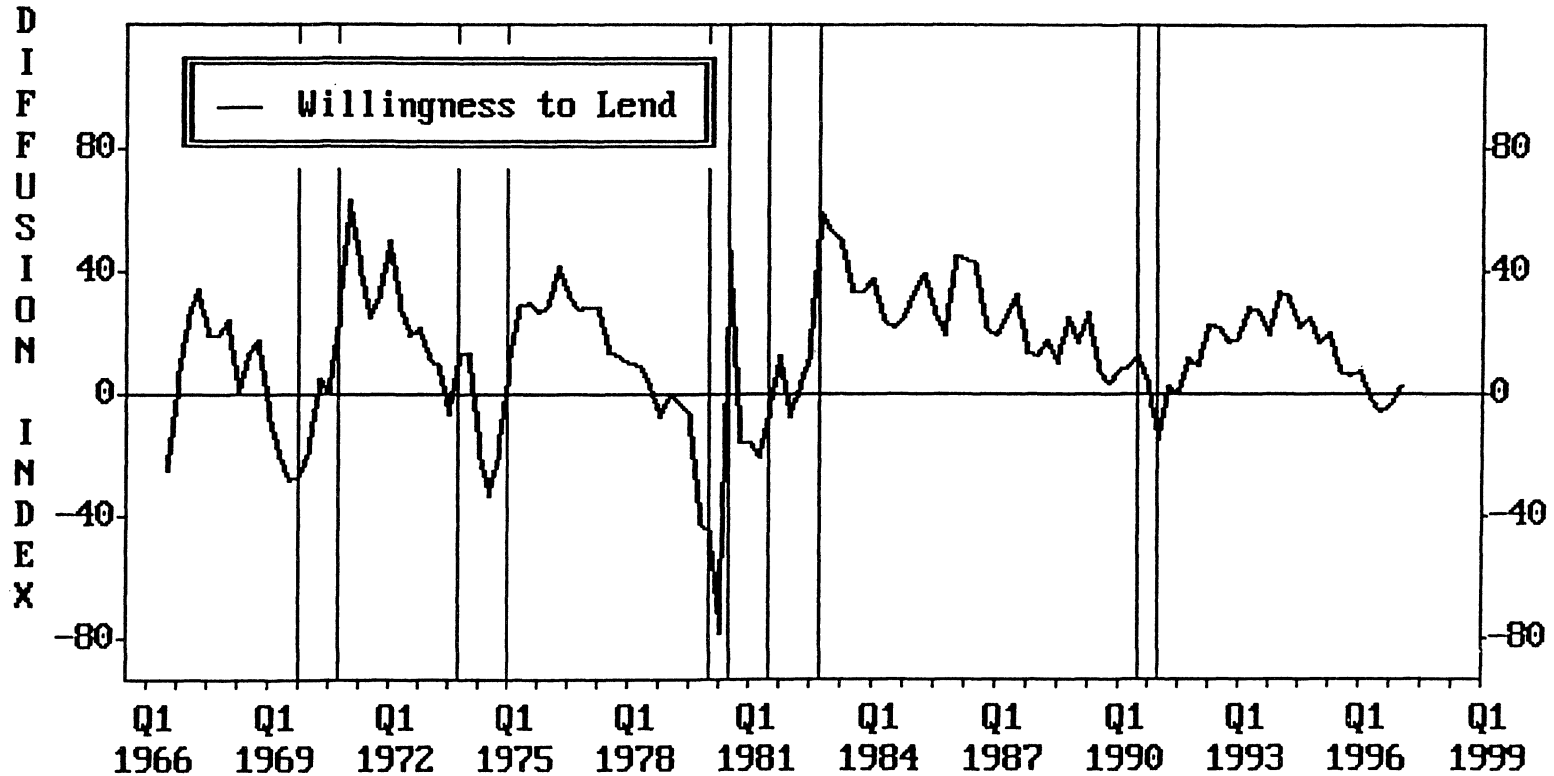
CHANGING PRIORITIES IN GOVERNMENT SPENDING



Notes: The chart shows federal, state and local government spending as a percent of GDP — ex transfer payments (solid bar) and transfer payments (shaded bar). Current dollars, net of grants-in-aid. Break in series in 1959.

Sources: Haver Analytics; Heinemann Economic Research

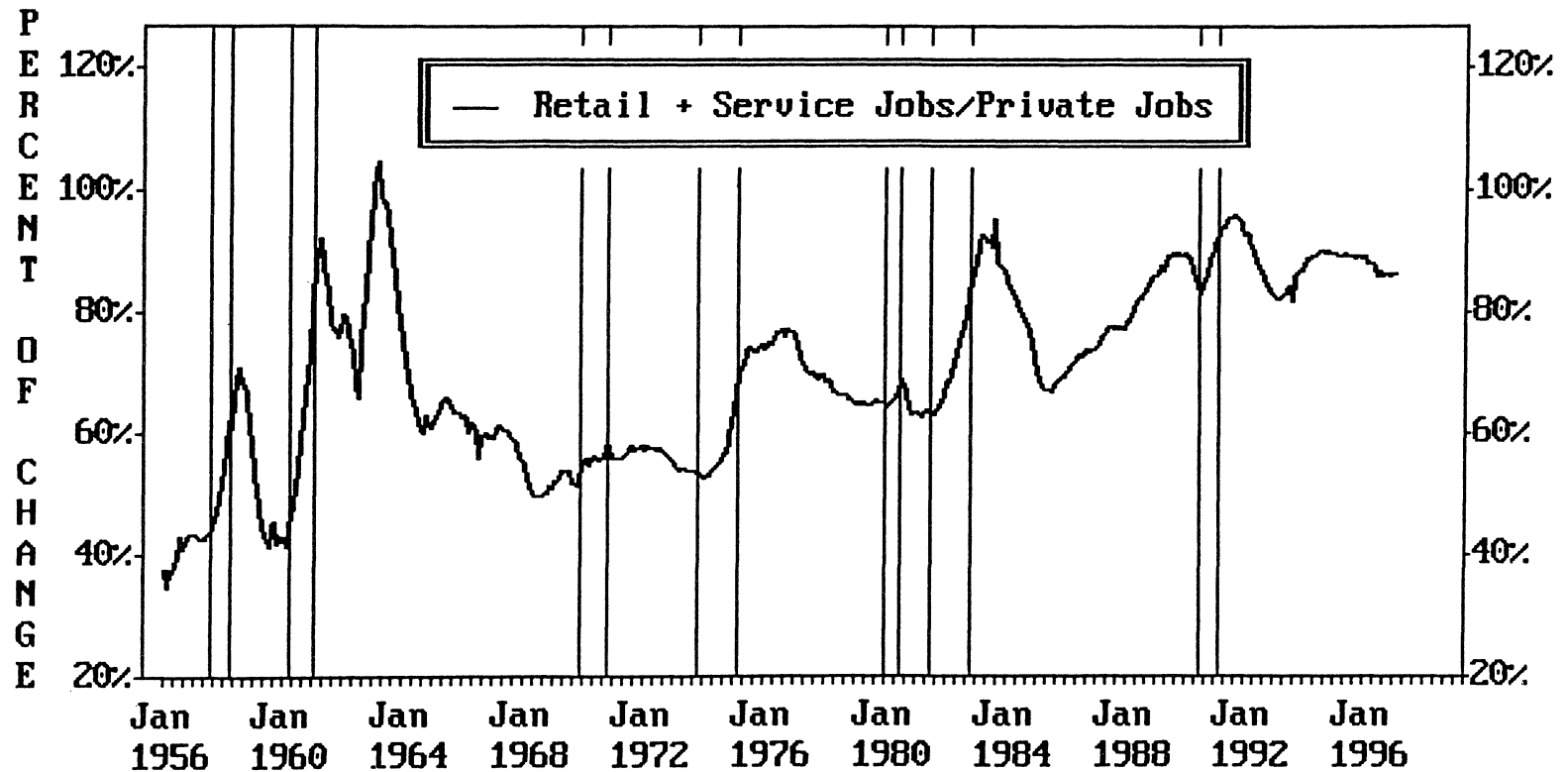
BANKS HAVE TIGHTENED UP ON CONSUMER LOANS



Notes: The chart shows the Federal Reserve Board index of bank willingness to lend to consumers -- the weighted responses of banks more willing to lend minus those less willing. IQ 1997 plotted. The vertical lines show recessions.

Sources: Haver Analytics; Heinemann Economic Research

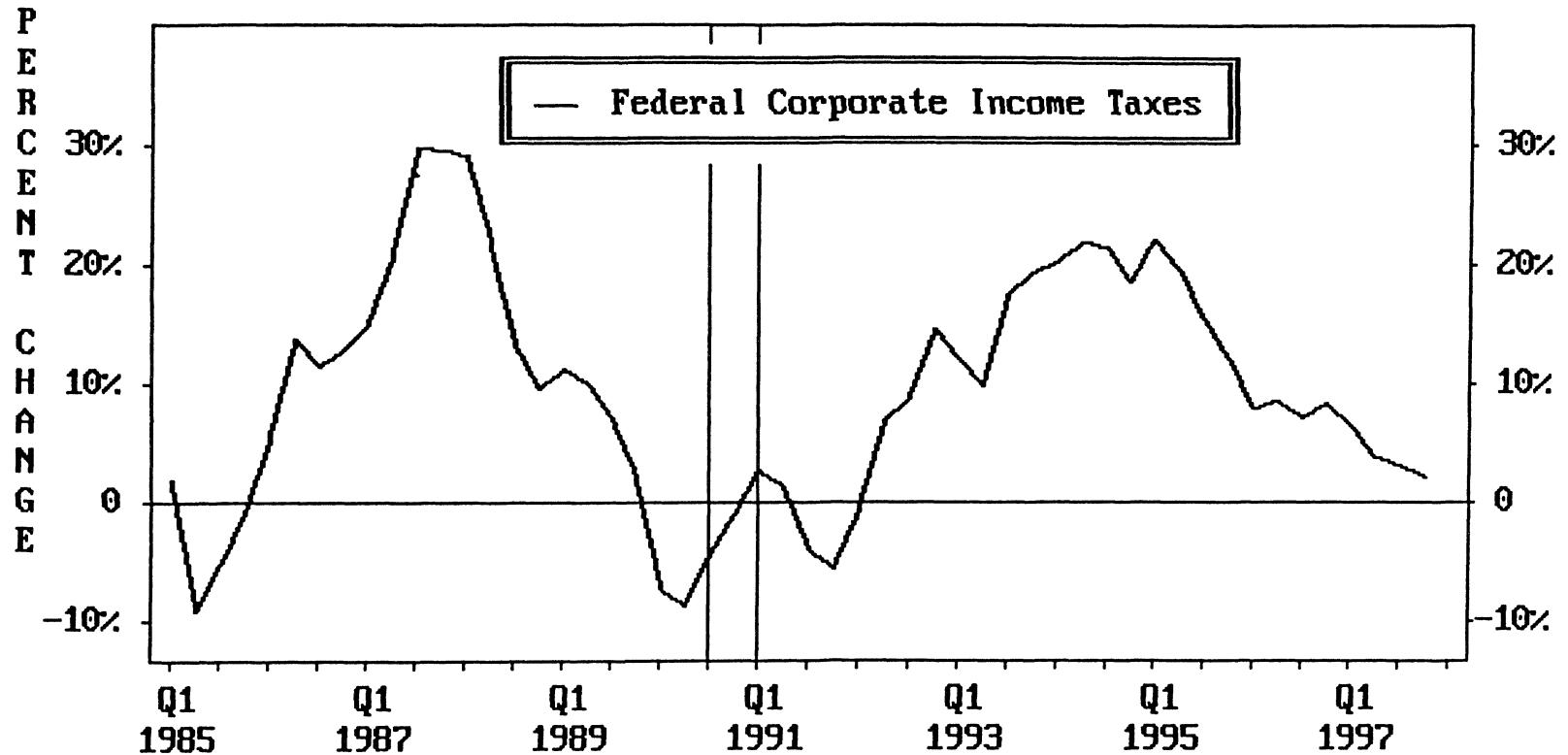
RETAIL & SERVICE JOBS DOMINATE PRIVATE EMPLOYMENT



Notes: The chart shows 10-year changes in retail and service jobs as a percent of 10-year changes in total private nonfarm payroll employment. Underlying data are thousands of jobs, SA. The vertical lines show recessions.

Sources: Haver Analytics; Heinemann Economic Research

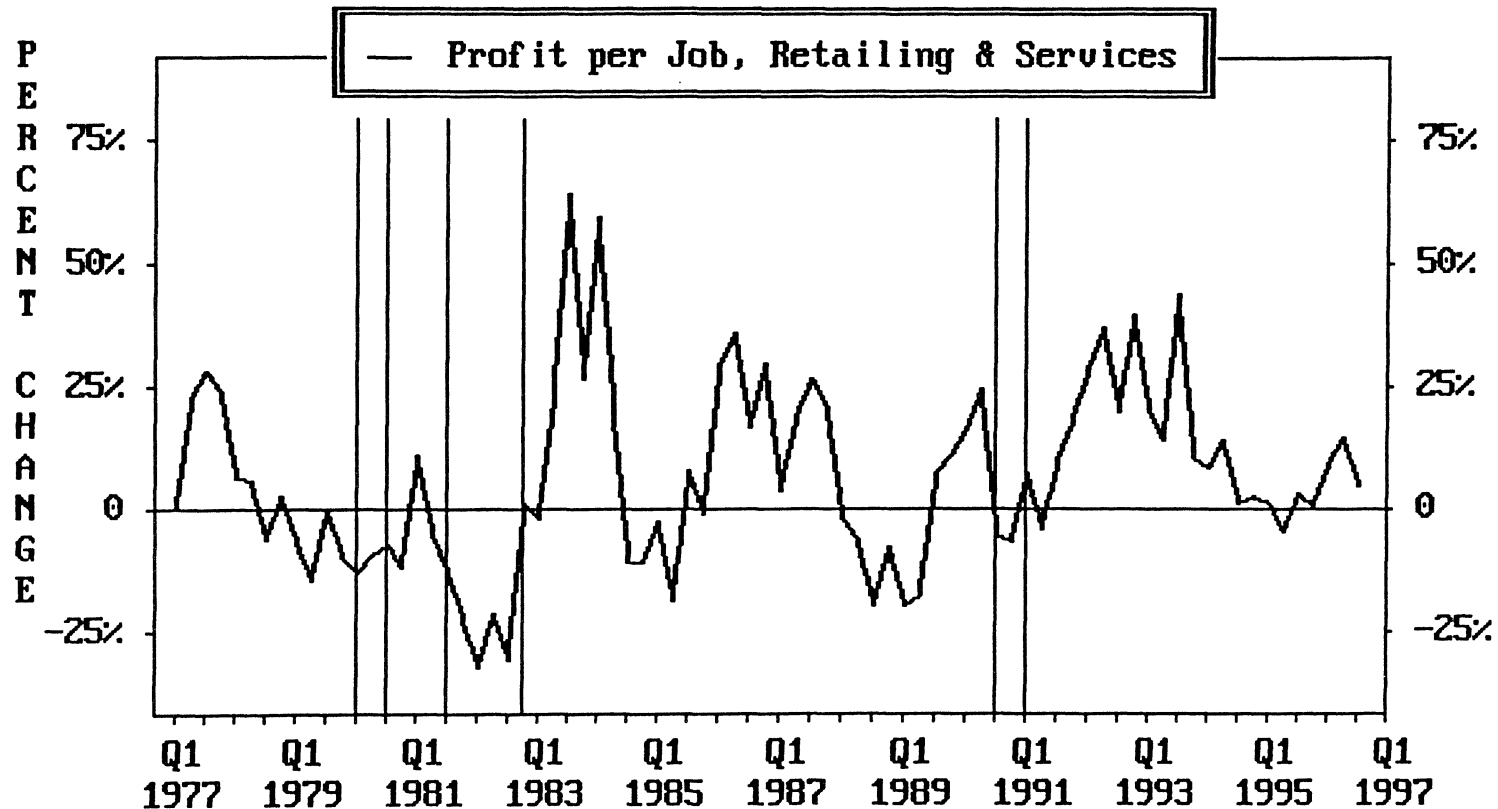
THE SLOWDOWN IN CORPORATE PROFITS



Notes: The chart shows annual changes in accruals of federal corporate income taxes, ex the Federal Reserve. 1997 data are projections by the Bureau of Economic Analysis. Current \$, 4Q moving averages. Vertical lines show the 1990-91 recession.

Sources: Haver Analytics; Heinemann Economic Research

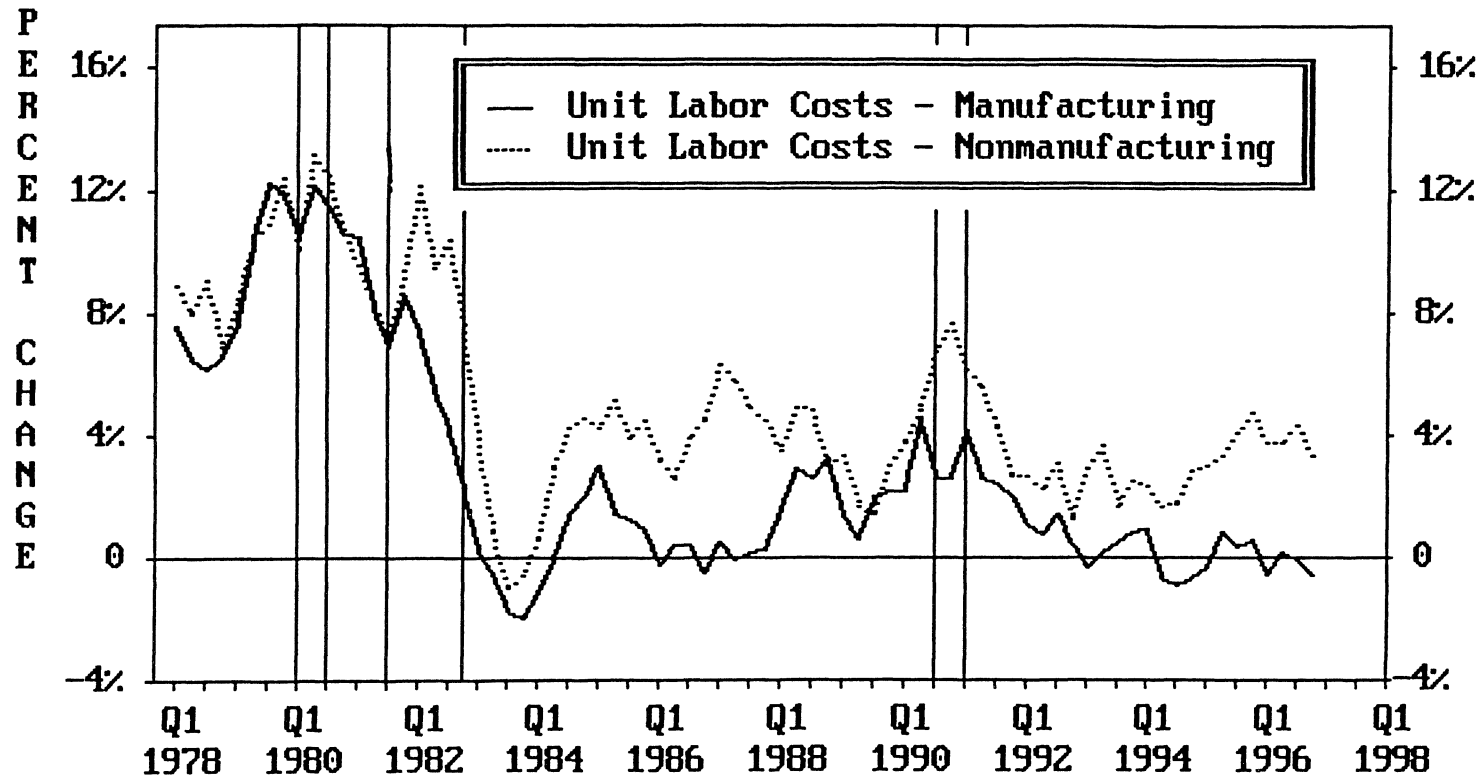
CYCLICAL CHANGES IN THE MARGINAL PROFITABILITY OF EMPLOYMENT



Notes: The chart shows annual changes in pretax profit per job in the retail and service sectors, adjusted for shifts in inventory valuation. In current dollars. Third quarter 1996 plotted. The vertical lines show recessions.

Sources: Haver Analytics; Heinemann Economic Research

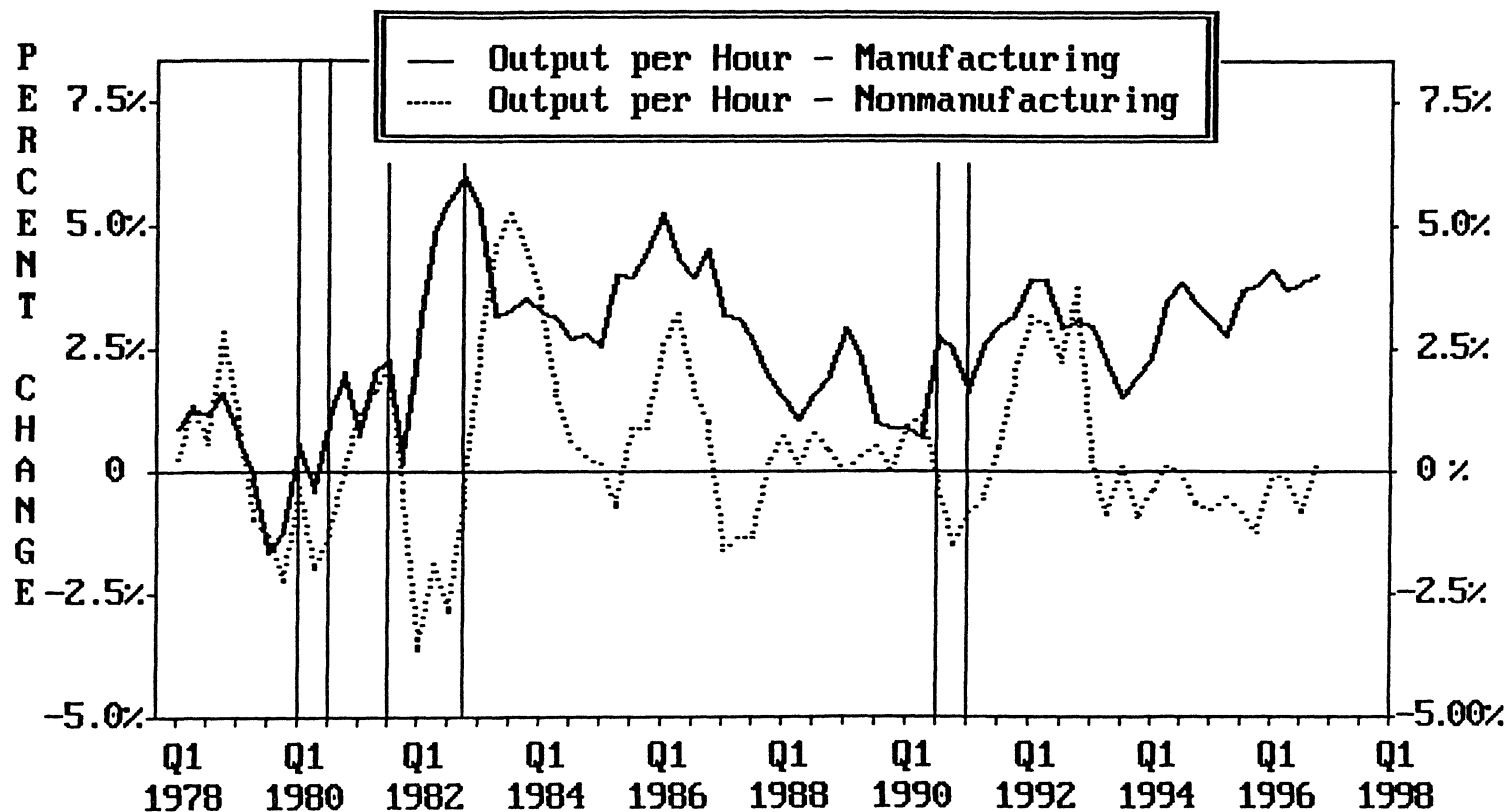
UNIT LABOR COSTS ARE DOWN IN MANUFACTURING, UP ELSEWHERE



Notes: The chart shows annual changes in unit labor costs in manufacturing (line) and in nonmanufacturing (mostly services and construction, dot). Derived from BLS indexes, 1992 = 100. The vertical lines show recessions.

Sources: Haver Analytics; Heinemann Economic Research

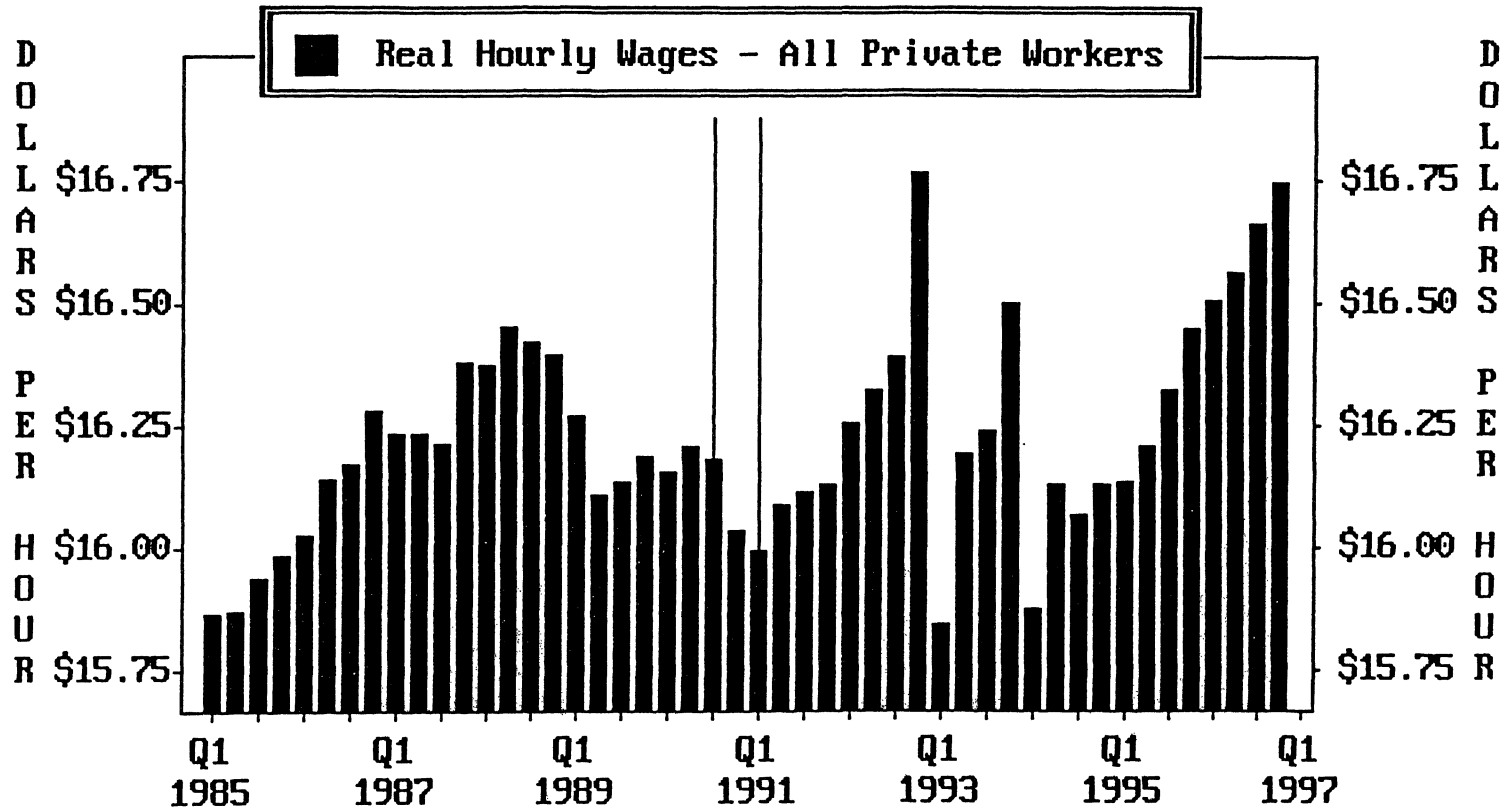
PRODUCTIVITY IS UP IN MANUFACTURING, DOWN ELSEWHERE



Notes: The chart shows annual changes in productivity in manufacturing (line) and in nonmanufacturing (mostly services and construction, dot). Derived from BLS indexes, 1992 = 100. The vertical lines show recessions.

Sources: Haver Analytics; Heinemann Economic Research

REAL WAGES ARE GOING UP

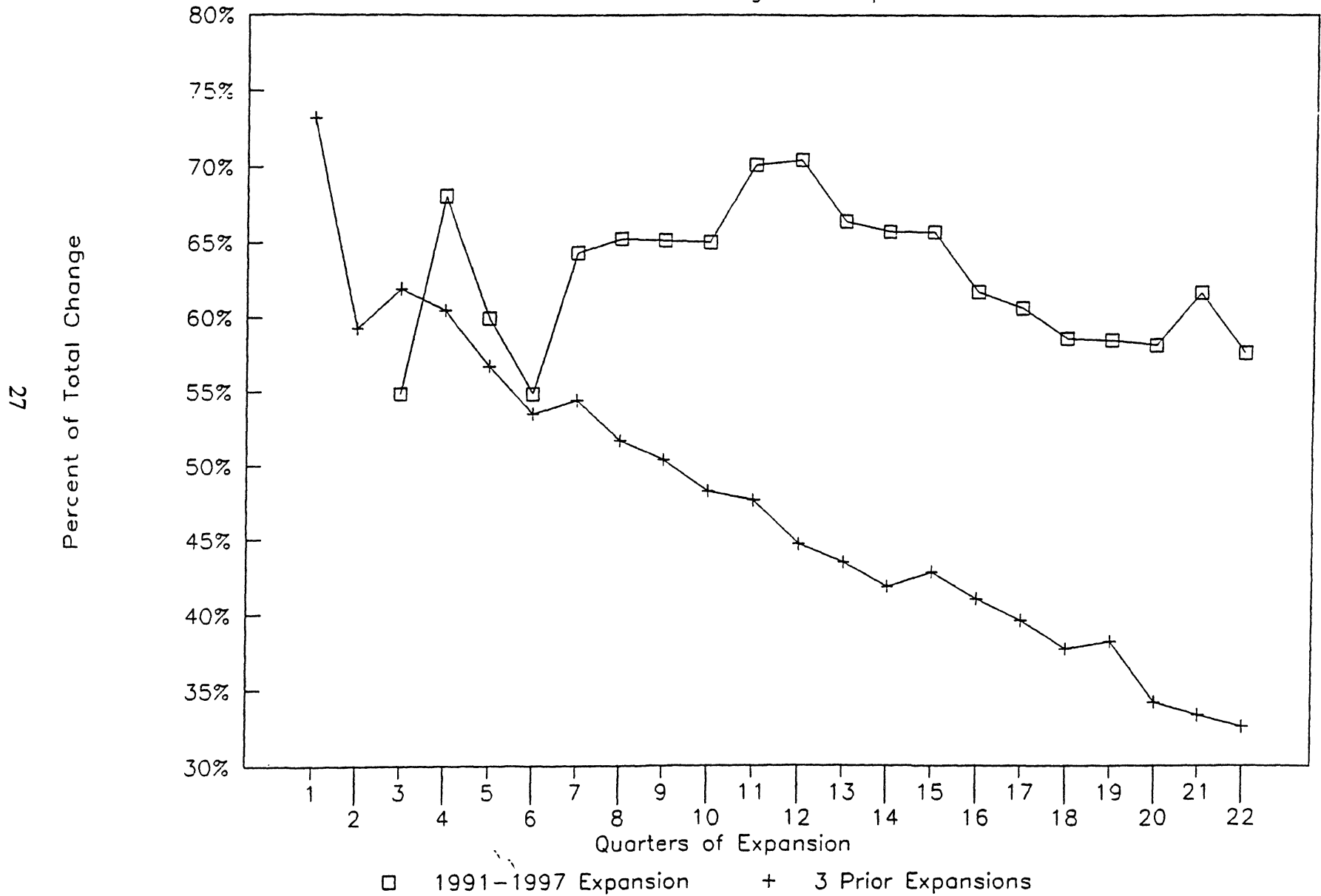


Notes: The chart shows wage and salary disbursements per hour to all private workers, divided by the chain weight deflator for personal consumption expenditures (December 1996 equals 100). The vertical lines show the 1990-91 recession.

Sources: Haver Analytics; Heinemann Economic Research

THE CYCLICAL SHARE OF EXPANSION

Cumulative Changes in Output



MEDICARE REFORM

Lee HOSKINS
The Huntington National Bank

THE PROBLEM

The Administration is pursuing legislation to control Medicare costs, partly in an attempt to achieve a balanced budget and partly because the hospital trust fund portion of Medicare will be broke as early as the year 2001. Yet there is nothing in the President's proposal that effectively addresses the long-term problem of inefficiency and subsidized consumption of medical services which is exacerbated by the same demographic trends that plague Social Security. Tinkering with the current system may keep a lid on the problem for a few more years but won't make it go away. Fundamental reform means families and individuals must take responsibility for purchasing medical services or insurance as they do for all other goods and services. If rational reform is started now, it will cost less than reform by "crisis" later.

The problem as reviewed by Congress and much of the public is that the cost of providing health care to future Medicare recipients will outgrow the ability of the younger working population to finance it through payroll taxes:

For the last 15 years, the cost of Medicare has grown at an average annual rate of 11 percent, faster than any other federal program. To pay for those benefits, the Medicare tax has exploded from 0.7 percent of the first \$6,000 of wages 30 years ago to 2.9 percent of every dollar of wages earned today. Medicare this year will spend every penny of taxes it collects from workers, every penny of premiums from beneficiaries, plus \$60 billion of general revenues, and still will be forced to draw down its reserves by \$9.7 billion just to pay for current benefits. It gets worse: Medicare will exhaust its cash reserve within four years and be \$500 billion in debt in 10 years.

Add in the aging population, which will increase the number of new retirees by 800 percent in 15 years, and we have a real disaster on our hands. When Medicare started in 1965 there were 5.5 workers for each of the 19 million beneficiaries; today there are 3.9 workers for each of the 37 million beneficiaries. Medicare trustees estimate that by 2030, when the last baby boomer turns 65,

there will be only 2.2 workers per beneficiary. That makes Medicare—which depends on direct transfer payments from workers to retirees—unsustainable.¹

While the financing of Medicare is in the spotlight, the real long-run disaster is the misallocation of resources caused by government interference with the market mechanism. Government laws, regulations, tax policy, and health care transfer programs (such as Medicare and Medicaid) separate the payment for medical goods and services from the procurement of those goods and services. By inflating demand and restricting supply, the decoupling of payment and procurement drives up prices, which strains the federal budget and distorts the allocation of society's economic resources.

Patients directly paid less than one-quarter of all health care expenses in 1990, up from more than one-half before Medicare was enacted in 1965. (See **Figure 1**) Patients paid an astonishingly small 5 cents out of every dollar of hospital charges in 1990. And more than 80 cents on the dollar of physician fees were picked up by third parties, including Medicare and Medicaid.² The availability of steeply discounted medical goods and services created a rush to stake health claims that raised Medicare spending, alone, to 2.6 percent of GDP last year.³ Medicare spending, as a share of GDP, is expected to double by 2015, triple by 2030, and top 9 percent in 2070.⁴ (See **Figure 2**)

The anticipated increase in Medicare spending will be caused mainly by escalating prices for medical goods and services. Expected growth in enrollment accounts for only a small share of the expected increase in spending, rising at an annual rate of 1.2 percent between 1996 and 2002.⁵ Most of the increase in spending is the result of growth in spending per enrollee. Increased spending per enrollee reflects increases in the number and complexity of services demanded per enrollee and increases in prices, both of which are inflated by the decoupling of the payment for and the procurement of medical goods and services. The unfortunate consequence will be a misallocation of resources that will undermine economic growth.

ECONOMICS 101 FOR HEALTH POLICYMAKERS

Health policymakers are faced with an indomitable fact of life that has marked man's trek through time—scarcity. There are, and always have been, an unlimited

number of competing uses to which man can devote his limited resources. Hence, even the wealthiest of nations cannot have all it wants of everything. Choices must be made. The problem of obtaining more or better medical care is painful testimony to this pervasive and inescapable fact. Society simply does not have the resources to take all known steps to prevent or cure illness and postpone death while continuing to meet the claims of housing, food, and pursuits of “the good life.” Moreover, classifying particular economic goods such as housing, food, or medical care as “needs” does not alter the fact that the world in which we live is one of too few resources relative to our desires.

“Needs” are not readily observable absolutes, nor are they costless to satisfy. Consequently, the problem society faces is to determine the level of medical “needs” or wants it is willing to pay for. In other words, what are we willing to give up for more or better medical care? To say we are willing to supply all that is “needed,” while laudable, is misleading. At some point, society will find that additional resources are more valuable in other areas.

Yet, the problem posed by scarcity is effectively dealt with daily in most areas of our economy. Why does it seem to reach crisis proportion in the medical sector? An important part of the answer can be found in the crippling of the market system usually employed to resolve scarcity difficulties.

The U.S. economy relies primarily on private incentives and consumer wants expressed through competitive market forces to settle problems posed by a world of too few resources. The underlying notion behind this form of economic organization is simply that individuals in their role as consumers and producers, by attempting to make themselves better off, end up putting their privately owned resources to uses most highly valued by society as a whole. That is, resources automatically would be put to socially desirable uses and in the appropriate amounts. This notion works surprisingly well in a market-oriented economy when markets are open to all comers and are allowed to respond to competitive forces. All the information and incentives needed to make the system work are guided by the “invisible hand” of the market.

The medical care system, for the most part, is shielded from this process, and market forces are severely crippled. Because so few of the funds paid out for health and medical care are private expenditures made in a market situation, the market signals yielded are confused and often go unheeded. Little information is generated on the most economically productive combination of medical resources (doctors, nurses, and hospitals). For example, since neither doctors nor hospitals openly compete on price, charges vary for similar services. Among other things, this lack of competition hides information about the most efficient methods, hospitals, and doctors.

Even more of a problem is the decision about how much care people want or demand is separated from the decision on the amount to be supplied or financed through programs such as Medicare. Supply and demand decisions pose a problem if they are split up because individuals behave differently when making choice decisions through groups (governments) than when making private decisions. For example, if a national health program or insurance scheme is financed through government, as the Medicare-Medicaid programs are, an individual citizen is involved in a “group” choice on the amount of medical services to finance through government. Higher levels of medical care then imply higher taxes for individuals. The gains (more or better medical care) are weighed against the costs (higher taxes) by the individual through his Congressional Representative and a specific level of care is set for a specific dollar amount in taxes. Medical care on the supply side is in no sense “free.”

But if the decision on the demand side to use medical care is an individual one where a good deal of care is offered “free” (or at nominal charges) after joining the program, then individuals would attempt to obtain more or better quality medical care than they indicated they were willing to pay for through the group or government decision. This behavior is perfectly consistent. Even under a government program, the amount or quality of medical care people actually seek is a private decision or choice. They weigh the added benefits from more service against the added cost. But since the added cost is essentially zero or minimal to them once they have joined the program, people seek more or better quality medical care than they would if each had to pay for it out of his own pocket.

A simple analogy would be a luncheon in which a group of people agree to split the bill. Each person has an incentive to order a more expensive lunch than the next fellow, since everyone in the group will bear part of the added cost. As a result, the total bill is likely to be larger than if each had agreed to pay for his own lunch separately.

It could be argued that a lower price or cost of “needed” care will not induce an individual to purchase more of it. It is certainly true that for some types of medical care, price will have little effect on the amount people seek. It is doubtful that a lower price would have much influence on the number of broken limbs repaired or slashed arteries stitched. But it may have a considerable impact on whether the more expensive hospitals or doctors are selected. Thus, for medical care as a whole, price or cost does have an impact on the amount and quality sought. People want (“need”) more or better medical care when the price to them is lower.

The outcome of splitting the supply and demand decision is that the actual government expenditures run far in excess of the planning amounts. Congress tries to limit the overruns since they imply even higher taxes. The outcome of such controls is a breakdown in the quality of service. Doctors refuse to treat patients covered under Medicare and Medicaid programs or give less time to them. A similar result occurs if hospital charges are also directly controlled.

FUNDAMENTAL REFORM: INDIVIDUAL RESPONSIBILITY

The private enterprise system is able to allocate medical goods and services as well as it allocates all other goods and services the economy supplies to meet consumer demands. Without government interference, individuals would be responsible for paying for their medical care or medical insurance as they were prior to the advent of Medicare in 1965. Tax preference also leads to “over consumption” of medical services. Employees receive medical benefits without paying taxes on them and this tax preference causes more medical benefits to be consumed than otherwise. Thus, fundamental reform starts with making individuals more financially responsible for their consumption of medical services.

Personal responsibility and reliance on market forces form the basis of Milton Friedman's recommendation to reprivatize medical care:

The reform has two major steps: (1) End both Medicare and Medicaid and replace them with a requirement that every U.S. family unit have a major medical insurance policy with a high deductible, say \$20,000 a year of 30 percent of the unit's income during the prior two years, whichever is lower. (2) End the tax exemption of employer-medical care; it should be regarded as a fully taxable fringe benefit to the employee—deductible for the employer but taxable to the employee. Each of these reforms needs further discussion.

Preferably, the major medical insurance policy should be paid for by the individual family unit, which should receive a reduction in taxes reflecting the reduction in cost to the government. There would be an exception for lower-income families and for families who were unable to qualify for coverage at an affordable fee. The government would help them finance the policy though not administer it. That would be done by private competitive insurers, chosen by each individual or family separately. Each individual or family would, of course, be free to buy supplementary insurance if it so desired.⁶

If reform of this magnitude is deemed political suicide by the Administration and Congress, then at least the principle of increasing an individual's financial responsibility for his medical care decision should be a guide post in their reforms. Consideration should be given to using vouchers for Medicare and Medicaid that would be used to purchase HMO services. By setting the voucher at the rate charged by the most efficient HMO's in a geographic area, Congress would encourage competition which would weed-out inefficient suppliers of medical services. Congress would be relying on the market to contain the rapid growth in per capita consumption of services by Medicare recipients.

If this proposal is deemed too bold by our current political leadership, then at a minimum, Medicare recipients should have higher deductible or co-payments than they do currently. This would push the problem back a few years, but that is probably all it would do. Permitting anyone to pair a high deductible insurance policy with a Medical Savings Account would go much further. The alternative is to do nothing and wait for the inevitable budget crises to occur down the road. While this outcome may be the most probable, it certainly will be the most costly.

To be successful, health care reformers must recognize the problem in the U.S. health care industry and address its causes. The problem is that prices of medical goods

and services are so high and have been rising so fast relative to incomes that many people are concerned they will be unable to purchase those that they might want. The high level and steep trajectory of prices reflect increases in demand fueled by the separation of the decision to obtain medical goods and services from payment for those goods and services.

Payment is divorced from procurement in two ways. First, the tax code encourages insurance policies that provide what amounts to first-dollar coverage. Individuals pay pre-tax dollars at the beginning of each year for an uncertain amount of unspecified medical goods and services, the unit cost of which can be lowered by consuming as many medical goods and services as possible during the year, regardless of prices. Second, government programs, such as Medicare, dilute the restraining effect of price on demand by providing enrollees with as many goods and services as they can consume according to a set of rules, again, without regard to prices. The lack of control, under existing law, over a significant and growing share of the federal budget and the misallocation of the nation's resources are unfortunate byproducts.

Fundamentally flawed attempts to subsidize health care have short-circuited the market mechanism, bloated our appetites for medical goods and services, and distorted resource allocation. Any reforms that fail to address the causes and consequences directly by increasing the exposure of the health care industry to market forces will not succeed and will likely make the situation worse.

NOTES

¹Phil Gramm, “How to Avoid Medicare’s Implosion,” *The Wall Street Journal* February 4, 1997, p. A18.

²John C. Goodman and Gerald L. Musgrave, *Patient Power* (Washington, D.C.: Cato Institute, 1992), p. 77.

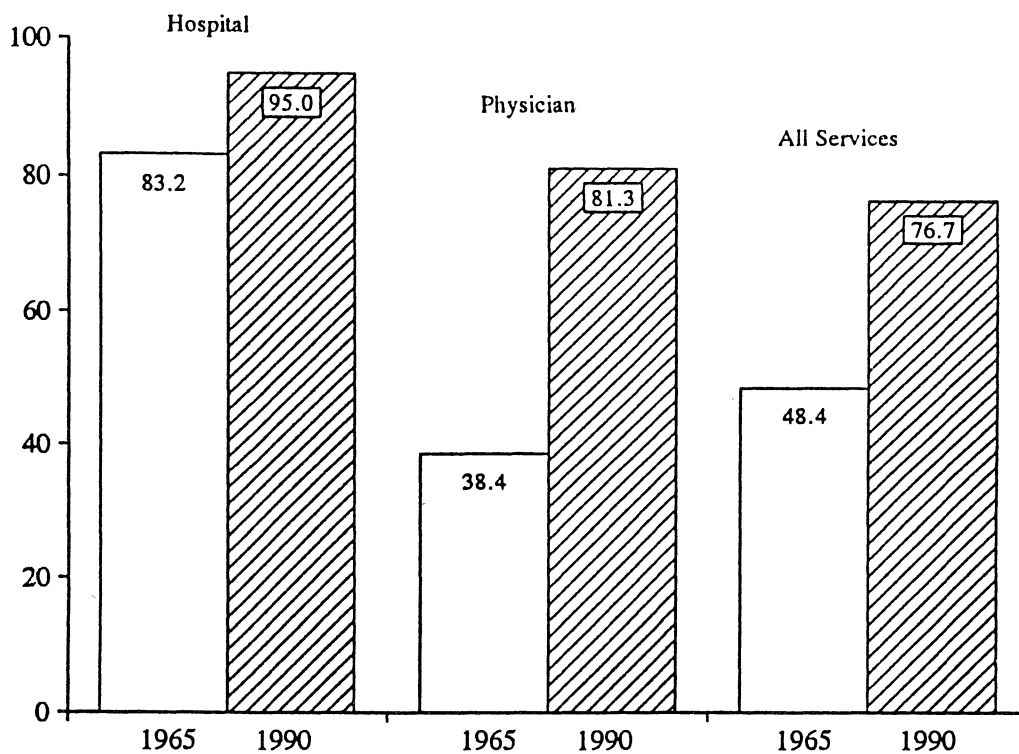
³The Economic and Budget Outlook: Fiscal Years 1998-2007, Congressional Budget Office, January 1997, p. 117.

⁴*Economic Report of the President* (Washington, D.C.: United States Government Printing Office, 1997), p. 98.

⁵CBO, *op. cit.*, p. 119.

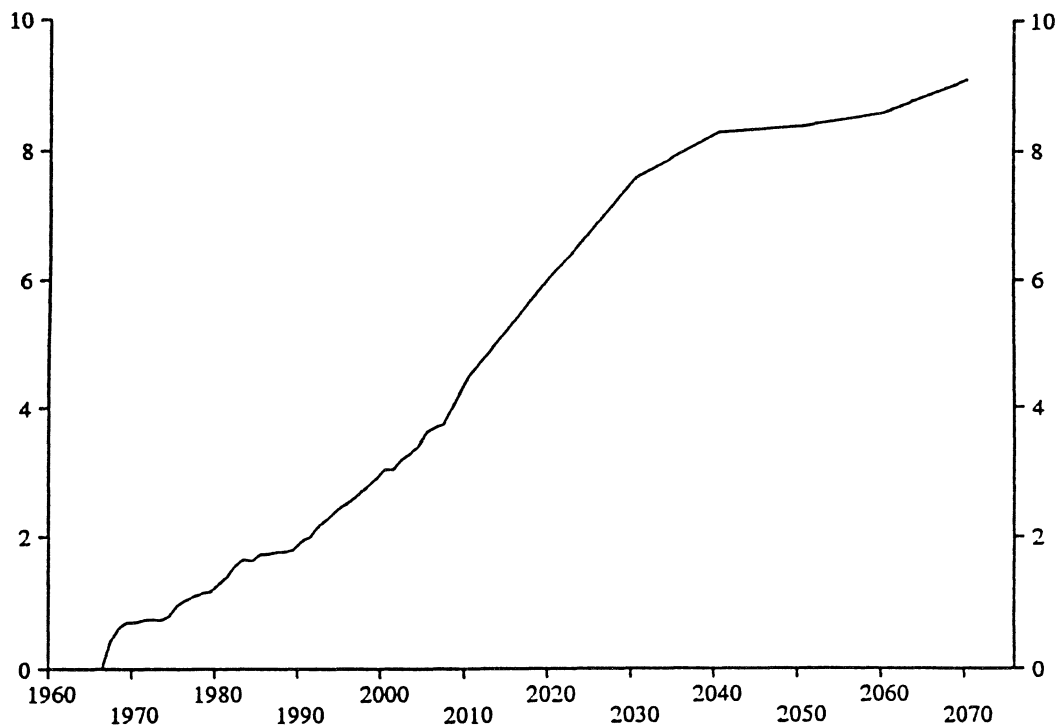
⁶Milton Friedman, “Gammon’s Law Points to Health-Care Solution,” *The Wall Street Journal* November 12, 1991.

Figure 1
 Personal Health Expenses Paid By Third Parties
 Percent of Total



Source: Goodman and Musgrave, Patient Power, p. 77, from the Health Care Financing Administration, Office of the Actuary.

Figure 2
 Medicare Spending
 Percent of GDP



Source: CBO Economic and Budget Outlook: Fiscal Years 1998-2007 and Economic Report of the President 1997.

MAINTAINING HEALTHY ECONOMIC PERFORMANCE

Mickey D. LEVY
NationsBanc Capital Markets, Inc.

Inflation remains low, the economy continues to expand, and its structure is sound, largely absent potentially disruptive imbalances that would sidetrack the expansion. These favorable outcomes, including healthy employment growth and higher real wages, rising investment and profits, and robust financial market performance and a strong U.S. dollar, are no accident. They stem from the favorable environment established by the Federal Reserve's credible low-inflation monetary policy that has squeezed nominal spending and smoothed fluctuations in aggregate demand. These trends have constrained inflation while facilitating efficient adjustments in the good, labor and capital markets.

Can this healthy economic performance be sustained? Yes, but the Fed's continued credible pursuit of its long-run objective of price stability is a necessary ingredient. This requires a monetary policy that slows growth of dollar spending toward the nation's long-run capacity to grow. This objective should take precedence; the Fed must not concern itself with the rising U.S. dollar or high stock valuations, as they result from sound economic performance and policies, and it must distinguish between using real wages, reflecting productivity gains, and rising inflation that is generated by excess demand.

SQUEEZING INFLATION

The substantial decline in inflation since the early 1980s and its stabilization at or below 3 percent 1992 (core CPI currently is at its lowest year-over-year level since June 1966) is a direct function of a Federal Reserve policy that has ratcheted down growth of money supply and nominal spending. The low inflation has nothing to do with the alleged decline in the NAIRU (nonaccelerating inflation rate of unemployment), as argued in detail in the *Economic Report of the President, 1997* and elsewhere. Inflation is generated by excess demand, not by low unemployment and healthy real economic

growth. Inflation approaches the extent to which nominal spending growth exceeds the nation's long-run capacity to grow. In the past, low unemployment rates and rising inflation were associated because excess demand created the umbrella under which prices in the labor and goods markets accelerated. It is incorrect to say that the higher wages caused higher inflation; excess demand was the source of both. The prime example was 1978-1980, when nominal GDP growth averaged 11.5 percent annualized, while misguided fiscal and regulatory policies suppressed aggregate supply; the excess demand generated a double-digit wage-inflation spiral.

The disinflationary process has been spearheaded by the squeeze on excess demand, as the Fed's monetary policy has slowed nominal spending growth toward capacity growth; each succeeding peak in nominal GDP growth has been lower. The slowdown in current dollar spending has inhibited the ability of businesses to raise prices without losing market share and has encouraged businesses to constrain unit labor costs in order to maintain profit margins. Compensation increases have slowed, reflecting flattening trends in both wage and nonwage compensation.

From 1995 Q4 to 1996 Q4, nominal GDP grew 5.0 percent, modestly faster than its 3.9 percent growth in 1995, but a significantly larger portion of the spending growth was real, while inflation declined. Real GDP grew 3.2 percent while the implicit GDP deflator rose 1.8; in 1995, real GDP rose 1.3 percent and the deflator 2.5 percent. Over the last 12 quarters, nominal GDP growth has averaged just below 5 percent annualized. The Fed's central tendency forecast for nominal GDP growth from 1996 Q4 to Q4 1997 is 4.5-4.75 percent, implying a modest slowdown. With healthy real growth, this would preclude any acceleration of inflation.

Increases in productivity seemingly have contributed to the low inflation by lowered unit labor costs and increasing potential output, but the magnitude of the contribution is muddied by measurement problems. Strong productivity gains have outpaced wage increases in the manufacturing sector, generating declines in unit labor costs, but a seeming understatement of productivity gains in the service producing sectors have led to an associated overstatement of unit labor costs in total nonfarm businesses.

The inflation pipeline in production remains more empty than full: excluding the volatile food and energy components, the core PPI for finished goods has risen 0.6 percent year-over-year, while the core PPI indices for intermediate and crude goods have declined 0.5 percent and 3.7 percent, respectively. That production costs remain relatively unchanged despite the increases in wages reflects largely productivity gains. The personal consumption deflator has risen 2.5 percent in the last year, modestly faster than the GDP deflator because it does not reflect the declining costs of business investment in information processing equipment. The CPI exhibits the most inflation: 3.0 percent year-over-year and 2.5 percent excluding food and energy. The 10 percent decline in oil prices from their recent peak has not yet been reflected in the CPI and is expected to suppress its rise in coming months. The strengthening U.S. dollar continues to restrain the cost of imports relative to domestic goods and services; in the last year, prices of nonpetroleum imports have declined 1.9 percent, and this trend is projected to continue.

As long as monetary policy constrains growth in nominal spending and limits excess demand, there is no inconsistency between low unemployment and low inflation. Rising wages associated with productivity gains—measured or unmeasured—simply reflect increased returns to labor and do not lift unit labor costs. Increasing unit labor costs that result from wage increases above productivity gains squeeze margins and raise the labor share of national income, but do not push up inflation unless excess demand provides the flexibility to raise prices.

Mounting evidence of low inflation amid sustained healthy real economic growth and low unemployment reveal the weaknesses of NAIRU-based predictions of inflation: by failing to consider aggregate demand, they do not accurately capture the inflation process. After-the-fact, *ad hoc* analyses that re-estimate the NAIRU to “fit” recent inflation experience, witness the *Economic Report of the President*, are unreliable for forecasting and provide a misguided framework for conducting monetary policy. While the Fed continues to publicly express its concerns that tight labor markets will renew wage and inflation pressures, its official forecasts implicitly recognize the weaknesses of NAIRU: it forecasts no change in the unemployment rate through 1997 Q4 (its central

tendency forecast is 5.25-5.5 percent) and a modest decline in inflation (its central tendency forecast for the CPI is 2.75-3.0 percent).

IMPROVED ECONOMIC EFFICIENCY

Economic performance has been enhanced by the reduced volatility of aggregate demand as well as the low inflation. This is in sharp contrast to the poor and erratic economic and financial market behavior of the 1970s-early 1980s that resulted from the Fed's procyclical, stop-go-stop monetary policies that generated wide swings in nominal spending. That uncertain environment hampered economic decision making by households and businesses, as the economy careened from temporary spurts of robust growth to recession. Periods of rapid growth of nominal spending generated accelerating inflation; subsequent efforts to suppress inflation expectations were costly, largely due to the Fed's unsure and erratic behavior, and its consequent lack of inflation-fighting credibility.

The recent muted fluctuations in nominal spending and lower inflationary expectations have established a favorable environment for sustained economic growth and productivity advancements. Heightened flexibility of productive processes and labor markets have enhanced adjustments to minor fluctuations in demand and helped avoid potentially disruptive imbalances.

With the squeezing of excess demand, a rising portion of nominal GDP growth has been real output, while inflation has receded. Real GDP has grown 2.6 percent annualized since the expansion began in 1991 Q2 and 3.2 percent in the last year. Growth of businesses fixed investment has significantly outpaced GDP and has risen as a share of national output, contributing to expanded capacity. Growth of corporate profits and cash flows have also outpaced GDP, underlying the rising expected rates of return on investment and providing internal financing for business investment and expansion. Employment has increased 1.9 percent annually (2.3 percent in the last year), lowering the unemployment rate to its pre-recession level, and real wages have rebounded.

A continuation of these favorable trends is expected in 1997, with sustained low inflation and healthy economic growth. The rate of growth is decelerating toward a

sustainable pace following the robust 3.9 percent annualized pace in 1996 Q4. Annualized growth in 1997 Q1 is pointing toward approximately 2.25-2.5 percent. Retail sales and housing activity began 1997 Q1 moderately, while businesses investment should remain healthy but below the near double-digit growth pace of 1994-1995. This would generate approximately 2.75 percent growth in domestic final sales. The net export deficit, which declined sharply in 1996 Q4, adding 2 percent of GDP growth, is expected to widen modestly in 1997Q1 and subtract from GDP. Under current conditions, real GDP growth is projected to fluctuate narrowly around a healthy trendline.

MONETARY THRUST AND ECONOMIC GROWTH

A potential concern for 1997-1998 is the acceleration of both money supply and nominal GDP growth which, if sustained, would generate rising inflation and adversely affect economic performance, financial markets, and the Fed's monetary policy. Since last October, growth in both the narrow and broad monetary aggregates have accelerated: in the last six months, sweep-adjusted bank reserves and the monetary base have grown 7.9 percent and 8.9 percent annualized, bringing in their year-over-year growth rates to 8.8 percent and 6.8 percent. Sweep-adjusted M1 growth has been 5 percent in the last six months and 5.8 percent in the last year. M2 has grown 5.4 percent in the last 6 months and 4.9 percent in the last year. Meanwhile, the spurt in economic growth in 1996 Q4 pushed year-over-year growth of nominal GDP to 5.2 percent.

At issue is whether the rise in money growth is temporary, reflecting a rise in money demand, or a more sustained pickup in money supply that would generate an inflationary pickup in nominal spending growth. There is insufficient evidence to confirm a trend, although our assessment is that the acceleration has been a temporary rise in money demand in response to stronger economic growth, large increases in wealth, and in lagged response to the lower interest rates in Fall 1996, which lowered the opportunity costs of holding money. A sustained acceleration of money supply seems unlikely given the stable federal funds rate, narrowly fluctuating GDP growth and moderating credit demands. If temporary, the pickup in money growth would mirror the pattern in 1996: following the acceleration of money growth and economic activity in the

first half of 1996, interest rates rose, economic growth moderated, and money growth flattened. In recent weeks, growth in the narrow aggregates and M2 has already begun to taper off. The pickup in currency growth has contributed to the recent acceleration in money; however, in recent years, fluctuations in foreign demand have made it a problematic indicator of monetary thrust.

This assessment suggests that monetary policy is consistent with nominal GDP growth of approximately 4.25-4.75 percent; this would be associated with 2.25-2.75 percent real growth and a 2 percent rise in the GDP deflator. With sustained moderated nominal spending growth, there would be little support for rising inflation.

IS ZERO INFLATION A WORTHWHILE TARGET?

The economic benefits of reducing inflation to low levels is unambiguously positive; that is widely agreed. Presumably economic performance would improve by achieving price stability. The *Economic Report of the President 1997* disagrees. It argues that the costs would exceed the benefits, for two reasons: first, the reduced economic output in the transition to zero inflation would outweigh the future benefits, and second, the economy functions less efficiently, and with undesired distributional consequences, operating with zero inflation than with low inflation. Its arguments are wrong on all counts.

The assumed transition costs presume a necessary tradeoff between output and inflation; this Phillips curve tradeoff was used in the past to argue against reducing inflation from higher levels. Whether reducing inflation involves a short-term reduction in output depends on the ability of economic agents in the goods, labor, and capital markets to anticipate shifts in monetary policy and adjust to changes in aggregate demand. The Fed's heightened inflation-fighting credibility and the associated increased speed of adjustment have reduced the short-run transition costs of achieving lower inflation. In fact, since 1991, the reduction in inflation has occurred without short-term transition costs: real GDP has grown 2.6 percent annualized, employment has risen and the unemployment rate has declined, and real wages and incomes have increased. With a credible monetary authority, there is no necessary short-run tradeoff between output and

inflation. The Fed has clearly announced its long-run objective of price stability, and market responses are efficient. Phillips curve-based assessments overestimate the transition costs of achieving price stability.

The argument that zero inflation would reduce economic performance—based on the assertion that unemployment would increase due to wage stickiness, that the central bank's efforts to stabilize aggregate demand would be inhibited by its inability to impose negative real interest rates, and that zero inflation increases the potential for deflation—are unfounded. In this period of moderate demand growth and healthy economic expansion, there is mounting evidence of declining compensation (wages plus benefits) within same job categories, suggesting more flexibility of labor markets than is assumed in standard Keynesian models.

Nor would inflation constrain the ability of monetary policy to manage aggregate demand. At zero inflation and expectations of price stability, the argument is that the Fed's demand management would be inhibited by its inability to impose negative real interest rates. This is a false concern: even in the severe hypothetical situation of insufficient aggregate demand and zero short-term interest rates, the central bank could still engage in open-market operations, increasing bank reserves and money supply, and generating an acceleration in demand. (The recent experience in Japan is not an example of the constraints of zero inflation on monetary policy, as some allege; instead it illustrates how misguided monetary policy results from targeting short-term interest rates rather than money supply and misreading economic and price conditions: in response to declining nominal and real GDP, the Bank of Japan allowed money supply to decline while interest rates minus actual and expected deflation were very high.) Insofar as the Fed's ability to manage aggregate demand at price stability would not be impaired, the potential for deflation is not a threat.

The argument that zero inflation would generate undesired distributional consequences is highly suspect; here, the analysis in the *Economic Report of the President* is simply wrong. Insofar as zero inflation is consistent with sustained economic expansion and job creation, marginally skilled and low income individuals would benefit from the reduction in unemployment, a major source of low income and

income disparities. The assertion that wealthy individuals benefit disproportionately from zero inflation, as it raises the real return to cash, is at best erroneous. Few low-income individuals are in the position to benefit from inflation, for example, through home-ownership. Also, low-income individuals hold the greatest share of their wealth in the form of currency; hence, they typically suffer disproportionately more from inflation.

FINANCIAL MARKETS

Current conditions of low and stable inflation and healthy, seemingly sustainable economic growth have generated healthy financial market outcomes: 1) low bond yields and a relatively flat yield curve, reflecting low inflationary expectations; 2) narrow corporate bond spreads over Treasury bond yields, reflecting high perceived creditworthiness; 3) a strong stock market, reflecting sustained growth of corporate profits and cash flows, the high quality of profits due to the low inflation, and low interest rates that raise the present value of the expected stream of earnings; and 4) a strong U.S. dollar, reflecting the high expected rates of return on dollar-denominated assets relative to assets denominated in other currencies whose nations suffer from poor economic performance and/or misguided economic policies.

While the economic fundamentals underlying the robust stock market gains are obvious, it remains uncertain whether future profits will rise sufficiently to meet expectations and support valuations. However, what is clear is that the rising market in no way reflects an asset price bubble generated by expansionary monetary policy; in fact, the strong stock market seems more a reflection of the Fed's successful disinflationary policies and the healthy economic environment that has resulted. In this regard, while the Fed's concern that a stock market selloff would damage economic performance is understandable, its policy objective must remain low inflation, not stock price management.

In the near term, bond yields are expected to remain in their recent range of 6.25-7 percent, and are expected to gradually recede toward a 6.25 percent as the market adjusts its expectations of inflation downward. Meaningful fiscal reform and long-term deficit reduction would push bond yields closer to 6 percent.

The current posture of monetary policy does not require a change in the federal funds rate in order to maintain inflation at its recent level. However, achieving zero inflation would require a modest rise in the funds rate in order to slow growth of money and nominal spending toward long-run potential growth, and eliminate excess demand. Such a process would involve a temporary rise in short-term interest rates, and a flatter yield curve, as the market adjusted down its inflationary expectations as the Fed tightened.

NationsBanc Capital Markets, Inc.
7 Hanover Square, 15th Floor
New York, New York 10004-2616
Tel 212 858-5500
Fax 212 858-5741

NationsBank

Economic & Financial Perspectives

MICKEY D. LEVY
CHIEF ECONOMIST
NATIONS BANC CAPITAL MARKETS, INC.

SHADOW OPEN MARKET COMMITTEE
MARCH 2-3, 1997

S N A P S H O T

QUARTERLY DATA	Levels				Quarterly % Change (annualized)				Yr-to-Yr % Change			
	1995		1996		1995		1996		1995		1996	
	Q1-96	Q2-96	Q3-96	Q4-96	Q1-96	Q2-96	Q3-96	Q4-96	Q1-96	Q2-96	Q3-96	Q4-96
Nominal GDP	7426.8	7545.1	7616.3	7715.4	4.2	6.5	3.8	5.3	3.9	4.7	4.2	5.0
GDP	6814.3	6892.6	6928.4	6994.4	2.0	4.7	2.1	3.9	1.7	2.7	2.2	3.2
Domestic Demand	6914.6	7003.0	7060.7	7090.3	3.0	5.2	3.3	1.7	1.4	2.5	2.7	3.3
Final Sales	6815.2	6884.7	6892.7	6977.4	3.1	4.1	0.5	5.0	2.5	3.0	2.2	3.2
Domestic Final Sales	6915.5	6995.2	7024.9	7073.3	4.1	4.7	1.7	2.8	2.2	2.9	2.7	3.3
Disposable Personal Income	5037.6	5054.5	5114.6	5145.9	2.0	1.3	4.8	2.5	2.7	3.0	3.1	2.7
Consumption	4649.1	4687.6	4693.5	4733.3	3.5	3.4	0.5	3.4	2.5	2.6	2.1	2.7
Residential Investment	271.1	281.5	277.8	277.6	7.4	16.3	-5.2	-0.3	2.0	9.7	5.9	4.2
Business Investment	743.5	750.5	781.4	791.8	11.6	3.8	17.5	5.4	5.6	5.6	8.7	9.5
Inventory Investment	-3.0	7.1	34.5	16.4	NA	NA	NA	NA	NA	NA	NA	NA
Government Purchases	1254.7	1278.2	1276.1	1274.8	1.6	7.7	-0.7	-0.4	-0.6	1.0	1.0	2.0
Exports	806.7	817.9	816.1	862.5	1.8	5.7	-0.9	24.8	7.2	7.2	4.2	7.4
Imports	910.7	932.6	953.5	962.5	10.6	10.0	9.3	3.8	4.1	5.4	7.8	8.4
Current Account	(c) -34.9	-40.2	-48.0	NA	-4.4	-5.3	-7.8	NA	4.2	0.8	-10.3	NA
GDP Deflator	109.0	109.6	110.2	110.7	2.2	2.2	2.2	1.8	2.2	2.1	2.1	2.1
Employment Costs (Private)	127.8	128.8	129.6	130.6	2.9	3.2	2.5	3.1	2.7	2.8	2.8	2.9
Unit Labor Costs (Non-Farm)	108.5	109.4	110.3	110.7	1.5	3.4	3.3	1.5	2.7	2.9	3.3	2.4
Productivity (Non-Farm)	101.5	101.7	101.7	102.2	1.6	0.8	0.0	2.0	1.0	0.8	0.4	1.1
Compensation (Non-Farm)	110.2	111.3	112.2	113.2	3.3	4.1	3.3	3.6	3.8	3.8	3.7	3.6
Corporate Profits A/T	(a) 408.8	408.1	402.2	NA	6.0	-0.2	-1.4	NA	8.4	8.7	5.1	NA
Operating Profits A/T	(a) 645.1	655.8	661.2	NA	5.4	1.7	0.8	NA	15.2	16.6	8.0	NA
Net Cash Flow	(a) 654.8	658.4	657.7	NA	3.8	0.5	-0.1	NA	6.1	6.7	5.1	NA
MONTHLY DATA	Levels				Monthly % Change				12 Month % Change			
	Oct-96	Nov-96	Dec-96	Jan-97	Oct-96	Nov-96	Dec-96	Jan-97	Oct-96	Nov-96	Dec-96	Jan-97
	Oct-96	Nov-96	Dec-96	Jan-97	Oct-96	Nov-96	Dec-96	Jan-97	Oct-96	Nov-96	Dec-96	Jan-97
Purchasing Managers Index	50.4	52.4	53.8	52.0	-1.6	4.0	2.7	-3.3	7.7	14.4	17.5	16.3
Non-Farm Payrolls	(b) 120.311	120.492	120.753	121.024	261	181	261	271	2.18	2.20	2.22	2.50
Manufacturing Payrolls	(b) 18.254	18.262	18.276	18.294	13	8	14	18	-0.67	-0.50	-0.50	-0.08
Unemployment Rate	(c) 5.2	5.3	5.3	5.4	0.0	0.1	0.0	0.1	-0.3	-0.3	-0.3	-0.3
Average Workweek (sa)	34.3	34.6	34.8	34.1	-1.2	0.9	0.6	-2.0	-0.6	0.6	1.5	0.9
Avg. Hourly Earnings (sa)	11.90	11.99	12.05	12.06	-0.1	0.8	0.5	0.1	3.0	3.5	3.8	3.8
Total Vehicle Sales, incl. Lt. Trucks	14.9	14.7	14.9	15.5	-2.0	-1.9	1.5	4.0	2.5	-1.1	-4.2	6.3
Domestic Unit Auto Sales	6.7	6.6	6.9	7.5	-10.0	-1.7	4.4	8.2	-6.3	-7.8	-8.1	7.4
Industrial Production	116.2	117.1	117.7	117.7	0.2	0.8	0.5	0.0	3.3	3.9	4.3	4.7
Capacity Utilization	83.0	83.4	83.5	83.3	-0.1	0.5	0.1	-0.2	-0.4	0.2	0.6	1.1
PPI	132.3	132.6	133.4	133.0	0.2	0.2	0.6	-0.3	3.0	3.0	2.8	2.5
PPI Ex. Food & Energy	142.1	142.2	142.4	142.4	-0.2	0.1	0.1	0.0	0.8	0.6	0.6	0.6
CPI	158.3	158.8	159.2	159.4	0.3	0.3	0.3	0.1	3.0	3.3	3.3	3.0
CPI Ex. Food & Energy	167.0	167.4	167.7	167.9	0.2	0.2	0.2	0.1	2.5	2.6	2.6	2.5
Retail Sales	207.5	207.3	207.9	209.1	0.7	-0.1	0.3	0.6	5.7	4.6	4.2	4.9
Housing Starts	1407	1486	1323	1350	-4.3	5.6	-11.0	2.0	1.8	2.4	-5.8	-6.5
Permits	1362	1418	1422	1400	-2.6	4.1	0.3	-1.5	-2.2	-2.2	-4.4	1.6
Federal Budget Surplus/Deficit	(d) -40.3	-37.9	18.8	13.4	-17.7	0.6	13.5	-6.1	-124.7	-124.1	-110.6	-116.7
Durable Goods Orders	174.9	171.9	168.8	174.8	0.6	-1.7	-1.8	3.6	7.4	5.8	0.7	4.5
Manufacturing Orders	321.9	320.2	316.1	NA	1.1	-0.5	-1.3	NA	6.8	6.0	3.3	NA
Personal Income (\$)	6543.7	6583.6	6638.9	NA	0.1	0.6	0.8	NA	5.4	5.7	5.9	NA
Personal Outlays (\$)	5386.1	5408.7	5433.6	NA	0.9	0.4	0.5	NA	5.5	5.2	4.7	NA
Personal Saving Rate	(c) 4.9	5.1	5.4	NA	-0.7	0.2	0.3	NA	-0.6	-0.1	0.5	NA
Leading Economic Indicators	102.5	102.7	102.8	NA	0.0	0.2	0.1	NA	1.6	1.8	1.6	NA
Total Business Inventories	1011.3	1010.9	1009.5	NA	0.5	-0.0	-0.1	NA	2.0	1.8	1.9	NA
Inventory/Total Sales	(c) 1.39	1.39	1.39	NA	0.00	0.00	0.00	NA	-0.06	-0.05	-0.03	NA
International Trade	(c) -8.0	-7.9	-10.3	NA	3.4	0.1	-2.3	NA	-1.1	-1.8	-3.9	NA
3 Month Bill	(c) 4.99	5.03	4.91	5.03	-0.10	0.04	-0.12	0.12	-0.29	-0.33	-0.23	0.03
2 Year Note	(c) 5.91	5.70	5.78	6.01	-0.32	-0.21	0.08	0.23	0.21	0.22	0.46	0.90
10 Year Note	(c) 6.53	6.20	6.30	6.58	-0.30	-0.33	0.10	0.28	0.49	0.27	0.59	0.93
30 Year Bond	(c) 6.81	6.48	6.55	6.83	-0.22	-0.33	0.07	0.28	0.44	0.22	0.49	0.78
DJIA	5996.2	6318.4	6435.9	6707.0	3.3	5.4	1.9	4.2	26.0	28.0	25.3	29.5
S&P 500	701.46	735.67	743.25	766.22	3.9	4.9	1.0	3.1	20.3	23.5	20.9	24.8
U.S. Dollar (FRB)	88.0	87.0	88.7	91.0	0.6	-1.1	2.0	2.6	4.6	3.4	4.3	5.5
Yen/\$	112	112	114	118	2.3	-0.1	1.5	3.4	11.5	10.2	11.9	11.5
DM/\$	1.53	1.51	1.55	1.60	1.3	-1.0	2.7	3.4	8.0	6.7	7.8	9.6
M1	1080.1	1079.9	1080.9	1079.6	-1.2	-0.0	0.1	-0.1	-4.9	-4.7	-4.3	-3.8
M2	3787.8	3809.3	3833.0	3849.7	0.3	0.6	0.6	0.4	4.4	4.7	4.9	4.9
Bank reserves	50135	49875	50167	49403	-2.4	-0.5	0.6	-1.5	-11.8	-11.5	-11.0	-11.2
C&I Loans & Non-Financial CP	953.4	960.1	970.9	NA	-0.2	0.7	1.1	NA	6.7	6.0	6.6	NA
Consumer Credit	1185.4	1190.5	1195.4	NA	0.6	0.4	0.4	NA	9.5	8.8	8.3	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

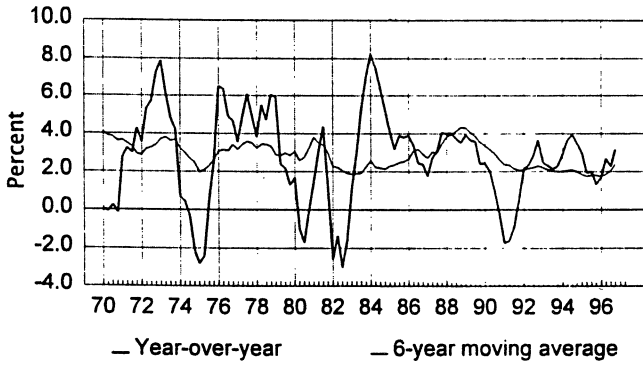
Note: All GDP data reflect chain-weighted measures.

02/28/97

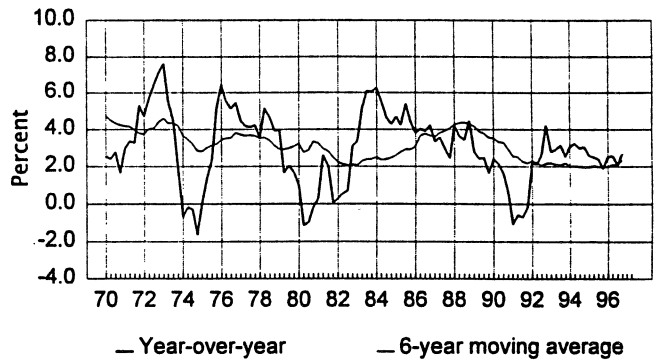
Chart 1

Trends and Cyclical Fluctuations in Economic Performance

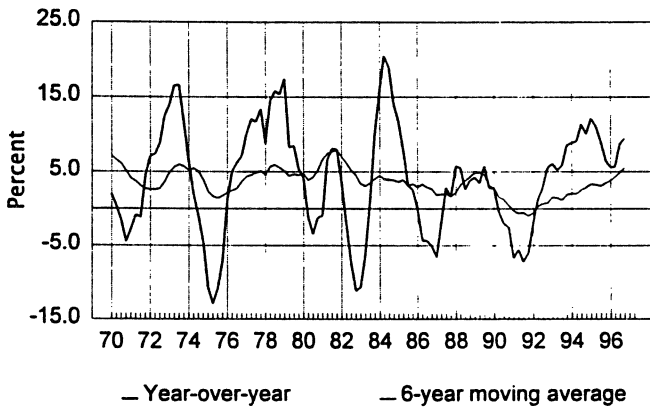
Real GDP



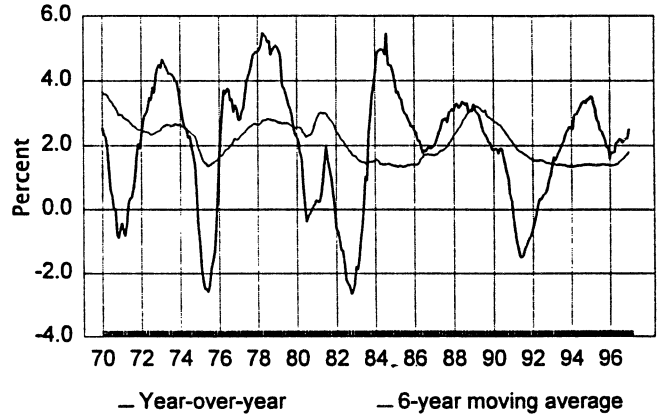
Real Consumption



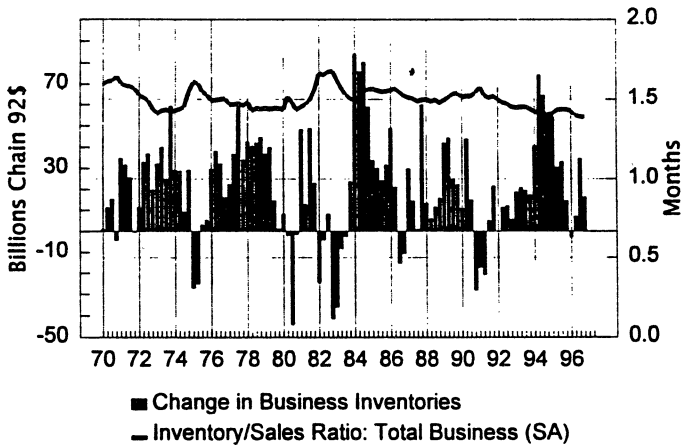
Real Business Fixed Investment



Employment



Inventory Building



Inflation

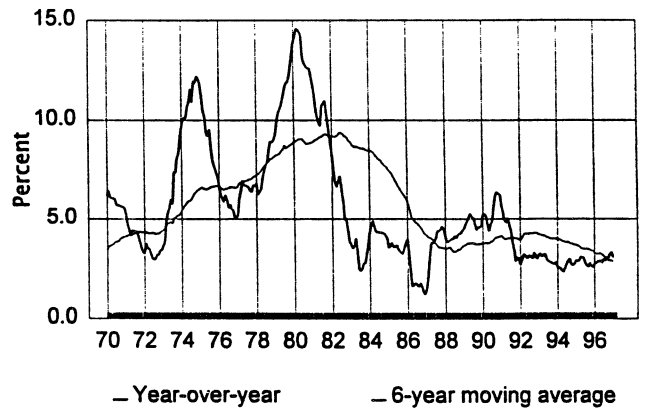
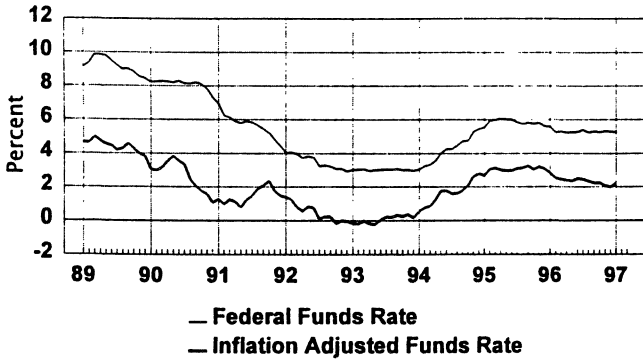


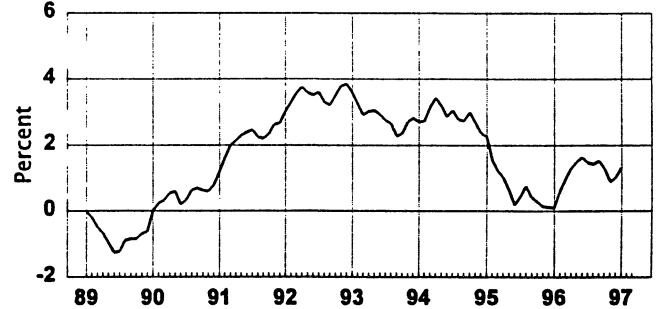
Chart 2

Measures of Monetary Thrust

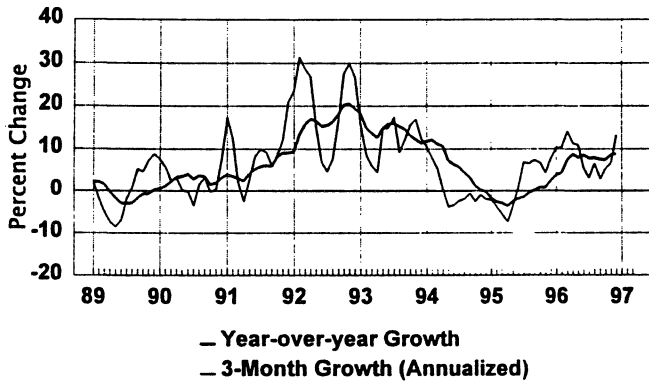
Nominal and Real Federal Funds Rate



10-Year Treasury Bond/Federal Funds Spread

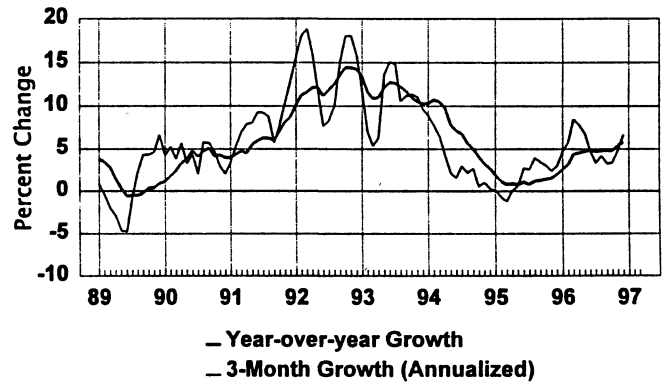


Bank Reserves Adjusted for Sweep Accounts *



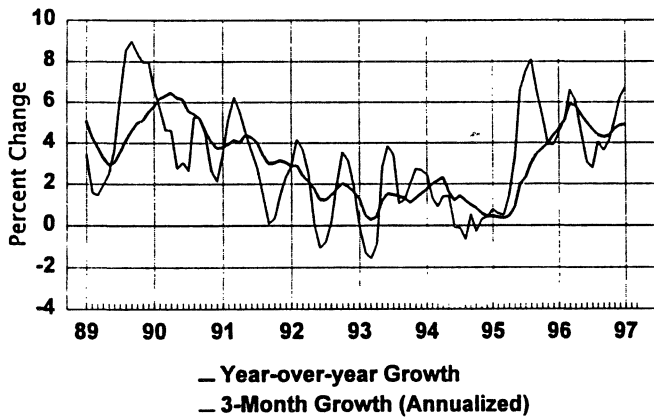
* Based on FRB estimates.

M1 Adjusted for Sweep Accounts *



Based on FRB estimates.

M2



MZM

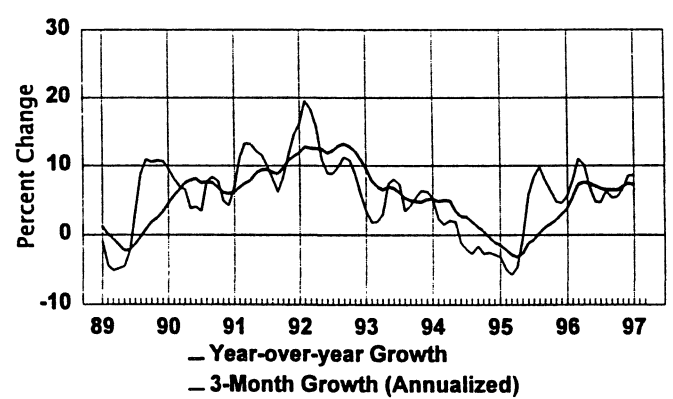


Table 1

Federal Reserve Estimates of the Impact of Sweep Accounts

Cumulative Sweeps of Transaction Deposits into Money Market Funds

	CumulativeTotal (Billions \$)
Jan 94	5.3
Feb 94	7.5
Mar 94	7.5
Apr 94	7.5
May 94	7.5
Jun 94	7.5
Jul 94	7.5
Aug 94	7.5
Sep 94	9.0
Oct 94	9.6
Nov 94	9.9
Dec 94	9.9
Jan 95	9.9
Feb 95	9.9
Mar 95	9.9
Apr 95	9.9
May 95	14.9
Jun 95	22.2
Jul 95	22.8
Aug 95	27.4
Sep 95	33.3
Oct 95	41.0
Nov 95	45.3
Dec 95	54.5
Jan 96	68.2
Feb 96	75.2
Mar 96	81.6
Apr 96	89.4
May 96	97.7
Jun 96	106.2
Jul 96	114.1
Aug 96	127.5
Sep 96	138.3
Oct 96	153.1
Nov 96	162.1
Dec 96	170.7

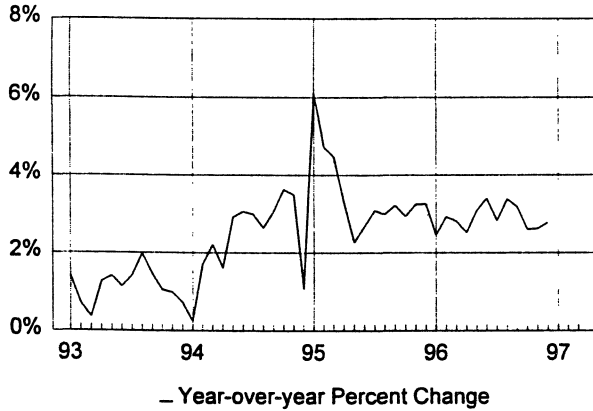
*Figures are the estimated national total of transaction account balances initially swept into MMDAs owing to the introduction of new sweep programs, on the basis of monthly averages of daily data.

Produced by: Division of Monetary Affairs of the Board of Governors of the Federal Reserve System

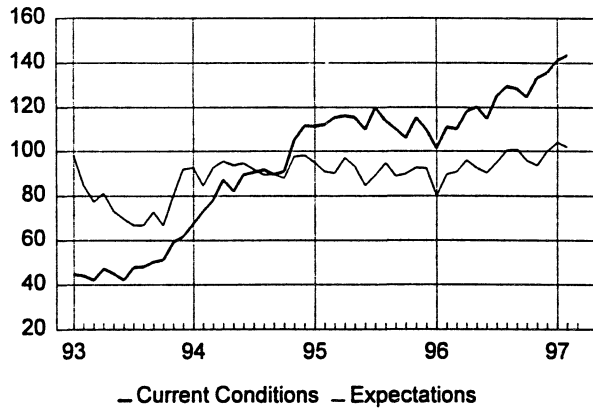
Chart 3

Selected Indicators of Income and Consumption

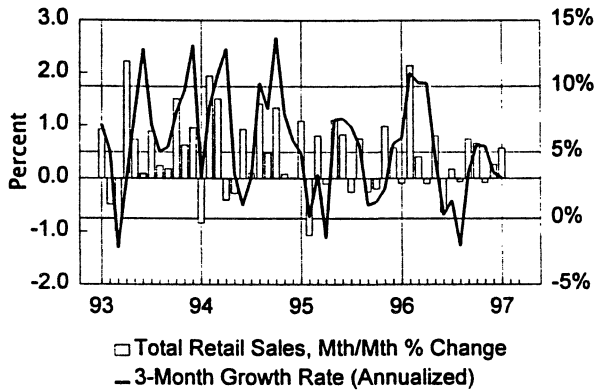
Real Disposable Personal Income



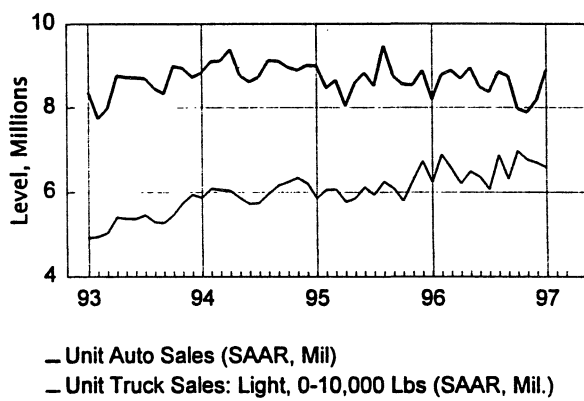
Conference Board Consumer Confidence



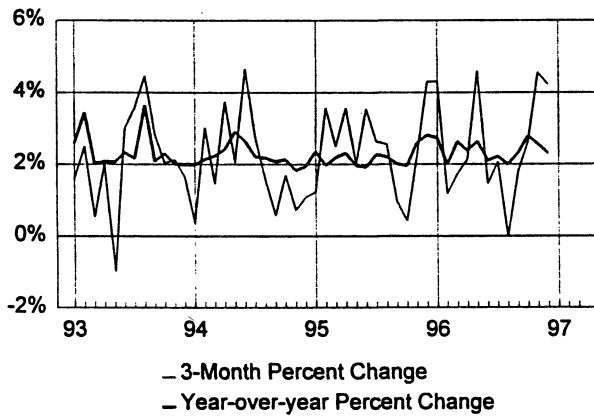
Retail Sales



Unit Auto Sales



Real Personal Consumption: Services



Real Consumption

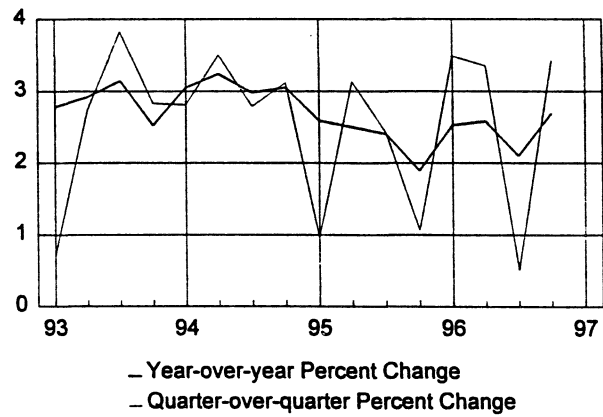
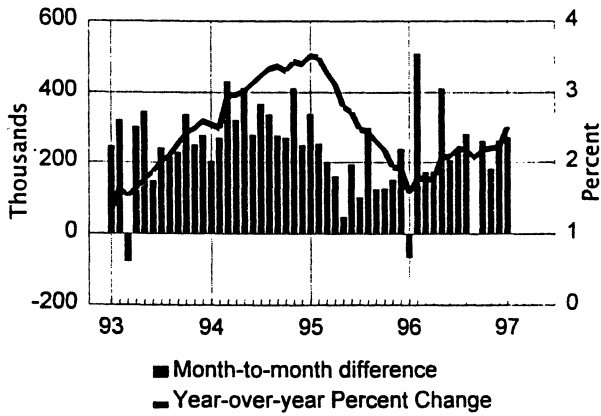


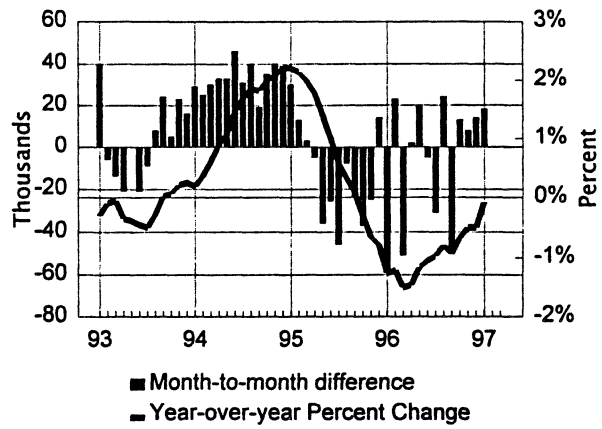
Chart 4

Selected Indicators of Employment & Production

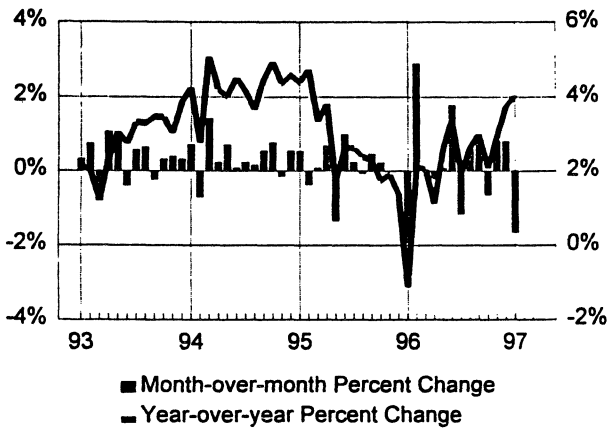
Nonfarm Payroll Employment



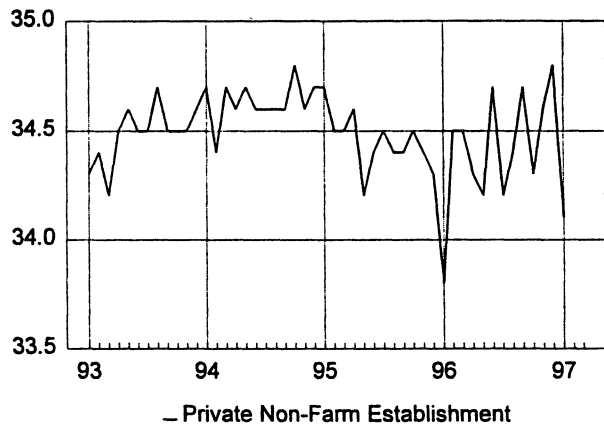
Manufacturing Employment



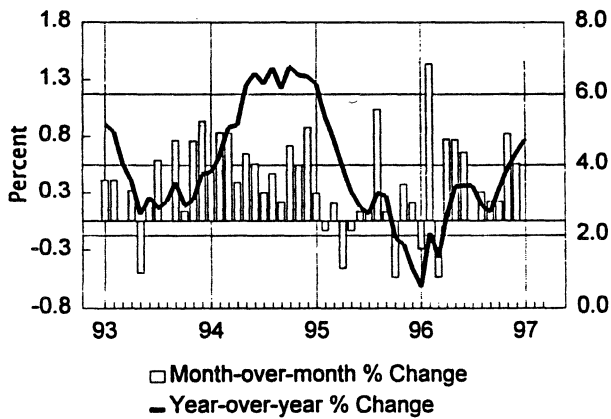
Aggregate Hours Worked



Average Hourly Workweek



Industrial Production



Productivity

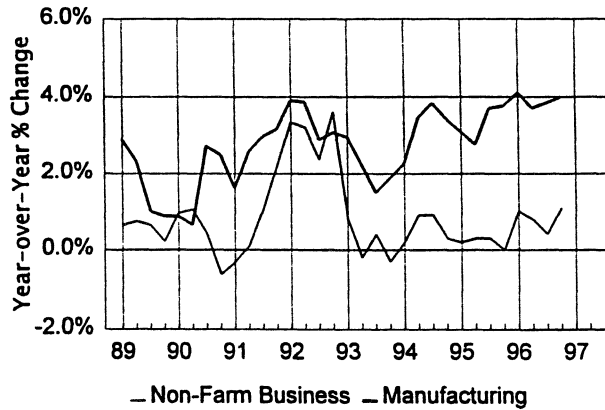
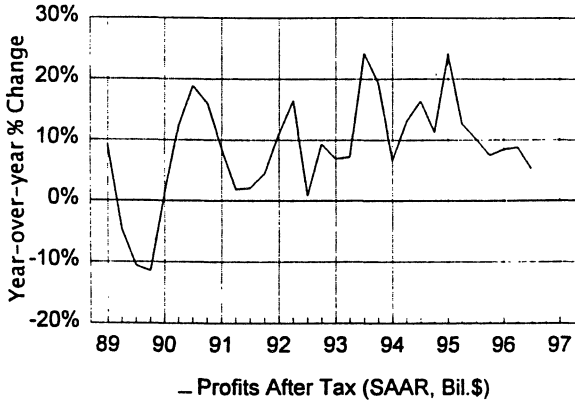


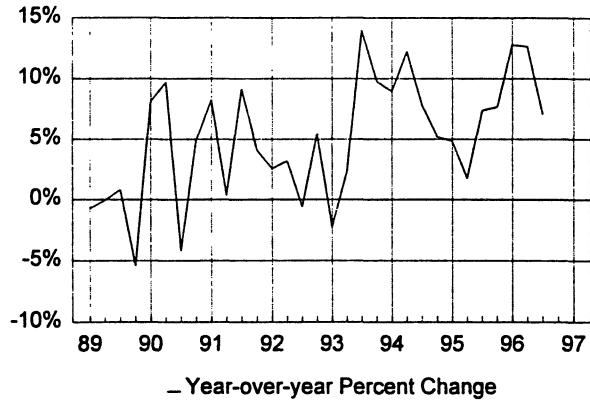
Chart 5

Trends in Corporate Profits and Cash Flows

Corporate Profits



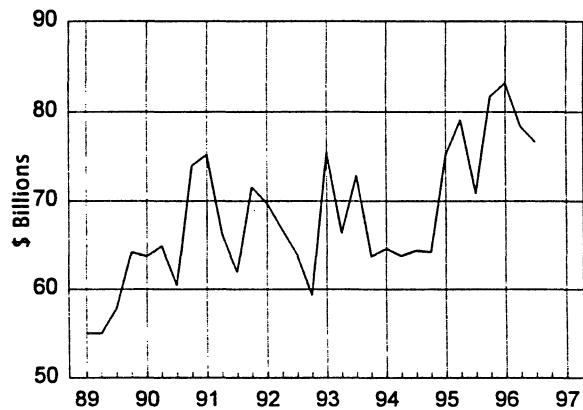
Corporate Net Cash Flow



Domestic Profits



Rest-of-World Profits



Growth of Profits Relative to GDP

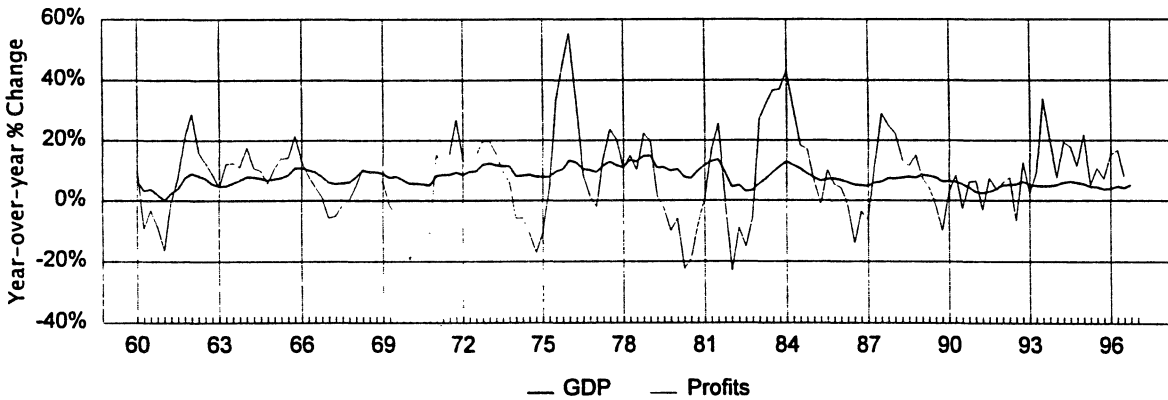
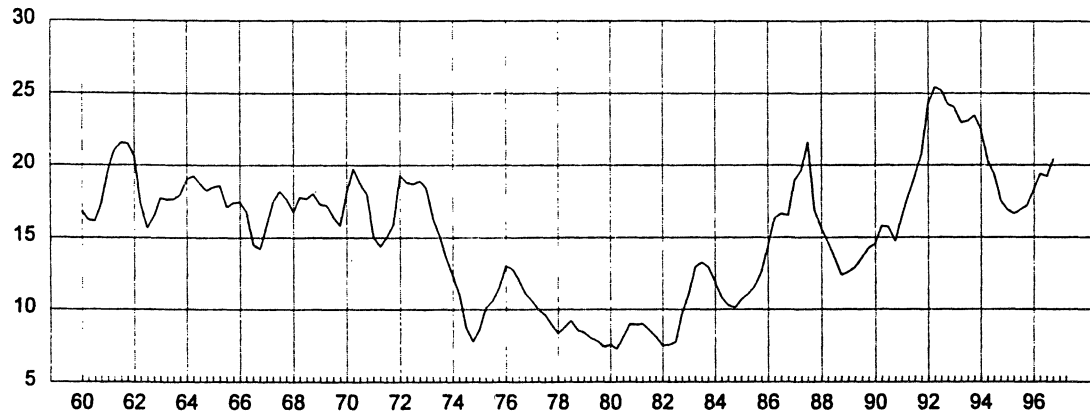


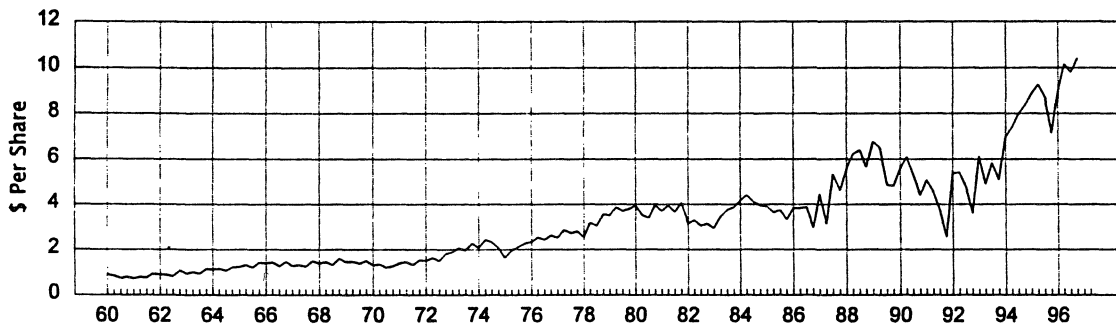
Chart 6

Selected Stock Market Indicators

S&P 500: P/E Ratio,
4 Qtr. Trailing Earnings



S&P 500: After-tax Earnings Per Share



— Level

Consumer Price Index

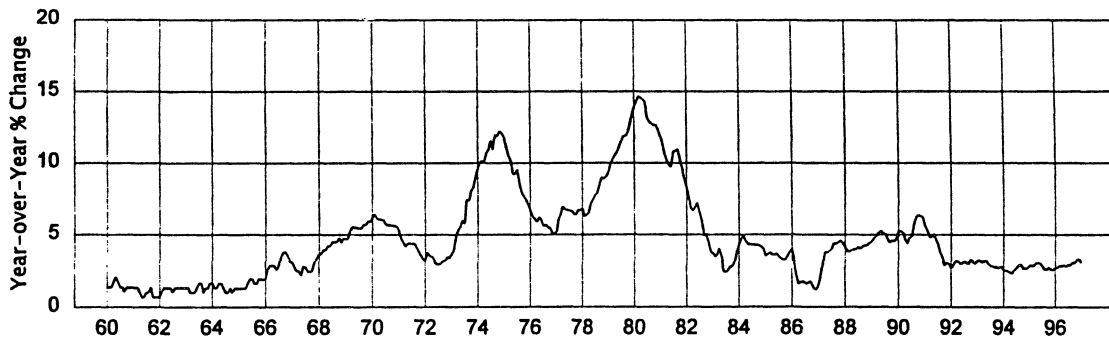
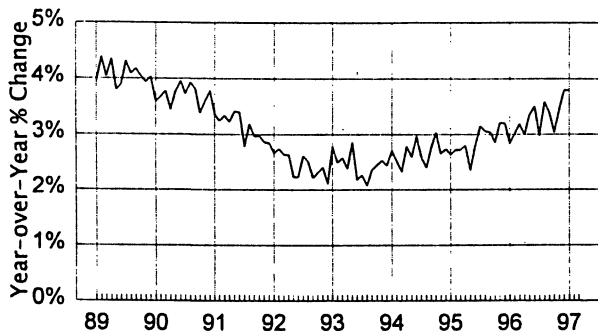


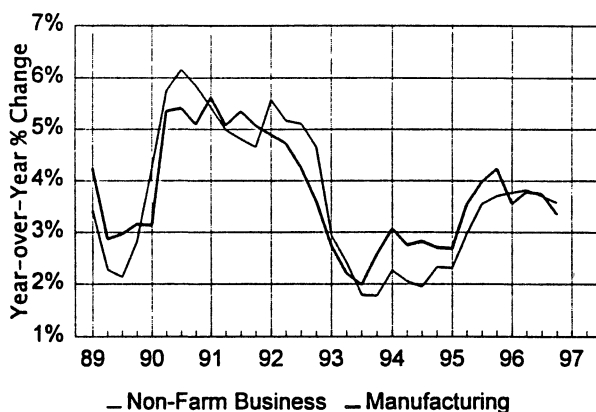
Chart 7

Trends in Wages and Unit Labor Costs

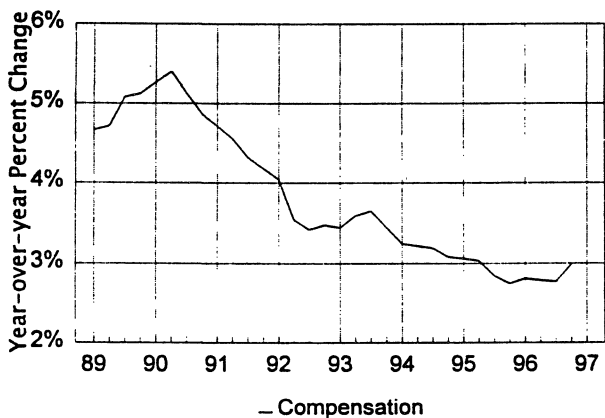
Average Hourly Earnings



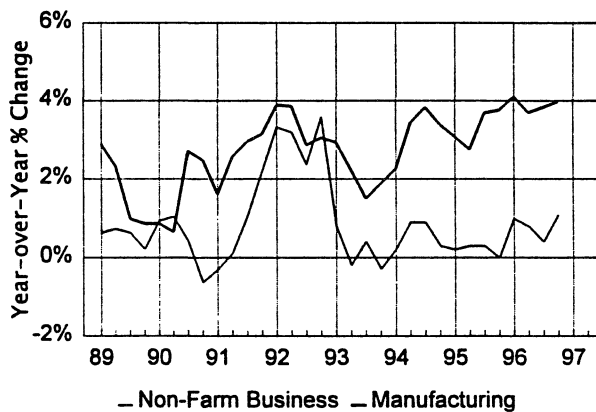
Compensation



Employment Cost Index (Civilian Workers)



Productivity



Employment Cost Index (Civilian Workers)



Unit Labor Costs

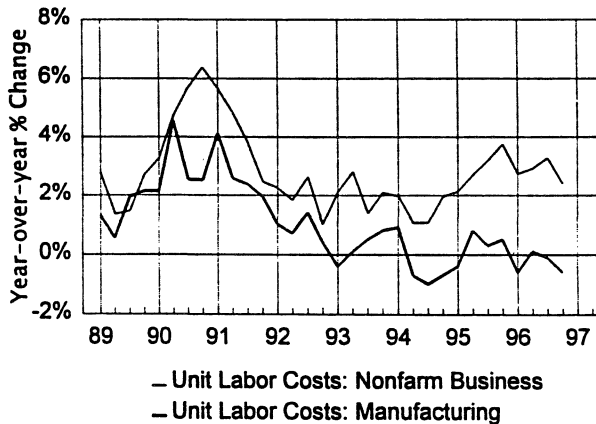
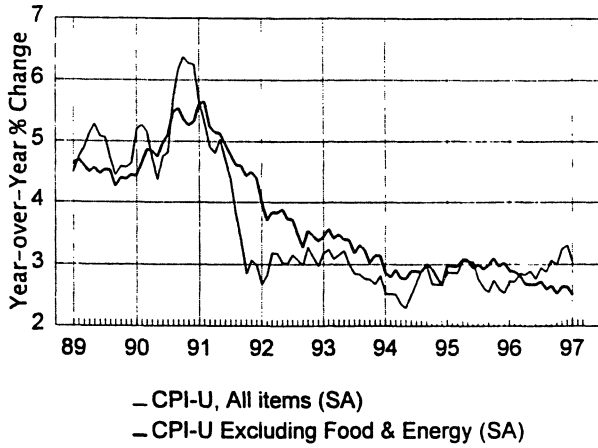


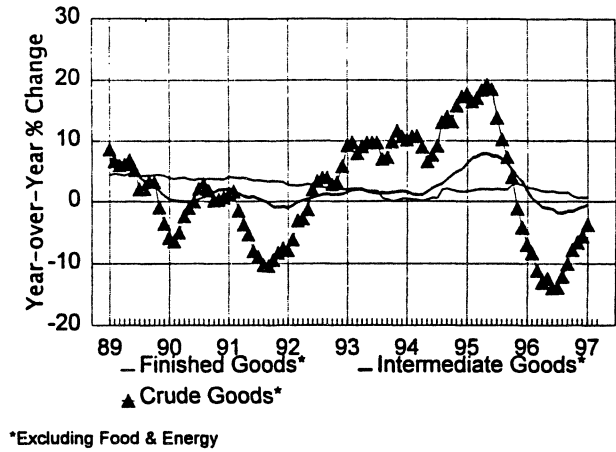
Chart 8

Selected Inflation Indicators

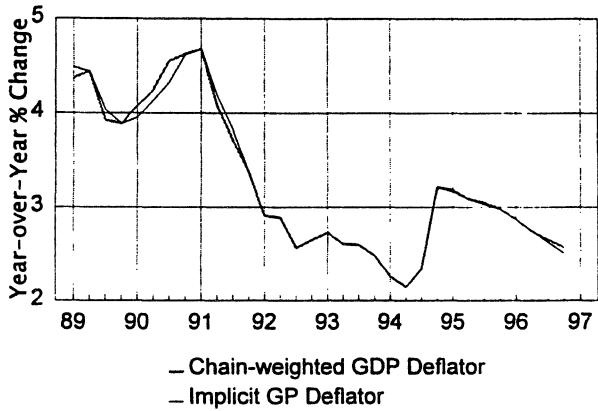
Consumer Price Index



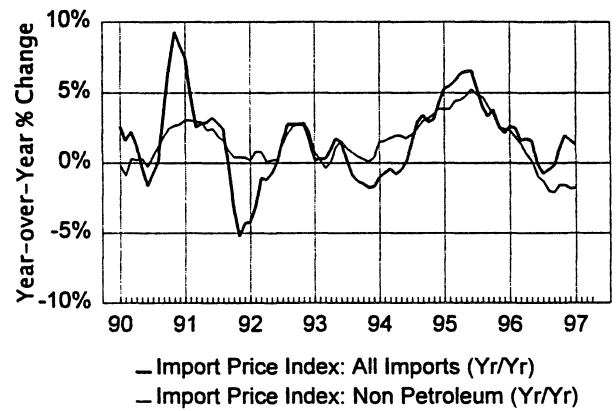
Producer Price Index



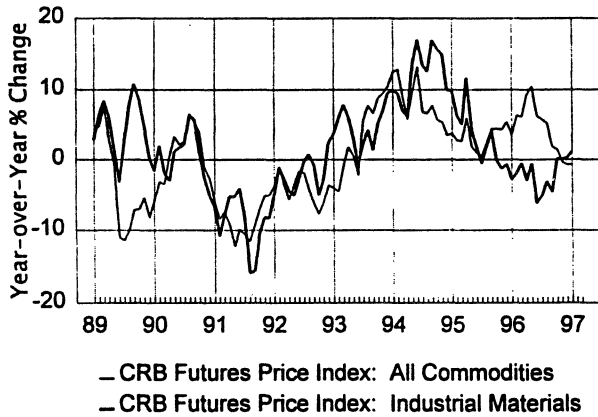
GDP Deflators



Import Price Index



Commodity Prices



NAPM: Survey of Prices

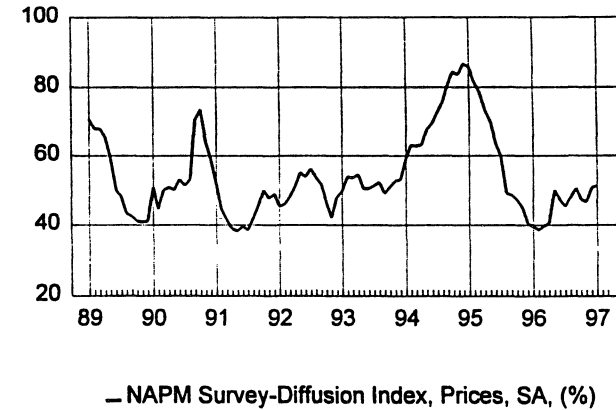


Chart 9

Trend in Nominal GDP

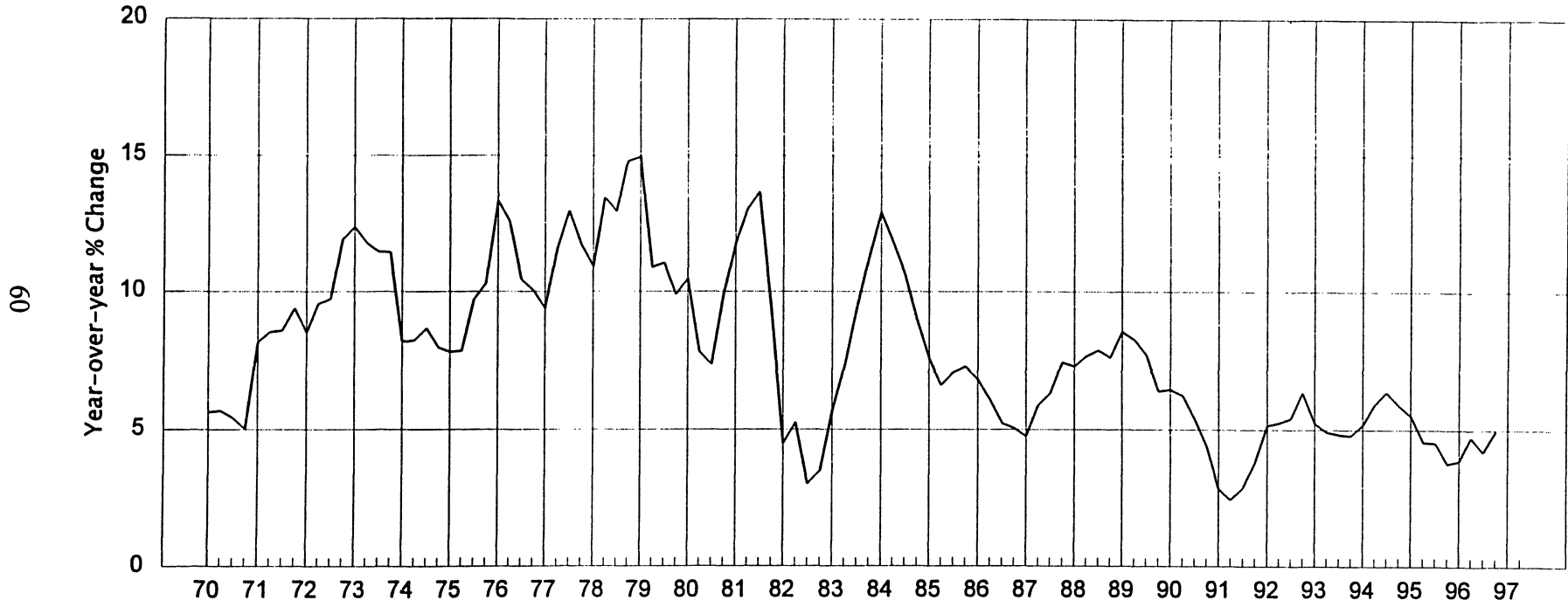
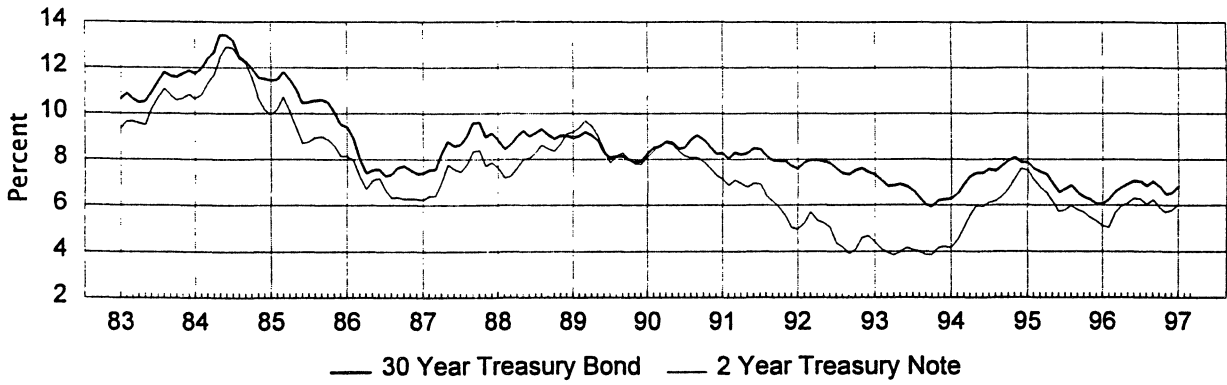
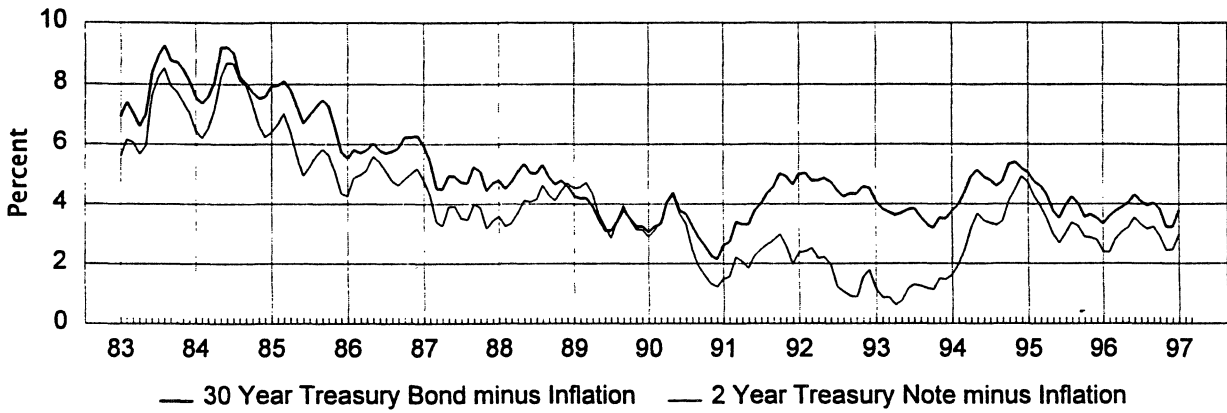


Chart 10

Selected Interest Rates



Inflation Adjusted Yields



Yield Spreads Over the Federal Funds Rate

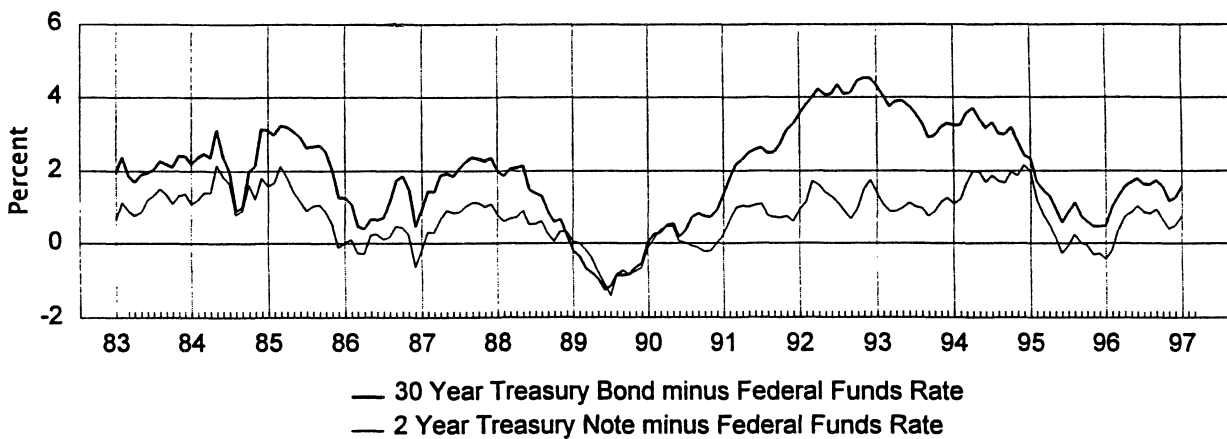


Table 2

I. Federal Reserve Objectives and Actual Performance

Central Tendency Forecasts for 1996 Q4 to 1997 Q4* Actual Performance

	<u>July 1996 Est.</u>	<u>Feb. 1997 Est.</u>	<u>1995 Q4 - 1996 Q4</u>	<u>1996 Q2 - 1996 Q4</u>
Real GDP	1.75% to 2.25%	2% to 2.25%	3.4	3.4
CPI Inflation	2.75% to 3%	2.75% to 3%	3.2 (2.5, core)	3.0 (2.6,core)
Nominal GDP	4.25% to 5%	4.5% to 4.75%	5.2	5.0
Unemployment Rate (4th Qtr.)	5.5% to 5.75%	5.25% to 5.5%	5.4 currently	

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II. The Fed's Money Targets and Actual Trends

	Money Supply Targets* <u>Q4:95 - Q4:96</u>	Annualized % Change		
		<u>Last 3 Months</u>	<u>Last 6 Months</u>	<u>Yr/Yr</u>
Bank Reserves†	Not Targeted	13.2	7.9	8.8
M1†	Not Targeted	6.7	5.0	5.8
M2	1% to 5%	6.7	5.4	4.9
M3	2% to 6%	9.1	8.4	7.4
Debt	3% to 7%	5.2	5.2	5.4

*Source: Board of Governors of Federal Reserve System, *Monetary Policy Report to the Congress*, July 1996 and February 1997.

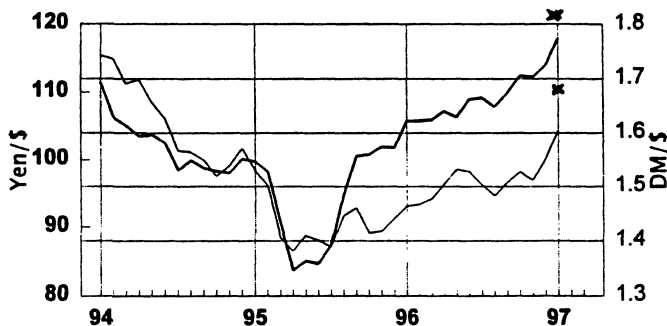
† Adjusted for FRB estimates of sweep accounts

Table 3**I. Economic Conditions in the G-7 Nations**

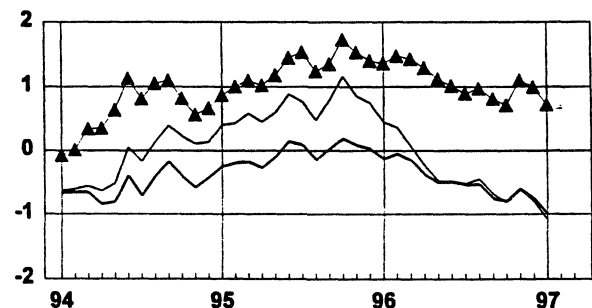
	Real GDP		Unemployment Rate %	Inflation		Comment
	Yr/Yr % Change	Current Condition		CPI (Yr/Yr)	PPI (Yr/Yr)	
Britain	3.4	moderate pickup	6.5	2.8	1.5	moderate pickup
Canada	1.6	moderate pickup	9.7	2.2	-0.5	stable
France	1.4	rebounding from recession	12.7	1.7	-3.5	stable
Germany	2.4	rebounding from recession	12.2	1.8	1.5	stable
Italy	0.7	decelerating	11.9	2.6	0.5	decelerating
Japan	3.2	rebounding from recession	3.3	0.6	1.0	stable
United States	3.2	healthy growth	5.4	3.0	2.5	stable

II. Interest Rates and Yield Spreads

	10-Year Bond	Short-term	Yield	Inflation-Adjusted Yields		Inflation Adjusted Yield Spreads to U.S.	
	Yields	Yields	Spread	Bonds	Short-Term	Bonds	Short-Term
Britain	7.1	6.0	1.1	4.3	3.2	0.8	0.8
Canada	6.2	3.0	3.2	4.0	0.8	0.5	-1.6
France	5.2	3.3	1.9	3.5	1.6	-	-0.8
Germany	5.4	3.1	2.3	3.6	1.3	0.1	-1.1
Italy	7.3	7.3	0.0	4.7	4.7	1.2	2.3
Japan	2.5	0.5	2.0	1.9	-0.1	-1.6	-2.3
United States	6.5	5.4	1.1	3.5	2.4	-	-

**U.S. Dollar Against
Selected Foreign Currencies**

— Foreign Exchange Rate: Japan (Yen/US\$)
— Foreign Exchange Rate: Germany (D. Mark/US\$)

Bond Yield Differentials

— Germany Minus U.S. — France Minus U.S.
▲ U.K. Minus U.S.

SOCIAL SECURITY REFORM

Charles I. PLOSSER*
University of Rochester

The Social Security Act requires that every four years an Advisory Council on Social Security be appointed to review the Social Security System. In March 1994 an Advisory Council was appointed and it finally reported its findings in January 1997. It was an unusually lengthy process and the report makes it clear why it took so long. The Council could not come to any consensus as to the nature of the “problem” nor to its sensible solution. As a consequence, the report presented three views of what to do about Social Security and a series of Appendices where the members of the Council accuse each other of not understanding the merits of their preferred approach.

THE PROBLEM WITH SOCIAL SECURITY

When it comes to entitlements, there are only two programs in the U.S. that really matter—Social Security and Medicare. Both programs involve significant transfers from the working population to the elderly and are funded primarily on a pay-as-you-go basis. In both cases the expenditures are rising rapidly, consuming larger and larger fractions of the Federal budget and national output. In fact this is true for many countries—retirement and healthcare entitlements are often among the largest and most uncontrollable budget items.

Like a typical chain-letter, Social Security is a pay-as-you-go redistribution from the young to the old and depends to a significant degree on an ever expanding pool of new payers to reward the individuals who got into the system earlier. The problem is that like a chain-letter, someone usually gets left holding the bag.

This all seemed well and good in 1935 and even into the 1950’s. Unfortunately, the pyramid scheme is becoming increasingly burdensome. Since its inception, the system’s viability has rested on the premise that there would always be many more workers supplying funds than retirees having a claim to those funds. It was never meant

to be a true pension or retirement plan. Unfortunately, two changes occurred that dramatically undermined the system's long-term health.

First, Americans became healthier and began living longer. Figure 1 shows that life expectancy for someone born in 1935 was less than 62 years. Thus, in the beginning, a retirement age of 65 seemed actuarially sound. By 1965, however, life expectancy had risen to over 70 years and it climbed to over 75 years by 1995. With people living longer, the cost of the program has risen significantly. By 2030, our life expectancy is anticipated to approach 80. Thus, the number of people eligible for Social Security has grown significantly simply because we are living longer.

The second factor is a change in birth rates, which has interacted with life expectancy to exacerbate the problem. There was a tremendous increase in the birth rate after World War II—the so-called baby boom. While this actually helped spread the burden of supporting retirees for a while, it also meant that the baby-boomers would eventually retire and wish to claim their Social Security checks. This would not have been so bad except that the baby-boomers decided to have fewer children on average than their parents. Consequently, as the baby-boomers retire, there are fewer workers per retiree.

As shown in Figure 2, there were more than 4.5 employed workers for every Social Security recipient in 1965. Today, that ratio has fallen to 3.3 to 1. By the year 2030, there will only be 2 employed workers for every beneficiary and by 2070 the ratio will have declined to just 1.8 to 1. Thus, every family with two wage earners not only will be supporting themselves and their own children, but also shouldering the burden of Social Security and Medicare benefits of one retiree. These demographic trends alone tell a frightening tale about the cost of maintaining the current benefit structure of the Social Security system.

In 1965 (the year Medicare was established), Social Security accounted for less than 16 percent of non-interest outlays of the Federal government (see Figure 3). By 1970, Social Security accounted for almost 17 percent and Medicare for 4 percent—a combination accounting for about 21 percent of non-interest outlays of the government. In 1995, Social Security alone amounted to 26 percent of non-interest outlays and

Medicare to 14 percent for a combined total of 40 percent of Federal non-interest outlays going to the elderly. The Congressional Budget Office projects that by the year 2030, unless fundamental changes are made, 56 cents of every Federal dollar not used to pay interest on the debt will go to the elderly. Overall, the CBO projects that Federal expenditures net of interest will grow from just 20 percent of GDP to about 28 percent by the year 2050—largely due to payments to the elderly. The Federal government is becoming more and more simply a vehicle to redistribute income from the working to the retired.

Figure 4 shows the implications in terms of payroll taxes on the workforce if current law doesn't change. Currently, payroll taxes amount to 15.3 percent of covered wages—12.4 percent for Social Security (OASDI) and 2.9 percent for Medicare-Part A (Hospital Insurance—HI). In order to meet our obligations under current law, OASDI would have to increase to 17.1 percent by 2030 and Medicare to 8.5 percent for a combined payroll tax of almost 26 percent by 2030. By 2070, the rate would have to rise to 18.8 percent to cover OASDI and 11.8 percent to cover HI for a combined total in excess of 30 percent, which is double the current payroll tax rate. And these figures do not include expenditures in what's known as Medicare-Part B coverage, which provides supplemental coverage for physician and outpatient services and is paid for out of general revenues. The more limited growth in the Social Security tax from 2030 to 2072 relative to the period 1995 to 2030, stems from the assumption that most of the baby boomers will have retired by 2030.

In some respects, Social Security has been extraordinarily successful. It has reduced the poverty rate of the elderly, which is now lower than that of the rest of the population. Larry Kotlikoff has estimated that due, in large part, to Social Security and Medicare, the consumption of the average 70 year old has increased from 70 percent of what an average 30 year old consumed in 1960 to almost 120 percent of the consumption of a 30 year old in the late 1980's.

The Medicare portion of our commitment to the elderly is facing the same demographic problem as Social Security. Unfortunately, its problems are made worse by the nature of the benefit. Unlike Social Security, which entitles the beneficiary to an

inflation-adjusted dollar benefit based on the individual's wage history, Medicare grants the elderly an open-ended entitlement that places no dollar limit on the benefits each participant may receive. If the cost of health care services rises, then the cost of Medicare rises. Improved technology and higher quality care have contributed to the cost of covered medical services, causing them to rise much faster than wages or other prices. Moreover, since the beneficiary pays little or nothing for the services there is a tendency to demand unlimited care no matter the cost to the system.

Improved quality and an insatiable demand have combined to exacerbate the demographic problem and to make the cost of the Medicare system increase at very high rates. Figure 5 shows that the actual spending *per beneficiary* grew at almost 14 percent per year during the 1970's, while the rate of inflation was less than 8 percent. During the 1980's Medicare spending *per beneficiary* grew at almost 10 percent per annum, or twice the average rate of inflation. Even in the 1990's the trend has continued, with spending *per beneficiary* growing at 8 percent per year while inflation has averaged about 3 percent. The bottom line is that Medicare spending is growing faster than anything else in the economy—faster than the wages of working Americans who must pay for it; faster than the number of elderly who qualify for it; and faster than spending elsewhere in the U.S. healthcare system. The typical Medicare recipient is simply living longer and consuming more and more medical care.

Good or bad, Social Security and Medicare have resulted in a large, systematic transfer of wealth from the young to the old, and it is growing larger with each passing year. Justified or not, the working population will have an increasingly difficult time sustaining these transfers of current rates.

One axiom of economics that is worthwhile to keep in mind was made popular by Herbert Stein, former Chairman of the Council of Economic Advisors under President Nixon. He was always quick to point out that one of the few things we know about unsustainable trends is that they won't be sustained.

One of the major difficulties Congress and the Administration have in addressing these "unsustainable" trends is that imminent disaster is not yet at hand. Social Security will not become a serious financial threat until sometime between 2025 and 2030, when

the bulk of the baby-boom generation will have retired. The Medicare crisis will occur between 2000 and 2005 because the cost of Federally provided health care is rising rapidly and Medicare recipients are consuming more and more of an increasingly expensive commodity.

There are those who will try to argue that we can delay—that the problem remains far into the future. This is a bad idea. Even if we were certain that Social Security would remain solvent for another 30 years, the longer we delay making necessary changes, the more difficult and disruptive they will become. Unfortunately, we really cannot be certain that the system will last 30 years. In 1977, President Carter found himself facing an insolvent Social Security system and signed a law reducing benefits and increasing taxes with the assurance that the system would remain solvent for the next 50 years. Well, he was wrong. There was another crisis five years later and in 1983 the Greenspan Commission approved an increase in the retirement age and further increases in the payroll tax.

The U.S. is not alone. Many OECD countries are facing rapidly aging populations. Depending on the size of the entitlements granted and the method of funding, many of these countries will be coming under increasing financial strain. The dependency ratio—which represents the number of persons over 65 as a percentage of those between the ages of 20 and 64—rises significantly for all major industrialized countries. (See Figure 6.) Indeed, Japan, Italy and Germany could be facing major challenges as they approach 60 retirees for every 100 people of working age. It would seem certain that entitlement programs funded out of general tax revenues or payroll taxes will have to be modified.

What are the options and what should be done? In the case of Social Security, the options range from a) trying to maintain the basic structure and adjust various parameters in order to make financially viable the current system, to b) a complete restructuring of the entire apparatus. In the first scenario, there are only a limited number of alternatives to consider.

- You can increase the tax rate on the working population.
- You can change the way Social Security benefits are taxed.

- You can raise the retirement age.
- Or you can change the way benefits are calculated. The primary option under consideration here is to reduce the so-called inflation adjustment calculation because the Consumer Price Index is thought to overstate the true rate of inflation.

There are other ways to help alleviate the pressure but they do not appear politically acceptable. For example, if part of the problem is that the workforce is too small to support the elderly, it might make sense to seek out ways of expanding the workforce. Two obvious methods are to encourage more births and to permit more legal immigration. In the current political environment it appears that the government is more likely to curtail legal immigration rather than expand it. In so doing, we will only aggravate these problems.

At the other end of the spectrum is the view that the whole system is fundamentally flawed and should be completely overhauled. One idea that is gaining increased respectability is that the Social Security system should be substantially privatized and transformed into something that looks more like a funded, defined-contribution retirement plan, much like we see in the private sector.

Privatization may sound like a radical idea to some, but it may not be as difficult to accomplish as it first appears. In fact, it has been done elsewhere. Chile established a social security system in 1924, over a decade before we did. In fact, we borrowed much of our structure from the Chilean system. By the late 1970's, Chile faced a rapidly aging population and a growing tax burden to support it. Their response to a crisis that was very similar to the one we currently face was to replace their old pay-as-you-go system with a substantially privatized, defined-contribution pension plan. By all accounts, the new system, implemented in 1981, has been both successful and popular.

PROPOSED SOLUTIONS

The U.S. Advisory Council on Social Security recently issued a report with three alternative plans to salvage the system's finances. The reason there were three plans was that the panel could not reach a consensus. There are and will be many who express the

view that any change is bad and must be resisted to preserve the existing system. This perspective is based on the view that the Social Security system is not and should not be a true pension system. That it was created as a redistribution plan that was, more or less, universal and that that is its strength. At the other end of the spectrum are those that would like to see a more fundamental reform of the entire system. They view the basic concept of a pay-as-you-go scheme as flawed and in need of repair. The Council could not agree on an approach to reform and as a result have offered three proposals.

Option 1

The proposal backed by six of the members is the most moderate of the three. It seeks to reform the system while making as little change as possible. It is called the **“Maintenance of Benefits”** plan. This proposal has five key elements.

1. All Social Security benefits in excess of already taxed employee contributions would be included in Federal taxable income and the proceeds deposited in OASDI trust funds. (This includes revenue now going to the HI Trust fund, which would be redirected to OASDI.)
2. All state and local government employees hired after 1997 would be covered under Social Security.
3. The benefit computation would be extended from 35 to 38 years—phased in over the 1997-1999 period.
4. In 2045 there would be a 1.6 percentage point increase in the payroll tax—0.8 percent levied on the employer and 0.8 percent levied on the employee.
5. Study the possibility of investing up to 40 percent of Social Security assets in private equities. “An investment policy board nominated by the President and confirmed by the Senate” would oversee these assets.

It must be pointed out, that while the plan only proposes that the investment in stocks be studied, the plan does not cover the financial deficit in the system unless such investments are carried out. In other words, the other proposed changes are not adequate alone. Either further increases in taxes or a reduction in benefits must be adopted if the higher returns are not achieved in the investment portfolio.

Option II

The “intermediate” proposal, recommended by two members of the Council is referred to as the “**Individual Account**” plan. The key element of this plan is as follows.

1. Regular Social Security benefits in excess of already taxed employee contributions would be included in Federal taxable income. (Unlike the MB plan, there would be no redirection of taxes from the HI Trust Fund to the OASDI Trust Fund.)
2. All state and local government employees hired after 1997 would be covered under Social Security.
3. The benefit computation would be extended from 35 to 38 years—phased in over the 1997-1999 period.
4. The gradual increase in the age of eligibility for full retirement benefits would be accelerated and extended. In particular, eligibility would rise to 67 by the year 2011 and would rise slowly thereafter with overall longevity.
5. Some modest reductions in the growth of benefits from middle- and high-wage workers.

The most significant element of the plan is:

6. The establishment of an additional mandatory defined contribution individual account in the amount of 1.6 percent of covered payroll. This is equivalent to a forced savings plan. These accounts would be held by the Government as defined-contribution individual accounts. Individuals would have a constrained set of investment choices ranging from a bond index fund to an equity index fund. These funds would not be part of the Federal budget. The accumulated funds would be converted into an annuity when the individual retired. The funds would be taxed only once. That is they may be tax-deductible when saved and taxable when withdrawn or taxable when saved and tax-free when received.

Option III

The third plan proposed by the Council, and supported by five members is called the “**Privately-Held Individual Accounts.**” This plan moves the Social Security system

to something much more like a funded defined-contribution plan that is frequently found in the private sector. When fully phased in, the system would take the place of the present Social Security system. The new system would be a two-tiered system with the first tier providing a flat retirement benefit for full-career workers and the second would be the funded individually retirement accounts.

1. Tier 1 benefits would provide a floor of support to all workers. This benefit would be \$410 per month and indexed.
2. The gradual increase in the age of eligibility for full retirement benefits would be accelerated and extended. In particular, eligibility would rise to 67 by the year 2011 and would rise slowly thereafter with overall longevity.
3. All state and local government employees hired after 1997 would be covered under Social Security.
4. Tier II benefits would come from Personal Security Accounts (PSAs). Each individual would reallocate 5 percentage points of the employee's share of the current OASDI tax rate into a PSA dedicated to retirement. These accounts would be individually owned and privately managed (unlike the accounts in the previous plan). Minimal regulatory restriction would apply to ensure that funds were invested in instruments widely available in the financial markets and that they were held for retirement purposes. Every worker under the age of 55 would participate.
5. Transition issues must be addressed. Workers over the age of 55 would be covered under existing rules. Workers under the age of 25 would be covered immediately under the new system. Workers between the ages of 25 and 55 would receive their accrued benefit under the existing system plus a share of the flat (Tier 1) benefit under the new system. The financing of the transition would be accomplished by a 1.52 percentage point increase in the payroll tax for 72 years. While this is sufficient in present value terms, the expense of funding is more heavily front end loaded. Thus Federal borrowing would have to occur in the amount of \$1.9 trillion over the next 40 years. The bonds issued would be fully repaid by the excess tax revenues in subsequent years. In one sense, this

debt financing is more like that which occurs at the local level where specific taxes are dedicated to specific bond issues.

A major problem with Option I and Option II is that in their effort to solve the financial crisis looming in the Social Security chain-letter, they arrange for the Federal government to heavily invest in the U.S. financial markets. This is troubling on a number of accounts. The risk of government deciding to use the investment strategy of these trust funds for political purposes is cause enough to be wary of these proposals. One also should be concerned with the risk that government appointed managers could directly influence the governance of privately held companies.

None of these plans go far enough towards privatization. There is no underlying reason for the government to be involved in providing retirement income for individuals. No eternity is involved and there is no reason why individuals can not make their own decisions regarding retirement savings. If government wants to provide welfare or income supplements to the needy, then it should separate that goal from the provision of retirement income. The current Social Security system hopelessly muddles these two issues.

It should be recognized as well that Social Security could become less of a financial burden if real per capita productivity could be raised by say 0.5 percent per year over the next 75 years. The higher growth rate of real wages that resulted would allow the current payroll tax to find all of the projected liabilities currently promised. Unfortunately, we know of no sure-fire method of obtaining such a result and so it would be folly to ignore Social Security reform in the hopes that it will occur. Nevertheless, government should continue to pursue policies that would promote increase in productivity, including tax reform and regulatory reform.

NOTES

*The author is Dean and John M. Olin Distinguished Professor of Economics and Public Policy at the William E. Simon Graduate School of Business Administration, University of Rochester, Rochester, New York 14627.

Figure 1
LIFE EXPECTANCY AT BIRTH

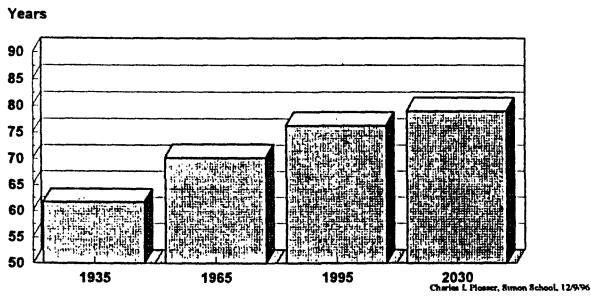


Figure 2
WORKERS PER BENEFICIARY

Source: Social Security Administration

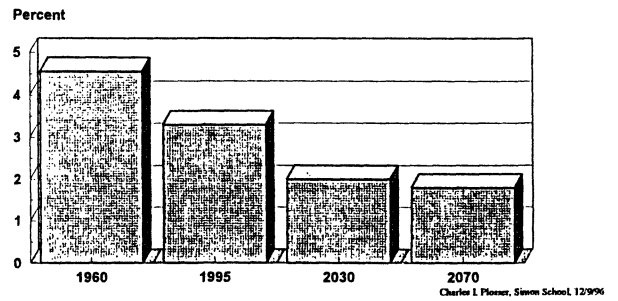


Figure 3
PROJECTED EXPENDITURES

Source: Congressional Budget Office

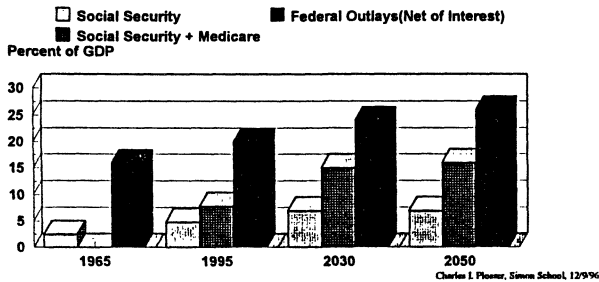


Figure 4
PROJECTED PAYROLL COSTS

Source: Social Security Administration

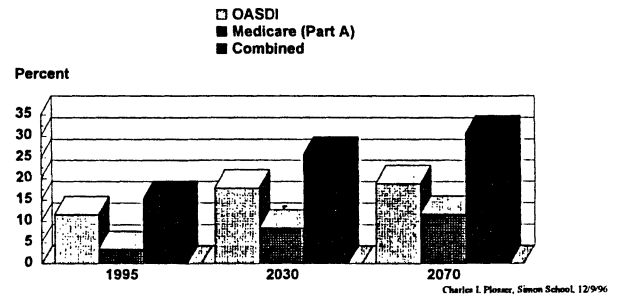


Figure 5
GROWTH IN MEDICARE SPENDING PER BENEFICIARY

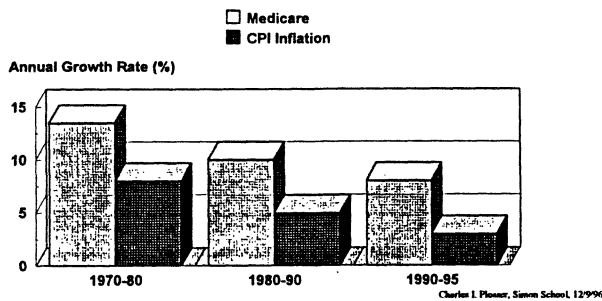
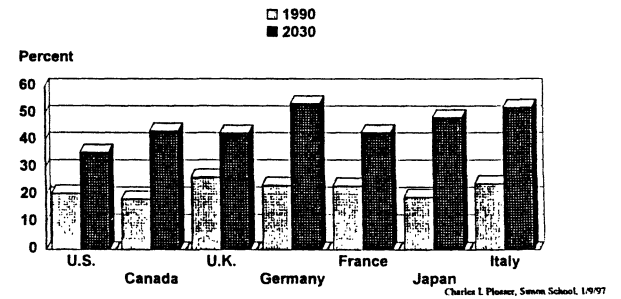


Figure 6
PROJECTED ELDERLY DEPENDENCY RATIOS



THE BOSKIN COMMISSION REPORT

William POOLE*
Brown University

The Advisory Committee to Study the Consumer Price Index, named informally the “Boskin Commission” after its chairman, presented its final report last December.¹ The Commission, established by the Senate Finance Committee, consisted of Michael J. Boskin, Stanford University (Chairman); Ellen R. Dulberger, IBM Personal Computer Company; Robert J. Gordon, Northwestern University; Zvi Griliches, Harvard University; and Dale Jorgenson, Harvard University. The Commission members are all recognized experts in the area of price index theory and practice. The Commission’s *Report* of almost 100 pages is an excellent summary of the major issues surrounding the CPI; the *Report* deserves to be taken seriously.

The Commission’s findings may be summarized under four major headings: the purpose of the CPI; problems with the existing CPI; consequences of the mismeasurement of inflation in the existing CPI; recommendations. I will organize my memorandum under these four headings.

THE PURPOSE OF THE CPI

Price indexes serve a number of different purposes, but the principal purpose of the CPI should be, according to the Boskin Commission, to measure as accurately as possible the cost of living. “A cost of living index is a comparison of the minimum expenditure required to achieve the same level of well-being (also known as welfare, utility, standard-of-living) across two different sets of prices. Most often this is thought of as a comparison between two points of time.” (page 20 of *Commission Report*; hereafter, all page numbers indicated will refer to the *Commission Report*).

The CPI is widely used in indexing government spending programs, tax law provisions, and private wage contracts. The purpose of indexing is to prevent inflation from changing real outcomes—that is, affecting the welfare or standard of living of

individuals. This purpose is clearly demonstrated in the history of indexing of Social Security benefits. As inflation rose in the 1960s and early 1970s, and before indexing, Congress periodically raised Social Security benefits in an effort to keep up with inflation—to offset the effects of inflation in the purchasing power of Social Security benefits. Without these adjustments, inflation would have substantially reduced the purchasing power of Social Security benefits in just a few years.

Social Security indexing took effect in 1975. Congress believed that formal indexing provided a more reliable method of offsetting the effects of inflation on benefits than periodic legislation to change benefits. Experience suggested that legislation tended to increase benefits by more than was justified by inflation per se, and to raise political problems that seemed unavoidable every time the political process touched Social Security. These problems were avoided by the automatic indexation of Social Security. In fact, the initial indexation formula was incorrectly constructed, leading to an excess allowance for CPI changes. This error was corrected in due time, but overindexing due to the upward bias in the CPI itself has not been corrected.

PROBLEMS WITH THE EXISTING CPI; REPAIR APPROACHES

When Social Security indexation was enacted, the problem was to deal with the main issue of putting the inflation adjustments on a sound and routine basis. In the early 1970s, economists knew, or at least widely believed, that the CPI overstated inflation, but that belief did not affect the decision of Congress because the overstatement seemed small compared to the political problems to be solved by indexing. Now, with over 20 years of experience with indexing Social Security, and experience of shorter duration with indexing other features of federal law, the issue of the accuracy of the CPI needs to be addressed.

The bottom line of the Commission's findings is that the Consumer Price Index is subject to an upward bias which, by the Commission's estimate, is about 1.1 percentage points per year. The upward bias in the CPI arises for a number of reasons. For anyone who is not an aficionado of the theory and practice of constructing prices indexes—99.9

percent of non economists and probably 98.9 percent of economists—understanding the sources of the bias requires studying issues of mind-numbing complexity and tedium.

The principal problems of CPI construction arise because we live in a world of rapid economic change. It is hard conceptually to define what is meant by “the cost of living” when new goods enter the consumption stream. It is easy enough to understand what is meant by the change in the cost of bread, but what is the change in the cost of treating a disease that used to be untreatable and is now curable? This problem for CPI statisticians is significant because consumers today spend a significant part of their income on goods that did not exist even a few years ago.

A less extreme, but still very important problem, is that the quality of goods changes, typically bit by bit year by year. Most, but certainly not all, quality changes in the U.S. economy are improvements. Many of the goods we consume today are similar, although not identical, to goods consumed twenty years ago. An example of this type of good is the automobile. Manufacturers have improved cars year by year: fuel economy has improved, components are, for the most part, more durable; safety advances have increased the probability of surviving a crash; many cars handle more securely; maintenance intervals are longer; and so forth and so on.

The Commission also emphasized that the basic design of the CPI as a Laspeyres index overstates inflation because this type of index does not allow for consumer substitution of lower for higher priced goods when prices change. A Laspeyres index measures the price of a fixed market basket of goods, and therefore answers the question of how much additional expenditure is necessary to buy the fixed market basket of goods. When relative price change, however, consumers routinely substitute one good for another, to a degree that depends on the type of good involved. For example, the CPI as currently constructed misses the substitution of new low-cost air travel for rail and auto travel. (This example is on my mind now that Southwest Airlines has entered the Providence - Baltimore market at prices dramatically lower than prices charged by air carriers previously in this market.)

Other methods of calculating a price index using the same underlying price data on individual goods are available—there is no need for the Bureau of Labor Statistics to

retain the Laspeyres formula. Although there are many technical issues to be decided, replacing the Laspeyres index is perfectly feasible, as shown by the fact that the Bureau of Economic Analysis uses an alternative index (the chain-weighted index) in calculating deflators in the National Income and Produce Accounts. Although the conceptual and data problems of dealing with quality change and new goods are substantial, substituting another index formula for the Laspeyres formula will not be costly or difficult technically, and the Commission makes a strong case for doing so.

Another set of problems concerns data collection and the need to construct the CPI within a budget. The Bureau of Labor Statistics does not, and should not, have an unlimited budget for the CPI. Consumers taken together buy scores of thousands of distinct goods from thousands of different companies at hundreds of thousands of different locations. When collecting prices, the BLS must decide how many stores and how many brands of specific goods to sample. The BLS must decide how often to update its sample design. These decisions necessarily reflect a tradeoff of accuracy against government expenditure on constructing the price index. The magnitude of this task is suggested by the fact that, “[e]ach month, prices for approximately 71,000 goods and services are collected from 22,000 outlets, in 44 geographic areas” (page 12).

The BLS must also decide how to allocate its budget between ongoing activities and research on new approaches. For example, an area under active study now is the use of store scanner data. Many stores today scan bar codes at the checkout counter, and firms use the data to improve the management of inventories, track trends in consumer buying, and conduct other types of research. The BLS might reduce the cost of its operations and increase the range of goods included in the CPI by using scanner data. Clearly, though, there are important issues of incompatible and/or changing software standards, coverage of outlets not using scanners, and so forth. Research into such issues is expensive, and diverts resources from the estimation of the CPI using current methods. Still, such research obviously promises great gains in the future in improving the accuracy of the CPI and reducing the cost of constructing it.

These comments are meant to just skim the surface of some of the important issues surrounding the CPI. What should be absolutely clear is that constructing the CPI

is an enterprise requiring great technical expertise. Although it has been a staple of economists' thinking for as long as I have been in the profession, and no doubt longer, that the CPI has an upward bias, fixing the bias and measuring its true extent is far from a trivial task. There is also a danger that in correcting areas that create an upward bias, other areas with a downward bias will be neglected. The goal of the BLS should be to create the best CPI possible and not just to create a CPI with a lower measured inflation rate. The Boskin Commission offers many specific suggestions on improving the CPI. Experts are sure to evaluate these suggestions and the BLS should implement as many of the sound suggestions as possible, as soon as possible.

CONSEQUENCES OF CPI MISMEASUREMENT

Certain parts of the federal budget, such as Social Security, are formally indexed to the CPI. Tax brackets, the personal exemption, the standard deduction, and certain other features of the tax law are also indexed to the CPI. The federal government now issues bonds indexed to the CPI. Taking the tax law and benefit schedules as given, overstatement of the CPI increases the federal budget deficit compared to what the deficit would be if the CPI were accurate.

The Commission, relying on estimates prepared by the Congressional Budget Office, emphasizes that CPI mismeasurement is a major issue for the federal budget. If the measured CPI were to rise by one percentage point less than currently projected, by 2006 the federal budget deficit would be lower by \$134 billion and by 2008 the national debt would be \$1 trillion lower than currently projected (page 10). These amounts in part reflect overpayments to beneficiaries of federal programs—"overpayments" in the sense of payments in excess of those needed to compensate for inflation correctly measured. The budgetary impact of CPI mismeasurement also reflects underpayments by taxpayers—"underpayments" in the sense that dollar tax payments at current tax rates are lower than required to just offset the effects of a rising price level correctly measured.

The Commission does not discuss the effects of CPI mismeasurement on private indexed contracts. That effect is probably minimal. In the private sector, wage indexation is typically partial and the basic wage rate easily adjusted to offset the effects of CPI

mismeasurement. However, the Treasury's new indexed bonds raise interesting issues. Because the Boskin Commission reported before the Treasury sold its first issue of indexed bonds, the yields presumably reflect investor expectations of the probability of changes in the construction of the CPI. Once those changes, if any, are announced, new issues of indexed bonds will reflect investors' expectations of the effects on the measured CPI of new BLS procedures. As a practical matter, it seems likely that the BLS will introduce changes in the CPI gradually, which will keep the effects on holders of indexed bonds relatively small.

RECOMMENDATIONS

The Boskin Commission makes clear that the large budgetary impacts of mismeasurement of the CPI provides a compelling case for the government to devote more resources to the construction of the CPI. Although a better CPI will be available for many other reasons as well, expenditures on an improved CPI will be returned many times over in a smaller budget deficit, at least to a point. Obviously, as with all expenditures, there will be diminishing returns to additional dollars spent on the CPI. Moreover, it should also be understood that the BLS cannot improve the CPI instantaneously. Still, the return in the form of a lower budget deficit of increasing expenditures now to improve the CPI will without question be large and relatively quick in appearing.

Although its recommendation is stated carefully, the Commission also makes a case for the Congress to reduce indexation in government programs and tax provisions by, say, 1.1 percentage points per year until the BLS is able to put in place the improvements to the CPI. This recommendation has much to recommend it. The Commission emphasizes that it is not suggesting an adjustment for past overindexing, but only for prospective future overindexing.

It is important to emphasize that political adjustment of the CPI itself is a terrible idea. For one thing, there is no way to know whether the government will impose an adjustment that is in fact justified, or whether the government might impose additional adjustments in the future. For another thing, private contracts based on the CPI already

reflect the understanding of the contracting parties as to the possible bias in the CPI. Adjusting the indexation formula in indexed programs to provide for “CPI less 1.1” should not be confused with adjusting the CPI itself. At the end of five years, the government could review progress in correcting the CPI and then decide whether to continue with CPI less 1.1.

“CPI less 1.1” however, cannot be applied to indexed bonds currently outstanding, because the government has a contractual obligation to existing bondholders. Nor would it make sense to sell new issues of indexed bonds under the “CPI less 1.1” formula, because the bond market would simply price the bonds to offset this provision.

CONCLUDING COMMENT

The CPI has widespread use. Economists use many price indexes in their research, but the CPI is the only index in general use in formal indexed contracts. Many labor contracts have cost-of-living-adjustments (COLAs) based on the CPI; the federal government has just issued bonds with payments tied to the CPI; Social Security payments and tax brackets are tied to the CPI by law. It would be a disaster of the first order if the political arms of the federal government were viewed by users of the CPI as affecting the professionalism with which the BLS constructs the index. For example, political manipulation of the index with the effect of reducing the interest burden of the newly issued indexed bonds would be the equivalent of a government fraud perpetuated on bondholders. The issue of the government’s credibility is extremely important, and nothing should be done that compromises confidence in the professionalism of the government’s statistical operations.

NOTES

¹Final Report to the Senate Finance Committee from the Advisory Commission to Study the Consumer Price Index, December 4, 1996, Updated Version. The full text of the Report is available on the World Wide Web at <http://www.politicsnow.com/news/special/cpiI/>.

RECENT BEHAVIOR OF VARIOUS MONETARY AGGREGATES

Robert H. RASCHE
Michigan State University

The attached charts illustrate the behavior of various monetary aggregates (including some that I had not heard of six months ago) over the past three years. The latest data plotted are December, 1996. The measures, roughly in order of narrowest to most inclusive definitions are as follows:

- 1) Base = St. Louis Adjusted Monetary Base
- 2) M1 = Reported M1 plus the estimated "Sweeps" series
- 3) M1 plus = Reported M1 + Savings Deposits (this is the most narrowly defined measure that internalizes the "Sweeps" process.
- 4) MzM = Zero Maturity Money as defined by Bill Poole: M2 - Small Time Deposits + Institution type Money Market Funds
- 5) M2minus = M2 - Small Time Deposits
- 6) M2

The solid line in each picture measures the annualized month-to-month rate of growth. The broken line is the year-over-year growth rate ending at the month plotted. Finally, in each of the graphs a horizontal reference line has been plotted at five percent.

The starting period of these graphs roughly coincides with the decision by the FOMC to start increasing its Funds rate target from the three percent level that had been maintained for several years. These last three years are a period in which there is a remarkable similarity in the growth rates of all of these aggregates. With the exception of the growth rate of the Adjusted Monetary Base, the growth rates of all the aggregates declined into the early part of 1995 (month-to-month basis) and then jumped to roughly a five percent rate of growth that was roughly maintained until the last several months. On a year-over-year moving average basis, the growth rates obviously bottomed out somewhat later, typically around the middle of 1995, and then rose steadily until early 1996. By late 1996 the year-over-year growth rates of all these aggregates has risen to or exceeds the five percent level. M1plus and MzM are the two aggregates whose growth

rates are the highest over the past year with current year-over-year growth rates that are substantially in excess of five percent.

The growth rate of the Adjusted Monetary Base continued and stayed around five percent from the middle of 1994 through the middle of 1995, then dropped sharply and trended upward until the middle of 1996 and has remained roughly around a five percent rate over the past six months. Consequently the year-over-year moving average of this rate did not reach a minimum until early 1996. This characteristic behavior of Base growth probably reflects a significant reduction in exports of U.S. currency during 1995 from the levels of 1994. By the end of 1996 the year-over-year growth rate of the base is also approaching five percent.

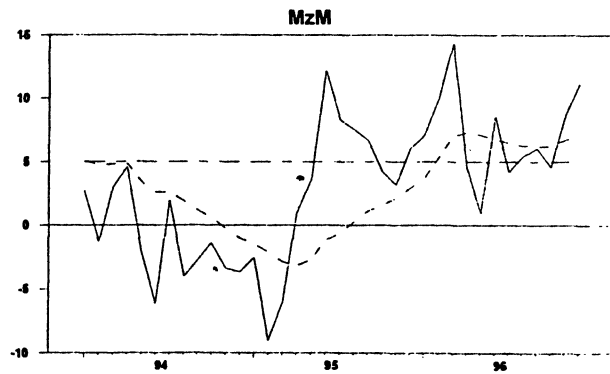
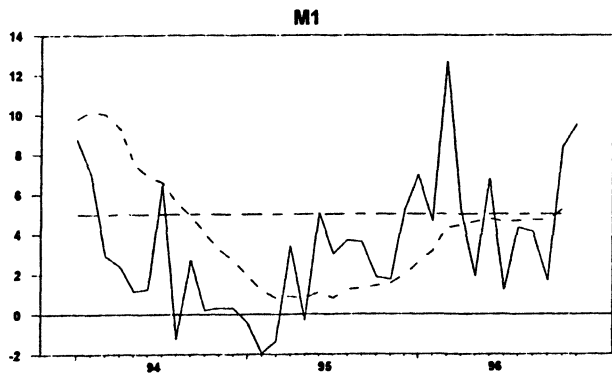
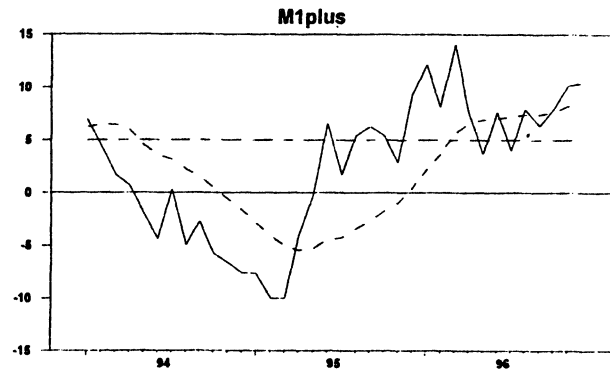
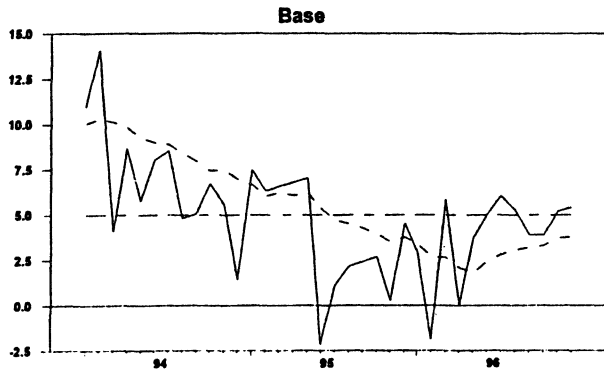
The issue that needs to be considered here is how will growth rates of these aggregates evolve if the current Funds rate target is maintained. Last September we concluded that the policy current at that time (a 5.25 percent Funds rate target), if maintained, would not substantially reduce inflation below the then current levels. We urged the Fed to reduce the growth rates of the monetary base and other monetary aggregates to achieve zero inflation. We argued that monetary acceleration of the past year should not be permitted to continue.

The data that have become available since our last meeting are not consistent with our recommendation. The most charitable interpretation that can be read in these graphs is that monetary growth was stabilized over the past six months; a more cynical view is that it has continued to increase during this period. Recent forecasts of the outlook for the U.S. economy for the next two years provide no evidence of expectations that inflation will slow from current levels. The CBO's forecast in The Economic and Budget Outlook: Fiscal Years 1998-2007 is for CPI inflation for 1997 and 1998 to continue at the 2.9 percent annual rate experienced in 1996. In the same document the CBO quotes the *Blue Chip* forecasters as projecting 2.9 percent CPI inflation for 1997 and a 3.0 percent rate for 1998 (p. 13). The CBO economic projections (not their forecasts) for 1999-2007 are for CPI inflation of either 3.0 or 3.1 percent (p. 15). The administration's forecasts of CPI inflation (fourth quarter over fourth quarter) for 1997 and 1998 are 2.6 and 2.7 percent respectively (Economic Report of the President February, 1997, p. 90)

and its projections for 1998 through 2003 are 2.7 percent. These forecasts and projections suggest that presently there is no credibility associated with the announced Federal Reserve policy of reducing inflation until it achieves a level that is no longer a significant factor in the economic decisions of private agents.

Growth rates of Monetary Aggregates 1995-1996

Solid = Monthly Growth; Broken = Year over Year Growth



Growth rates of Monetary Aggregates 1995-1996

Solid = Monthly Growth; Broken = Year over Year Growth

