MONETARY AND FISCAL POLICY: THE ESSENTIAL LINKAGE

1059

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MONETARY AND FISCAL POLICY: THE ESSENTIAL LINKAGE

FRIDAY, JUNE 12, 1981

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON MONETARY AND FISCAL POLICY
OF THE JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10 a.m., in room 5110, Dirksen Senate Office Building, Hon. Roger W. Jepsen (chairman of the subcommittee) presiding.

Present: Senator Jepsen.

Also present: James K. Galbraith, executive director; Charles H. Bradford, assistant director; Bruce R. Bartlett, deputy director; and Timothy P. Roth, professional staff member.

OPENING STATEMENT OF SENATOR JEPSEN, CHAIRMAN

Senator JEPSEN. The subcommittee will now be in order.

I am pleased to welcome Mr. Larry Kudlow before the Subcommittee on Monetary and Fiscal Policy this morning to talk about the interrelationship between monetary and fiscal policy and what this means for the economy.

As you know, the bond market is a mess and interest rates remain in the 20-percent range despite the impending enactment of the most severe budget cuts in our Nation's history. One of the main reasons we are making these massive and excruciatingly painful cuts is precisely to help the bond market and to reduce interest rates by reducing Federal credit demands. Yet, the markets remain skeptical.

Secretary Regan and others have suggested that, because it has failed to maintain consistent, moderate growth in the money supply, the Federal Reserve may be responsible for the present interest rate situation. The markets have been fooled by the Fed so many times in the past. So it appears the markets are going to wait and see whether the Fed keeps its promises before they react by bringing down interest rates.

The same may also be said of the Congress and its actions on the budget, although I believe the Congress has shown sufficient good faith for this to have been reflected in the bond market by now if this were the only factor.

So it is clear that our Nation needs both a sound monetary policy and a sound fiscal policy if our economy is to prosper. If they are not properly coordinated, one may very well cancel out the other.

Larry Kudlow is highly qualified to discuss these issues. We welcome you this morning. He is chief economist for the Office of Management and Budget and was previously chief economist for two large Wall Street brokerage houses.

So, Larry, you are on stage. You may proceed.

STATEMENT OF LAWRENCE A. KUDLOW, ASSISTANT DIRECTOR FOR ECONOMIC POLICY, OFFICE OF MANAGEMENT AND BUDGET

Mr. Kudlow. Thank you, Mr. Chairman.

Let me begin by trying to describe what I think is the centerpiece of the linkage between fiscal and monetary policy.

I think the linkage must start with the budget and the deficit and the credit absorption process which is spawned by a proliferation of Federal Government programs developed during the last 10 years. These deficits and programmatic increases have impacted financial markets in a significant way. To some extent this is perhaps not as well understood as it might be.

I think the demand for credit by the Federal Government has caused interest rates to remain at much higher levels than would otherwise be the case. I think we have had significant gyrations in the movement of interest rates, unpredictable gyrations, occasionally pushing rates to shockingly high levels.

I think this has created a financial market disrepair, and I think this disrepair has spilled over into the economy at large, where capital markets are no longer open to all borrowers in the private sector. Medium- and long-term interest rates have become prohibitively high. Borrowers have had to postpone financing necessary to replenish plant and equipment, to develop new technology, to improve existing technology, to shift into new product lines, and to create, of course, additional capital formation necessary to expand productivity and jobs.

So my first point is to suggest that the proliferation of Federal credit demand through the budget, off-budget, and even off-off-budget loan guarantees and other financing techniques, has had a significant impact in disrupting financial market behavior, keeping interest rates extraordinarily high and causing considerable gyrating in the markets, all of which has caused a weakness in market confidence and has tended to deny private-sector borrowers access to long-term credit.

I also feel that in this issue of budget deficits and credit demand, new announcements by the Federal Government have a significant impact on the movement of interest rates, particularly in the short run. I wish to draw your attention to a couple of important examples.

You may recall several years ago in 1976 interest rates by and large were declining and, as I recall, long-term Government bond rates had slipped all the way down to about 7¼ percent by the late fall of 1976. That would be a very admirable objective today.

In early 1977, the financial markets eagerly awaited the budgetary presentation by the new administration and, as it turns out, that presentation was enormously disappointing and suggested a continuation of large budget deficits and heavy Federal credit demand.

The bond market almost overnight turned from a dramatic bull market to a much more pessimistic bear market, and long-term interest rates rose by about 50 basis points, which at that time was a shocking movement in a short period. Today 50 basis point gyrations are nothing. But in the relative stability of the mid-1970's, any turnaround of 4 or 5 points was considered major. And, I would argue that this was a direct consequence of the disappointing budget announcement made in January 1977, which suggested that in the future years the Federal credit demand would continue, monetary policy would be interrupted and complicated, interest rates would be higher, and inflation would become worse.

Hence, we saw this immediate market impact resulting from the budget announcement.

I think down through the late 1970's we saw similar effects. In late 1979, for example, after considerable monetary tightening, financial markets again eagerly awaited the administration's budget plan in the hope that an anti-inflation policy was beginning to unfold and a reliable trend of lower interest rates would be created.

Regrettably, the budget plan presented by the administration in early 1980 proved to be a terrific disappointment, and we saw new chaos in financial market activity, with long-term rates, for example, rising to 11, 11½, 12, and then 12½ percent in the winter of 1980. And this was another situation where the budget announcements had a major effect on the movement of interest rates.

The movement of interest rates causing enormous financal disruption again had an impact on the economy as borrowers were denied access, capital formation was prevented, normal liquidation of balance sheets was impossible, and we wound up having considerable decline in economic activity.

The point of all this is to suggest we are living in an era when the Federal Government has become such a significant factor in all of its many forms in financial market behavior that announcements of new policy by the Government can, by themselves, affect interest rates in a significant way. And the implications for public policy in this regard are quite significant because it suggests that budget process and deficits and credit plans by the Government are now center stage, no longer an arcane, esoteric thing. Now financial markets around the world react quickly and significantly to the changes.

The linkage of the Federal Government through the marketplace can be elaborated in another way. We are witnessing, to our dismay, unprecedented borrowing requirements in the open market. In 1981, the administration inherited a very difficult public finance situation where, during the first 6 months of fiscal 1981, from October through March, the Treasury Department had to raise $63.5 billion in new money. This was a record borrowing for the first half of any fiscal year, and when we compared it to the 1970-80 period, the previous 10 years, we found the 1981 performance was running 61 percent ahead of the first-half fiscal borrowing in the previous 10 years.

That was quite an accomplishment. And incidentally, it is my judgment that one reason interest rates are higher, higher than any of us would like, and one reason for the upward pressure on interest rates during the late winter and spring months of this calendar year, is this extraordinary burden of new Treasury finance.

But that doesn't tell the whole story. We at the Office of Management and Budget have been tracking what we call the Federal credit budget in its many manifestations, and in that regard we find the total financing burden of loan guarantees, indirect loans, Government-sponsored enterprises, and the like as a much more significant number than even the $63.5 billion which came from the budget financing and the direct off-budget financing.

For example, we found in calendar 1980 that the Federal Government was responsible for credit absorption in the private sector of $124 billion, which is really more than twice the sum of this $63.5 billion I described earlier. And when we put State and local borrowing on top of the absorption of the Federal Government, we found total public sector finance was almost $165 billion.

Now, many analysts have argued that Federal Government deficits do not have much of an impact on interest rates or inflation. And, typically, they bring out charts and figures showing that Federal deficits as a percentage of GNP or as a percentage of all credit market activity is rather small, and sometimes the case is made that the ratio of Government borrowing to total credit has changed very little over the past 10 or 15 years.

However, I am saying that we are measuring this credit demand inaccurately and must take account of the myriad of off-budget and off-off-budget agency financing which is occurring to the tune of almost $125 billion in 1980, with higher estimates for 1981 and 1982.

By the way, what we find is public sector credit absorption, too, in nearly 42 percent of all funds raised in the U.S. capital market in 1980, and OMB estimates suggest that we will take in 46 percent of all funds raised in the U.S. capital market in 1981.

That is a significant increase from what was taking place in the 1960's and the early 1970's.

For example, between 1965 and 1969, using this same measure of total public credit absorption, it came to only 25 percent of credit market activities. So this has nearly doubled in the intervening 15 years. And perhaps even more important, the Federal share of this total credit absorption has increased from 12 percent in the late 1960's to 38 percent in 1981. That is in effect more than doubling.

And this, I think, gives a more accurate picture of the sort of interest rate pressures which have been developing in recent years as the result of the huge growth in Federal credit commitments which are financed in the open market through one agency or another, as well as through the Treasury, and which have a lingering and adverse effect on interest rate movements.

In my judgment, the whole structure of interest rates has been held up abnormally higher than what we might expect in the absence of this massive public sector credit demand. And the disrepair of the financial market coming from these abnormally high-interest rates is also a reflection of the fact that the Government is absorbing billions of dollars of scarce, private sector saving which might be otherwise channeled to far more productive use in building new plants and equipment, venture capital, and new technology, ultimately leading to expanded job creation and lower unemployment.

Now, the fiscal-monetary linkage becomes much clearer when viewed in this light. If we recognize that these public sector credit demands have an interest rate effect, and the mere announcement of public sector credit demands have an interest rate effect, we see why monetary policy is heavily influenced by Government credit policy.

And when these sorts of interest rate pressures develop down through the years—yielding in recent times, record interest rates—then we understand why the job of central banks and the Federal Reserve in particular has become so difficult. I think it is incumbent on the Government to recognize that its budget and credit policy has substantially interfered with and complicated the conduct of monetary policy and has made the Federal Reserve's admirable effort to constrain the growth of money that much more difficult.

I will also point out, as I have in my testimony, that the relationship of credit demand by the Government sector and deficits and the rate of growth of money is a relationship which probably deserves, I think, more significance than it has generally been accorded.

My view is that the deficits by themselves, which have been growing steadily in the 1970's, correlate very nicely with the rate of change of money growth. It is not a perfect relationship—quantitative relationships never are—but we find a clear association in that regard.

And, frankly, I feel as we undertake more statistical work and fold in our budget analysis and revise the budget financing numbers to totally reflect the credit demand of the public sector, we will see the relationship between credit demand and money growth become statistically more significant.

The point is very simple. With interest rates very high, raised, I think, in large measure by this Government credit demand, it is very difficult for the central bank authorities to withhold or deny the provision of credit in the short run to businesses, individuals, households, and consumers who, of course, have desperate need to get their hands on additional money and credit. And this notion of high interest rates crowding out thousands and thousands of borrowers from the money markets puts the central bank in a defensive and difficult position. It is no wonder, in my judgment, with this sort of Federal budget and credit policy, we have witnessed an expansion of money growth during the 1970's.

I would point out continuing linkage from the budget to money growth, that there are clear relationships between the rate of money growth and inflation. I think there is a long literature on this—well documented, numerous scholars, financial economists, and the like. The quantitative evidence, I think, is overwhelming. I have, for the record, written some of this evidence in my prepared statement.

We find that in the 1965 to 1980 period there has been a gradual increase in the rate of money growth. This has been accompanied by an acceleration in the rate of general inflation.

I would add that in my judgment sustained inflation year in and year out is always a monetary and financial phenomenon. Whatever the individual sector shocks from energy prices or food prices or whatever the cause, these are temporary and are not the causes of sustained long-term inflation. Without increasing money growth to finance price pressures, it would be impossible for the general level of prices to rise. I think it is important to recognize that inflation is indeed a monetary phenomenon, although the equation is not quite so simple in terms of reducing money growth when Federal budget and credit demands are as substantial as they have been in recent years.

In addition, I would carry the analysis from credit demands to money, and from money to prices, and also from money to prices to interest rates. We reprinted in the prepared statement a brief chart showing the movement of inflation, money, and interest rates in the last 15 or 20 years.

I think interest rates, as we have learned, respond quickly to inflationary expectations. Of course, my argument is that Government budget and credit policy by itself is a major influence on these inflationary expectations.

One of the things many of us have found in recent years is that these budget announcements tend to suggest to the marketplace future monetary growth patterns. Large deficits and heavy credit demand hint at increased money growth, which causes interest rates to rise because lenders demand a higher inflation premium. That is the most volatile and significant portion of the interest rate calculation.

Hence, when we follow the linkage again, the fiscal and monetary policy, budget announcements, deficits, credit demand on the one side, working through disruptive financial markets, raising the structure of interest rates, denying credit to needy borrowers, force all too frequently the hand of the central bank to increase the growth of bank reserves and money, which in turn raises the actual inflation rate and drives interest rates even higher.

I would also like to take this linkage through monetary policy and into the tax sphere. What we have found is that the collision of rising inflation and a progressive tax code in the 1970's has had one of the most debilitating effects on the real economy, on saving, and on investment. One of the charts I have in the prepared statement shows the substantial tax bracket creep which has occurred in all the main areas of the tax code—half the median income, the median income, and twice the median income. And I believe twice the median income tax rates have jumped by 95 percent in the period 1965 to 1980.

This suggests that the return on work effort and the return on saving investment in after-tax yields has declined, and this has undermined the vitality of the economy. It has undermined the vitality and strength of incentives of individual agents and firms in the economy and in the aggregate has had a deleterious effect on overall activity.

I believe I have one chart to briefly make that point, where we can see clearly that the expansion of deficits is accompanied by an increase in inflation which is accompanied by a reduction in productivity, which is accompanied by an increase in the unemployment rate.

What we are seeing, I think, is very clear. It needs to be recognized explicitly as one of the fundamental issues regarding public policy in the economic and budget area. That is, again, the linkage between fiscal and monetary policy starts with the budget, moving through deficits and overall Government credit demand, affecting interest rates adversely, interfering with the appropriate conduct of monetary policy, all through the rising money growth and interest rates.

This, in turn, spills over into the tax sector where a sort of tax-brake effect inhibits investment and economic growth. That, in turn, causes reduction of saving, investment, and capital, a lowering of productivity, a weakening of job markets, and an increase in unemployment.

And this is no abstraction for an economist in the Budget Bureau, because when the economy weakens and inflation rates rise, we pay for this dearly in terms of a widening budget deficit and even greater Federal financing requirements.

A 1-percentage-point change in the unemployment rate is likely, over a 1-year period, to raise the net deficit by about $20 billion. We are forced to increase outlays on the expenditure side, to cover income maintenance and unemployment insurance, and we also lose valuable tax revenues on the other side because of the lost output and the higher unemployment.

There could be $20 billion swings caused by the 1-percentage-point increase in unemployment because of the collision of tax rates and inflation and the general undermining of the economy.

Again on interest rates, a 1-percentage-point change in short-term interest rates is worth about $3.5 billion in additional budget outlays to pay the interest on the national debt; $3.5 billion would go a long way regarding budget programs in the defense or the nondefense area; $3.5 billion represents the best efforts of members of the executive branch and the legislative branch to close the budget gap and create a more creditable fiscal policy.

So, with one movement of 1 percentage point in the short-term money market, we can wipe out the $3.5 billion of good work done on the budget in a variety of places.

And on inflation, cost-of-living adjustments which are pervasive throughout the economy cost about $2 billion for a 1-percent rise in consumer index.

When we begin to aggregate the effects of monetary inflation and rising interest rates and so on, we find there's a sort of vicious-circle effect going on here, where bad policy begets deteriorating financial market and economic conditions, and the deterioration in financial and economic conditions in turn begets even worse budget policy later on.

What I am suggesting is that the interaction of fiscal and monetary policy is another way of discussing the overall interaction of the economy and the budget. And we recognize that in order to remove ourselves from this debilitating vicious circle, we will need a dramatic change in budget and credit policy of the U.S. Government to significantly discipline expenditures, in order to reduce deficit finance, to curtail the credit absorption which has become heavily excessive, and to improve the conduct of monetary policy.

And, of course, this is what President Reagan's overall economic budget program is designed to do.

In my judgment, this represents an important first step in that direction. We have entailed a dramatic reversal, a 180-degree turn in budget and financial policy in 1981, and with the help of the Congress, we feel we can work toward a better tax situation, a better regulatory situation, an improved inflation situation, lower interest rates, and a more stable and sound financial market behavior, which by themselves can work us toward a better investment and economic growth in the 1980's.

But as a budget economist, I have to come back to where I began. I think the blame rests squarely on our shoulders, and I think we have to deliver on our promises and we have to affect our policy over the period of several years so we can convince financial markets that we are serious and determined. We will remove this onerous credit absorption demand which has caused the financial and economic disorder that we all wish to reverse. Thank you.

[The prepared statement of Mr. Kudlow follows:]

PREPARED STATEMENT OF LAWRENCE A. KUDLOW

Mr. Chairman and members of the committee, I am pleased to have the opportunity to appear before you today to discuss the linkage between monetary and fiscal policy within the context of the President's program for economic recovery.

Let me first emphasize the fiscal objective to discipline Federal expenditures, eliminate deficit finance and substantially curtail public sector credit absorption. In recent years expanded Federal credit demand and numerous upward budget revisions have intensified inflation expectations, disrupted financial market activity, and frustrated the conduct of monetary policy. All this has contributed to record interest rates, double-digit inflation and weakened economic performance.

The relationship between budget announcements, inflation expectations and interest rates is well illustrated by events in late 1976 and early 1977. During 1976, interest rates on long-term government bonds declined to about 7¼ percent, aiding the recovery in investment and real output growth. Fiscal and monetary policies were moving along a non-inflationary path, and business confidence was reviving.

However, as yearend information regarding the newly elected Administration's 1977 budget and deficit plans reached the market, long-term rates abruptly reversed direction. Inflation fears were suddenly re-ignited, and government bond yields retraced back to 7¾ percent in only a few months. Expansive budget policy caused a major financial turn for the worse. At the time, a 50 basis point credit market adjustment was considered a substantial and unsettling change.

There are additional examples of the budget announcement effect. After a tightening of monetary policy in late 1979, inflation expectations had moderated slightly and long term government bond rates declined. As a follow-up to monetary restraint, credit markets anxiously awaited the previous Administration's new budget package, heralded in advance as a policy of restraint. Instead, the budget plan projected rapid outlay growth of 14.3 percent for 1981, with a deficit of $55 billion. Negative expectations swept the financial markets immediately. Government bond rates jumped to 10⅝ percent in January and escalated to 12½ percent by early March. As a result of new pessimism over the future value of financial assets, the price of gold passed through $800 per ounce and short-term interest rates exploded to around 20 percent.

Inflation expectations intensified during the early winter of 1980 because the budget announcement implied continued deficits, more rapid money growth, accelerating future inflation and escalating interest rates. Not until the major budget revisions of March and April 1980 was there any dampening of inflation fears and relaxation of tight credit market conditions. And this easing of financial markets was short-lived, as budget outlays and deficit estimates were again adjusted upward during the summer and autumn months, and interest rates spurted once more with the budget induced revival of inflation expectations.

The breakdown of fiscal policy, and the related volatility of money and credit market behavior, also has acted as a significant deterrent to economic growth. From the fourth quarter of 1978 to the end of 1980 real growth increased at an average annual rate of only 0.7 percent while inflation accelerated to an average of about 9.0 percent. Substantial inflation premiums were built into long-term rates, along with new risk premiums to reward investors for the heightened uncertainty and frequent gyrations that became commonplace in the credit market. Investment horizons were shortened.

As another reminder of the damaging effects of deficit finance, during the first half of fiscal year 1981 financial markets were forced to absorb a record level of Treasury borrowing. Net new borrowing amounted to $63.5 billion during the October–March period, an increase of 69 percent from the average rate of first half new borrowing during the past 10 years.

But even this fails to capture the total credit absorption for public sector use. In addition to new Treasury borrowing from the public, the government has absorbed substantial additional amounts of private saving to finance government guaranteed loans and to finance various government sponsored enterprises. The loan guarantees include programs for housing stabilization and subsidies for agriculture, energy promotion, education and small business. Government sponsored enterprises include the Student Loan Marketing Association, Federal National Mortgage Association, Farm Credit Administration, Federal Home Loan Bank System, and the Federal Home Loan Mortgage Corporation.

When these credit demands are added to explicit Treasury borrowing and State and local borrowing, total new credit absorption by all levels of government and government sponsored enterprises comprised 42 percent of all funds raised in U.S. credit markets in 1980. OMB estimates suggest that this will rise to 46 percent of all U.S. credit market financing in 1981.

CREDIT ABSORPTION FOR FEDERAL AND FEDERALLY ASSISTED USES

[Fiscal years; in billions of dollars]

	5-yr averages					1980 actual	Current estimates	
	1955–59	1960–64	1965–69	1970–74	1975–79		1981	1982
Total funds raised [1]	37.1	52.0	80.6	156.9	309.4	344.7	[2] 361.0	[2] 403.0
Federal borrowing	2.1	4.5	6.4	13.0	56.0	70.5	[3] 71.0	[3] 60.0
Guaranteed loans	4.7	4.4	5.2	14.4	14.8	32.4	[3] 48.0	[3] 48.4
Government-sponsored enterprise borrowing	.4	.7	1.0	5.0	12.9	21.4	[4] 18.2	[4] 24.9
Funds raised under Federal auspices	7.1	9.6	12.6	32.4	83.8	124.4	137.2	133.3
Federal absorption (percent)	(19)	(18)	(16)	(21)	(27)	(36)	(38)	(33)
Tax-exempt borrowing	5.0	5.5	7.9	14.3	20.4	[2] 23.6	[2] 31.0	[2] 34.0
Deduction for double counting with guaranteed loans	.2	.5	.6	1.5	.7	4.1	3.3	3.2
Total raised for all Federal and federally assisted uses	11.9	14.6	19.9	45.2	103.5	143.8	164.9	164.1
Total absorption (percent)	(32)	(28)	(25)	(29)	(33)	(42)	(46)	(41)

[1] Funds raised by nonfinancial sectors. Source: Federal Reserve Board, "Flow of Funds Accounts," except 1981 and 1982.
[2] OMB staff estimates derived from Treasury, CBO, DRI, and OMB data.
[3] Based on March budget revisions estimates.
[4] Based on January budget estimates.

Between 1965–1969, average credit absorption for public uses amounted to only 25 percent of total funds raised in U.S. capital markets. The average for the early 1970's jumped to 33 percent, and the estimate for the average of 1980–82 is 43 percent. Credit absorption under Federal auspices alone was 16 percent of total capital market financing in the late 1960's, rising to 27 percent in the late 1970's and an estimated 38 percent in 1981.

The effect of this activity is to absorb valuable private sector saving and to place upward pressure on interest rates. The total effect of the massive public sector credit absorption and the abnormally high interest rate levels substantially complicates and interferes with the conduct of monetary policy.

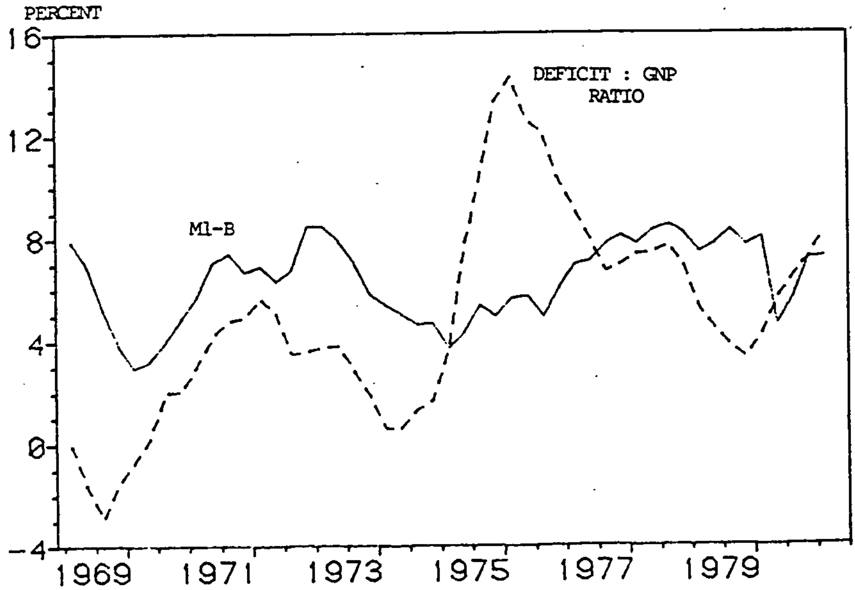
In these circumstances the fiscal linkage with monetary policy becomes obvious. Although the relationship is not precise, evidence suggests a strong association between government deficits, borrowing and money growth. During the past decade this relationship was broken only briefly in 1975 and 1976, when several special factors converged to attract unexpected foreign demand for U.S. government securities. Other than those two years, the association between government deficits and money growth holds up well.

There is also a reasonably clear relationship between money growth and inflation. Sustained inflation is primarily a monetary phenomenon. Over time, continuous increases in the general price level can occur only when the rate of money growth exceeds the rate of growth of real goods and services. As the following graph suggests, the imbalance between real product and money, as measured by the rise in the ratio of money supply per unit of output, correlates closely with the increase of the price level.

The movement of interest rates is also heavily influenced by monetary changes or expected monetary changes. Market interest rates are comprised of 3 components. First, the natural or real rate, which varies little over time, and is influenced by changes in the productivity of capital. Second, the risk premium, is a function of the creditworthiness of the security and, recently, the volatility of financial market behavior.

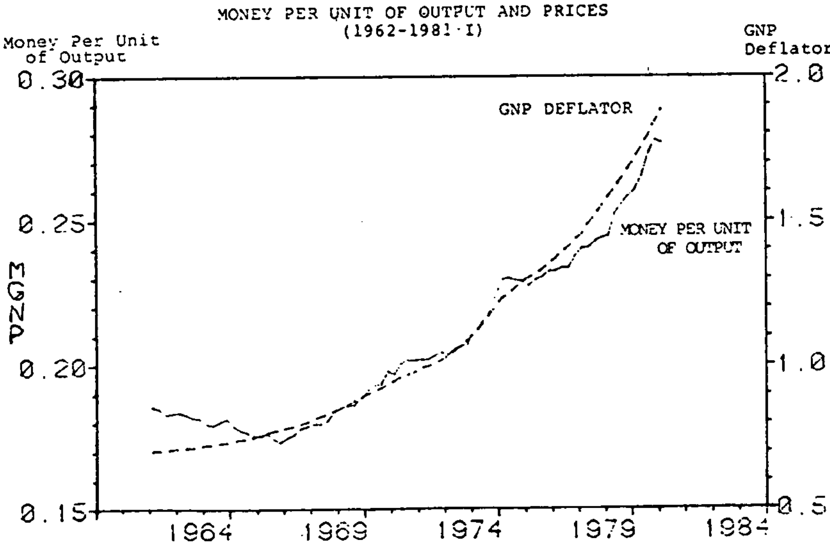
Third, the inflation or price premium, is a function of the expectation of future inflation and the future purchasing power of money. The inflation premium is

DEFICITS AND MONEY GROWTH



SOURCE: Federal Reserve Board; U.S. Department of Commerce

MONEY PER UNIT OF OUTPUT AND PRICES
(1962-1981·I)



SOURCE: Federal Reserve Board; U.S. Department of Commerce

by far the most volatile interest rate component. Lenders and borrowers are constantly adjusting the inflation premium in response to changes in fiscal and monetary policy. As the following table indicates, there are clear associations between the movement of money growth, inflation and interest rates.

MONEY GROWTH, INFLATION, AND INTEREST RATES, 1956–80

	1965–64	1965–74	1975–80	1977–80
M1B growth (yearly percent change)	1.94	5.55	6.62	7.40
GNP deflator (yearly percent change)	1.99	4.80	7.52	7.66
90-day T-bill rate (yearly average)	2.77	5.50	7.48	8.51
20-yr average Government bond rate	3.8	6.0	8.8	9.2

Source: U.S. Department of Commerce and Federal Reserve Board.

The fiscal-monetary linkage—moving from expanded public sector credit absorption to excessive money growth to rising inflation—has worked to undermine the economic saving-investment process in two important ways. First, as a hedge against inflation investors seek to protect their wealth by shifting portfolios out of productive financial assets such as stocks and bonds and into non-productive tangible assets such as gold, silver, and other commodities. Second, the collision of the steeply progressive tax structure with accelerating inflation has substantially raised marginal tax rates and reduced after-tax rewards for work effort and saving.

	½ median income		Median income		Twice median income	
Year	Income	Marginal rate (percent)	Income	Marginal rate (percent)	Income	Marginal rate (percent)
1965	$3,900	14	$7,800	17	$15,600	22
1980	12,300	18	24,600	24	49,000	43
Increase 1965–80		29		41		95

Note: Marginal income tax rates for 4-person families.

This tax brake effect has undermined investment and output growth during the 1970's, and is a direct result of the linkage between public sector credit demand, excessive money growth and accelerating inflation. Among the most visible economic consequences have been the decline in productivity rates and the rise in unemployment. These issues could be explored exhaustively, but in brief terms the following data paint a bleak picture.

AVERAGE GROWTH RATE

	Level of the NIA Federal deficit (billions)	GNP deflator	Output per hour [1]	Unemployment rate
1960–65	–$2.1	1.6	3.4	5.2
1966–70	–5.0	4.2	1.9	3.9
1971–76	–29.7	6.4	2.1	6.4
1976–81	–42.6	9.5	.7	6.8

[1] Private business sector.

From a budget standpoint, the effect of rising inflation and unemployment is substantial. Each percentage point increase in the average unemployment rate adds approximately $9 billion to outlays. A rough rule of thumb suggests that a 1 percentage point increase in the unemployment rate may reduce Federal receipts by as much as $12 billion and increase the deficit by roughly $20 billion. For inflation expectations, each percentage point increase in market interest rates adds roughly $3½ billion in outlays for interest expense on the national debt. In addition, each percentage point gain in the Consumer Price Index results in nearly $2 billion in cost-of-living adjustment related outlays.

In sum, the linkage between fiscal and monetary policy, and the economic effects of this linkage, is not an abstract matter. Another decade of accelerating Federal budget growth and massive government credit absorption virtually insures a continuation of the trend toward financial disorder, higher inflation, weaker productivity and rising unemployment. In turn, these trends insure a continuation of widening budget deficits and even greater Federal credit absorption.

With financial markets increasingly a government monopoly, U.S. business will be unable to replace obsolete plant and equipment, product lines will become outdated and unprofitable, and balance sheets will become dangerously illiquid. Venture capital will dry up and entrepreneurial innovation will falter. Our export position will deteriorate in a manner entirely consistent with the slump in investment, productivity and real output.

To prevent this, immediate steps must be taken to repair the existing financial market disorder and reopen long-term credit markets to the private sector. This cannot be achieved without a major reversal in government budget and credit policy—and this is precisely what the President's dramatic budget control plan is designed to accomplish.

When combined with the related elements of an incentive minded tax policy, regulatory rollbacks and monetary restraint, a cooperative interaction between fiscal and monetary policy can produce the desirable mix of financial market stability, lower inflation, and economic growth. The combination of sustainable growth and reduced inflation provides the surest and quickest path to a balanced budget, a restoration of fiscal credibility and a reliable value of money.

Senator JEPSEN. I want to compliment you on your statement and discussion about the monetary and fiscal policy. I will see to it that printed copies of this hearing will be distributed to many organizations. I thought it was crisp, clear, precise, and one of the best I have ever heard. It helps me to understand the issues even better.

I want to ask your interpretation of some of the buzz words used.

What is the difference between off-budget and off-off-budget?

Mr. KUDLOW. Well, perhaps the best way to do this is to refer to the prepared statement.

The budget deficit, starting at the very beginning, is, of course, the excess of expenditures over revenues reported by Government. On top of that, we have something called the off-budget deficit which is principally the activities of the Federal Financing Bank, a very small portion, less than 1 percent of total off-budget activity is generated by the Rural Electrification and Telephone revolving fund, Rural Telephone Bank, Postal Service fund, U.S. Railway Association, and Synthetic Fuels Corporation.

Senator JEPSEN. May I stop you there. When you say "off-budget," is that the ones where the Government specifically will go into the money market and borrow at what the current rate of interest is, say 17 percent, and under a given program will loan the amount borrowed for 2 percent or 4 percent?

Mr. KUDLOW. Yes; some concessions are granted to those agencies, granted under the direct aegis of the Treasury. And they are financed through the issuance of Treasury securities. And, typically, when we discuss Treasury borrowings, we are referring to all Treasury borrowings, budget and off-budget. But I want to stress the off-budget section is primarily the FFB, the Federal Financing Bank.

Now, in addition to that, we have, as the text suggests, a number of programs where the Federal Government guarantees certain loans. And, of course, these loans have to be financed in the open market.

On top of that, there are Government-sponsored enterprises. And going through the list, the loan guarantees include programs for housing—that, by the way, is about 60 percent of the total loan guarantees—subsidies for agriculture, for energy, for education, and for small business. The so-called Government-sponsored enterprises include—and I think these are well known—the Student Loan

Marketing Association, Fannie Mae, Federal Home Loan Bank System and the Federal Home Loan Mortgage Corporation.

Senator JEPSEN. Are these the off-off?

Mr. KUDLOW. These are the off-off, and I suppose in some ways the off-off-off because the loan guarantees are perhaps a little closer, but that is a distinction I think need not be made because the key point is that the Federal Government is, in effect, either directly or indirectly, guaranteeing the financing of these activities. And as a result of those guarantees, the Federal Government is ultimately responsible for the absorption of credit from the private sector.

Senator JEPSEN. Then Federal activities in the credit market are the primary reasons for this credit expansion?

Mr. KUDLOW. That is right. The expansion in credit today can be directly traced to the growth of these commitments and these agencies.

And this is a relatively recent development. This is not something we have had for 40 or 50 years. This is something which has grown up in leaps and bounds in the last 5 or 10 years.

And one of the reasons I have this chart in my prepared statement with all the excruciating detail is to try to point out that much of the growth in total Government absorption of credit comes from the Federal sector.

If you trace the Federal participation rate, which is about midway down the chart, you can see that just looking at the 1970's we have moved from 29 percent in the early seventies through 42 percent in 1980, estimated by OMB at 46 percent in 1981. And that is a heavy rise and we cannot blame this on State and local governments. We have to take the blame ourselves.

You can also see in 1982 we are estimating reductions in guaranteed loans of almost 18 percent. And that is part of the President's budget and credit program where we are trying to roll back the growth of these off-budget credit activities.

Senator JEPSEN. Now, there is a correlation, is there not, in the Government causing credit expansion and the increase in interest rates?

Mr. KUDLOW. Right.

Senator JEPSEN. Do you know how much Federal credit activity is needed to influence interest rates? How much would the Government have to borrow to increase interest rates by 1 percent?

Mr. KUDLOW. It would be really difficult, sir, to calculate this in any precise fashion, although I will say that ongoing work is proceeding, to try to answer that question.

It has been fairly recent that the Government has in any organized way tried to collect this sort of credit budget information in any ongoing fashion. There have been ongoing studies published by OMB, and there has been some interest generated in this, but one of the reasons I was happy to come up here and accept your invitation was my judgment we would like to publicize this as much as possible because I think too many people, economists and noneconomists, tend to downplay the importance of Federal credit demand. When they do that, they are suggesting they are only looking at a small sector of credit demand. So we are trying to factor this in and also are trying to increase our own calculations and projections and are trying to more precisely estimate the interest rate effect.

But I will say as a former financial market economist that it is very clear to me that the saving absorption by all these programs, the private savings siphoned off by all these programs, is having a significant interest rate effect. I would argue as a general matter that wherever the level of interest rates might be, given inflationary expectations, given certain economic and credit demands, supply relationships, interest rates will be higher as a result of this effect.

Senator JEPSEN. You see, there is a problem involving off-budget items that I sense and see from personal experience in the committees. When we start working on individual authorizations we have a goal of coming in under the budget. Now, the off-budget says we take and load money into a program for which the Government has borrowed, we'll say for conversation, at 18 percent, and we loan it at 2 percent.

Now, when you get down to trying to hold things to a budget and we're talking about these loan programs, many who are in a position to vote will say, "This is not an expense; it is simply a loan."

Mr. KUDLOW. Right.

Senator JEPSEN. So, how can you consider this in the budget?

However, some of us lay folks who are not economists can at least add and subtract and we will say, "Well, now, when you borrow money at 18 percent and loan it at 2 percent, you have to include that difference in the budget. Somebody has to pay for it."

But there still is a tendency to try to gloss over that issue, some maybe with good intentions and not quite understanding it, and others maybe understanding the issue and still wanting to gloss over it and while pretending there is no problem.

One of the reasons the country is a fiscal mess is that people love to play Santa Claus—they think it's fun to spend other people's money; the feeling is it doesn't really belong to anybody and it feels so good to bestow it on folks.

That's the same mentality that exists in this off-budget issue. And when it exists with the off-budget, think of how difficult it is for some who don't seem to understand the off-budget to understand the off-off-budget. Now, you have introduced a new dimension to me this morning, the off-off-off-budget.

Mr. KUDLOW. I think in general there is a somewhat enlarged recognition of the financing implications of Government programs, and I think that has surfaced in this session of Congress.

But I also feel that, as you say, there is still an inadequate recognition, and one of the reasons for that inadequate recognition is the relative obscurity of these off-budget programs. I think it behooves budget analysts in all the parts of the Government to make known to the public and elected officials exactly what these programs are, exactly what the numbers are, exactly what the aggregates amount to, so people can understand just how significant the issue really is.

I don't know how often I have heard the view that budget deficits don't really matter because in relation to the overall economy or other aggregate ratios deficits haven't increased very much in recent years.

And the flaw in that argument is twofold.

First, a deficit is a deficit and has to be financed at a given moment in time. If market conditions are not receptive, there's a problem, no matter what percentage of the GNP that deficit may aggregate to.

Second, the calculation of deficits is greatly inadequate because we must factor in all these additional credit agencies. When we do that we find the first argument about the relative small size no longer holds anymore; we have had a major expansion in financing requirements by the Government when measured properly. I think this set of facts and these new relationships and their financial market implications—no one wants higher interest rates—need to be publicized as widely as possible.

Senator JEPSEN. Do you feel that this administration is adequately reflecting in its economic program projections, its recommendations and budgets, a sensitivity and understanding of the off-off-budget issue and the things that aren't quite so apparent but should be included in the deficit? I think I understood you to say they should be included in economic considerations?

Mr. KUDLOW. Yes.

Senator JEPSEN. Do you think this administration is doing that?

Mr. KUDLOW. I think we have made a good start. I don't know whether we have carried the ball as far as it needs to be carried.

Senator JEPSEN. Do you think—forgetting about the political partisanship—the last administration did? I mean, this isn't a newly discovered, newly verbalized dimension of budgeting that has crept up like cat's-paws in fog and all of a sudden, whammo, it hits us now. It's been going on for years. We have gone from 12 percent to 38 percent since 1965 in the Federal share of credit consumption and nothing much has been said about it, as I remember, in past years. Has it or was it?

Mr. KUDLOW. No; in the public sense I think you are absolutely right.

Senator JEPSEN. Has someone warned about that since 1965?

Mr. KUDLOW. Well, I don't know about the history of the analysis. I think the totals were probably sufficiently low in the mid-1960's as to warrant a certain degree of obscurity which they eventually gained.

I think, however, in the 1970's, particularly in the second half of the 1970's, sophisticated budget analysts were aware of these emerging developments. And there have been some special studies. As I mentioned, I know the Office of Management and Budget published one last year which is quite good and is in effect a primer on this, and we are all learning from it, myself included. The Congressional Budget Office has also done work in this area.

But, I think the important point here is the need to make these new analyses more public, and the need to link, as I have tried to do this morning, this massive credit absorption with developments in the financial markets, that is, interest rate behavior, and with developments in the economy.

One of the key linkages we tried to develop at OMB in the last 4 or 5 months is the notion of the significance of the financial market to the rest of the economy. If we continue burdensome financing requirements and the absorption of scarce saving, and if we allow these massive interest rate gyrations to persist, and if we continue to deny the private sector the credit it needs and the capital it needs to rebuild, and retool, we will never achieve the economic recovery everybody desires. No matter how sound our monetary policy may be on paper, no matter how sound our tax policy may be on paper and in theory, ultimately it is a sound budget and credit policy which gives credibility to the other elements of the economic plan. This is a view we feel particularly strongly about.

So I make this linkage: budget, credit, financial market, the economy.

My own judgment is, incidentally, the marketplace today, in the last several months, remains somewhat skeptical. Having witnessed a discouraging trend of rising credit demand, public credit demand, and the effects I have described, the market is saying, "Well, we see some new developments, and we think they are moving in the right direction, but we are not sure and a few months is insufficient time," and therefore the skepticism marches on. And I think we need to address that skepticism in a budget and credit sense frontally, directly, as much as possible.

Senator JEPSEN. You have discussed the impact of the deficit and of off-budget loans on financial markets. However, Government regulations also have financial implications by forcing businesses to borrow to build pollution-control devices and other related facilities. We are all for clean air, and pollution devices should be installed, but it's the impossible wish for the pure air that some people are reaching for that has driven businesses to either go out of business or to require unusually unpredicable amounts of capital.

Has OMB tried to quantify the financial impact of such regulations?

Mr. KUDLOW. We are in the process of trying to put some realistic dollar signs on these regulatory reforms and are trying to relate that to the sort of financial market analysis that I have attempted. We have not completed that yet. As you know, the regulatory reform process is still moving ahead and we have additional proposals coming in 1981. I think we are all trying to develop the right data base and the right application so as not to mislead.

At this point all I can say is I agree wholeheartedly with your general analysis and hope that in the not too distant future we will have some quantitative support for that view.

Senator JEPSEN. I'd like to also probe the psychological effects, the market effects, and the subsequent economic impact that Government projections and forecasts and the release of Government statistics have. As a Senator from a farm State, Iowa, I can assure you that food producers and farmers out there absolutely go right up the wall when the USDA comes out with its fantastic and, most of the time, erroneous projections of the crops and what they are going to be. These announcements cause prices to go up and down like a yo-yo.

I have seen my grandfather's reactions in these cases. I have seen my father's reaction. My brother calls me at 6 o'clock in the morning when the USDA has come out with one of these announcements.

I know they affect markets. I know they affect the very economic well-being of folks. Unfortunately, if you ask, as I have, "Where do you get these figures, how do you vouch for their accuracy?" You get an answer that goes something like this: "We are working on that. We know we've got some problems in that area and it's not as accurate as we would like, but we are working on that."

In the meantime, as has gone on for years, people lose money immediately on the basis of those announcements.

Now, the announcements you're talking about are in respect to monetary and fiscal policy. What announcements are you talking about and who makes them? What announcements affect the monetary policy?

Mr. KUDLOW. Well, I think in a general sense the most important announcements are those concerning the U.S. budget document. When I say, "the document," I refer to all of its tentacles and many programs, off-off, and off-budget.

This is a recent development, it seems to me. I think for a long time people argued that the effect of the budget on inflation, on monetary policy, on tax policy, on interest rates, was not trivial but not terribly significant, either. Many experienced and well-regarded analysts have tended to downplay the budget as a source of expectations and change in the private sector.

However, I think in recent years we have seen how important these budget announcements have become, because the budget is consuming larger shares of national income and GNP, and because all the Federal commitments are consuming larger shares of total credit and saving.

Now, in these newer circumstances it is very clear to me, as a market analyst or a former market analyst, that the effects of budget announcements by the President, by senior Cabinet people, and by Members of Congress, can cause big changes in public behavior, because the implications of these budget developments are coming home to roost.

I raised a couple of examples in my prepared statement, that late 1976 or early 1977 and late 1979 or the early 1980's was a particularly interesting period of time when interest rates, to use the financial market metaphor again—and commodities because commodities, of course, move as quickly if not more so than interest rates—responded immediately and changed direction immediately upon receipt of the new budget information from Washington.

I think today in the current context, announcements by key members of the tax-writing committees, budget committees, key members of the administration, and so forth, have a major effect. If you read the papers, the financial market columns, the commodities columns, and the stock market columns, you see constant allusions to what such and such an official said about a fiscal or budget development and what the implications are going to be for monetary policy, tax policy, and so on. You have this massive guessing game going on in the markets, "What are we going to do next?"

So I think probably in the economic and financial area, much more work needs to be done. We need to have some catching up. But I think there has been a profound change just in the last couple of years.

Senator JEPSEN. Please, let's for the record give some examples, going from those announcements that have the most effect to those that have less. Let's name about six or seven organizations or people in Washington here whose announcements would affect the financial market.

Mr. KUDLOW. Well, I would have to rate the President first on that. In these days, I would say that the Secretary of the Treasury and the Director of the Office of Management and Budget would certainly affect market movements. I would also say that senior Members of both Houses of Congress can affect market movements. I think the tax discussion and the budget discussion and the reconciliation discussion are accorded a lot of attention, and rightly so, and their statements have effect.

The Chairman of the Federal Reserve Board is always a key person in regard to these monetary and fiscal developments.

So I would say those are the key players.

It is also probably true, though I'm not particularly well informed on this, that in specific market areas—you mentioned commodities—I would reckon if the Department of Agriculture makes an announcement about a program or if the Department of Housing and Urban Development makes an announcement about a housing program, that the relevant commodity or financial markets will respond to it very fast.

In other words, you have segmented announcement effects as well as broad announcement effects. I think this is occurring more and more.

In credit market terms, the work of these Government agencies becomes terribly significant. The volume of this effort becomes so important that you have growing up in commodities markets, financial markets, and foreign exchange markets, a whole subculture of analysts and economists and computators and mavens and gurus and what not who are paid handsome salaries in order to keep track of all these developments. I think in the world of private enterprise this is about as good a statement of the importance of Government as anything I can find.

Senator JEPSEN. Some have claimed that the Reagan program for economic recovery is not internally consistent, that a tight monetary policy cannot be reconciled with the President's proposed tax cut. Would you comment on this?

Mr. KUDLOW. Well, I would point out that the tax proposals are part of the overall budget and fiscal plan. Though some of our critics have only recognized this reluctantly or not at all, the fact of the matter is, as we use the most useful analytical tools, our budget reduction plans will shrink the size of Government by significant magnitude in the next 4 years, from 23 percent of GNP to 19 percent of GNP by 1984.

The tax program is expected to shrink the tax share of GNP from about 21 percent in 1981 to 19 percent by 1984.

And, therefore, we find that the Government's share is shrinking at a faster rate than the tax cut.

In fact, we calculate that we are engendering a major change, a major shift in resources, that the combined effect of the budget program and the tax program will shift by 1984 approximately $155 billion from the public sector to the private sector. I do not understand how a massive change of resources from the public sector, which has no profit maximization efficiency constraint, to the private sector which does, can be labeled inflationary. I find that a very difficult argument to take. In my judgment, our tax program is exactly what the doctor ordered right now.

Senator JEPSEN. The Government doesn't use these resources efficiently, then?

Mr. KUDLOW. Well, I might not go that far, but I think it is very clear in rudimentary budget analysis that for many, many years, three-quarters of the Federal budget goes for consumption and current expenditures. I think that is a wasteful use of scarce private resources. My hope is that in the years ahead, the President's tax proposal, when combined with the budget proposal, will cause resources to shift back and will create incentives to use those private resources even more efficiently. I do not feel these resources are currently being used efficiently. I think we have gone way too far. I think that is one of the problems.

Senator JEPSEN. Just for the record, where does the Government get its money? I know it sounds super-simple, maybe, but I want it for the record. Where does the Government get its money?

Mr. KUDLOW. The Government has to raise the money either through public finance in the capital markets or through taxation. Those are the only two sources.

I suppose you could add a third source where it is possible that the Government can create additional money by increasing the supply of essential bank money or monetary base, and this in turn will generate an expansion in bank credit which would then be used presumably to finance the deficits in the whole credit demand. So I guess I'll put that as a third. I usually think of that as a tax or inflation tax but I guess that's a third source.

Senator JEPSEN. Well, a lot of folks think that the Government takes money away from the people before it can do anything to help the economy—that the Government redistributes it, reallocates it, establishes a basis to go out and borrow on it.

Be that as it may, in your statement you discussed a 1 percentage point change in short-term interest rates.

Mr. KUDLOW. Yes.

Senator JEPSEN. And you said that change would be worth $3.5 billion?

Mr. KUDLOW. Yes; I was calculating 1 percentage point changes in three key variables that affect the budget. One was unemployment, second interest rates, and the third the consumer price index.

On interest rates, our estimates suggest that a 1 percentage point rise in, let's say, a 3-month Treasury bill will increase budget outlays by $3.5 billion over the next year or so, due to the added payment on the national debt. I use that number in as many forms as I can, because I sometimes feel that this hammers home the importance of the financial market to people interested in balancing the budget.

Again we can all expend a considerable amount of effort, time, and resources in what we might summarize as political capital, in disciplining Government expenditures in the hope of balancing the budget, only to find that the off-budget and off-off-budget credit demand is causing interest rates to rise and restoring the very budget cuts we have just made.

It is not a cynical view on my part; it is a practical view, because this is one of the principal problems in the budget in the last 2 years when we have had these tremendous gyrations in interest rates going from 20 percent to 10 percent and back up to 20 percent.

I might add it has caused a considerable amount of public cynicism about the credibility of the Washington budget process because it seems as though the promises are never kept. I think, frankly, the intentions have improved a lot in the last few years, but the interaction of the economy and the budget and the interaction of interest rate movements and the budget must be more widely known and appreciated.

Senator JEPSEN. We have heard a lot about the potential inflationary impact of personal tax rate cuts. What response do you make to the claim that they would be inflationary?

Mr. KUDLOW. Well, again going back to the budget portion, I would say that, first of all, we are cutting expenditures when we compare this to total GNP growth. It can't be a static analysis. We have to realize the economy is growing and policy changes need to be made in that framework.

However, I will take the analysis a couple steps further.

I would also suggest that in many respects the President's tax program will merely halt the rise in tax burden and tax rates, that if we factor in various estimates of inflation—take the administration's inflation estimates, other estimates, and factor them in to the normal tax bracket creep—we find that we are in many cases slowing the tax bracket creep or halting it, and we are merely trying to preserve real income. This is not inflationary. This is a counter to inflation.

And, third, besides the resource transfer and besides the counter to inflation, I think significant incentives will be created in many parts of the tax code or the proposed revisions in the tax code.

I am very confident, for example, that the reduction in the top tax rate and the reduction in the capital gains rate will have a significant effect toward improving investment incentives. This, in turn, I think, will create additional incentives to save in order to accumulate money that can be used for investment purposes.

We are raising the after-tax yield on investments, and I think we will see many individuals and many firms take advantage of this. I don't think that is inflationary. Quite to the contrary, I think it is disinflationary. I think it will improve capital formation, and I think it will improve productivity and improve real output growth. In my view, growth is never inflationary; growth is what we need.

Let me make one last comment on the tax bill.

I am not unhappy to see a growing agreement on the need for a multiyear tax cut because I think to some extent that is going to force our hands on the budget side. I think if we can target tax reduction in the out years, this will send a signal to policymakers and financial markets that, given the high priority we all attach to new budget equilibrium and new budget balance, if we are willing to make these tax reductions in order to create new incentives, in order to shift resources back to the private sector, then we are going to have to make good on that promise on the budget side.

In many ways I view the tax reduction plan as a compelling device to keep the momentum going toward the reduction of budget outlays, at least against current service estimates.

So really for all those reasons—the resource transfer, a halt to tax bracket creep, incentives for investment and saving, as well as a compelling device to create initial budget savings, I don't view this as inflationary. In fact, quite the contrary. I view this as an integral part, a complementary part of a broad program regarding the budget, taxes, regulatory rollbacks, and monetary restraint, which certainly has the capacity, if implemented in the next 4 or 5 years, to take a big dent out of the inflation rate.

Senator JEPSEN. You have alluded to incentives and to the effects they would have on creating confidence for capital formation and expansion. Does Government spending—spending, now—have adverse effects on working incentives and private investment?

Mr. KUDLOW. I believe it can and I believe it has in many instances.

Senator JEPSEN. I am interested in the overall theoretical basis for this—the price effects, the reallocation of resources. I have a follow-up question on unemployment compensation which I am leading up to now.

Mr. KUDLOW. Well, one way to measure the tax burden throughout the economy is to recognize first that all Government expenditures need to be financed. So it is money from tax revenues or inflation, which is in effect a tax increase, or Government financing, which is in effect a tax increase.

Senator JEPSEN. And you could include regulation, which is essentially a tax increase.

Mr. KUDLOW. Or regulation which is essentially a tax increase; that's right.

If you recognize that all Government activity has to be financed by the private sector in one form or another, then it is easy to use a ratio of Government spending as a percentage of GNP and to call that the average tax rate for the entire economy. We have seen a gradual edging up from 17 or 18 percent in the early 1970's to 23 percent in the early 1980's. And that is a reflection of the average tax rate increase and a reflection of the tax burden.

Now, in that context I would say, broadly speaking, increased expenditures add to the tax burden and tend to undermine private sector growth.

There are only two ways to go. We have a private sector and a public sector. If the public sector grows, it will grow at the expense of the private sector. If the private sector grows, it will grow at the expense of the public sector.

I will make that a dynamic model, not a static one. It is the rate of growth we are interested in. One of the crucial objectives, as you know, of the President's overall program is to be sure that the rate of private sector growth significantly exceeds the rate of public sector growth in the next few years.

Senator JEPSEN. How important is unemployment compensation as a deterrent to the work incentive?

Mr. KUDLOW. Well, I am not an expert on unemployment compensation. I would only point out in a very general sense that the wisest course regarding Government assistance programs, which are necessary in many cases and which are to some extent embodied in our concept of the safety net—the wisest course for these programs would be to create a financial structure which will reward work. I think whatever the benefit levels are, we need to keep in mind the importance of rewarding work on an after-tax basis.

Senator JEPSEN. Mr. Kudlow, there are some in Congress who seem determined to eliminate the third-year tax cut proposed by President Reagan. How important, in your opinion, is this third-year tax cut?

Mr. KUDLOW. Well, I think it is quite important. We have argued the need to create a new expectation throughout the economy of lower budgets and lower tax burdens, not just for 1 year but for several years.

What we strive for is to create a permanent change in expectations regarding business activity, investment, financial markets, and the like.

As I mentioned before, there is a certain skepticism throughout the economy and marketplace concerning economic policy. And, as you know, there have been a lot of promises made down through the years, and as you also know, some of these promises have been kept for 1 year or 2 years but have been abandoned after that.

And I think from a planning sense, from a longer term sense, from an expectation sense, the notion of permanence is important.

Now, 3 years is not permanent, but 3 years is better than 2 years and 2 years is better than 1 year, and that is the way we look at this. I think 3 years represents a decent horizon, a decent time interval to suggest that we are serious about these expenditures and tax changes, and we won't renege. And 3 years to some extent locks the Government in. I think this is a very important and desirable objective to lock the Government into the commitment we have made.

Senator JEPSEN. Actually, with all your experience in the private sector—you have spoken of experience on Wall Street and so on—can you think offhand of any specific company or any general business that doesn't plan, financially plan, at least 3, 5, or 10 years in advance? Is there any business you know that is very successful that wings it every year?

Mr. KUDLOW. Not many.

Senator JEPSEN. That is what the Government has been doing, hasn't it—winging it from year to year.

Mr. KUDLOW. I agree with you, and in that regard it is worth pointing out, because of the constant fine-tuning and U-turning and flipflopping by Government policy, even the most efficient firms in the private sector have had to shorten their time horizons. What used to be the long run, which is 20 or 30 years for investment, capital formation, machinery, research, and technology and the like—that investment time horizon has been shortened considerably because of the uncertainties surrounding Government policy in many areas. That uncertainty and the shortening of investment horizons has, in my judgment, been a major contribution to the weaker economic performance in growth and investment.

Now, on this 3-year tax plan, the administration has tried to provide in general a 5-year budget and tax plan. We are trying to reduce the level of uncertainty about policy in order to allow efficient private firms and individuals to once again expand their own horizons to the normal planning dimensions you described. One links to the other. They cannot work in isolation.

So in my judgment that is another reason for us to move that horizon out.

As you know, we are stressing this on the budget side as well as the tax side. Attention is perhaps focused on the tax side when it comes to these multiyear programs, but in fact our budget plans have been very straightforward in this regard, and I think that is a very big plus. Now it is up to all of us downtown and on the Hill to implement these proposals and regain some credibility.

Senator JEPSEN. High interest rates are probably on everybody's mind.

Some Wall Street analysts tell us interest rates are high now because of the fear that the Reagan economic plan will cause higher deficits. Some claim that. Other Wall Street analysts tell us interest rates shot up because of the large upswing in money growth earlier this year.

Where is the truth in all of this?

Mr. KUDLOW. Well, I think, as always, the truth lies somewhere in between. I think there are influences operating on interest rates and, as I mentioned in my oral statement, I think budget announcements relating to deficits, credit demands, and total Government credit absorption are playing a crucial role in this interest-rate behavior.

I don't wish to discount the importance of monetary policy. Clearly, swings in money growth also affect inflation expectations and the behavior of interest rates.

I would, however, point out that in recent times, with the proliferation of Government credit demands, it seems to me in many ways the Government's credit position has become a leading indicator of monetary policy trends. I would suggest that markets in many ways have used the Government's credit policy and budget policy as a barometer of what to expect regarding monetary policy and future inflation.

And my sense is, without for a moment downplaying the importance of the monetary trends, that the cutting edge of financial market behavior, at least the bulk of it, has shifted to the budget and the Government's credit policy.

So I find myself to some extent understanding the financial market's skepticism, and I think policymakers have to recognize how important it is that we live up to our objectives and our promises.

Senator JEPSEN. As you know, Congress established a commission to study the role of gold in the international economy last year. I was appointed a member of that commission, and I have been giving some thought to the whole gold issue. I understand that when you were the chief economist to Barron & Stearns, you endorsed returning to some sort of gold standard. Do you still favor a gold standard?

Mr. KUDLOW. I can only say in my current position that the administration has not yet formulated a gold policy. The administration does, however, look with great interest on the work of the Gold Commission. Speaking personally, I think the issue of gold, the monetary role of gold in domestic affairs and international affairs, is a matter which deserves the most serious consideration and study possible. My great hope is that the Gold Commission produces some good research and some strong recommendations which can be evaluated by the administration and Congress.

I think we have learned, however painfully, in recent years that the importance of gold cannot be downplayed. If governments attempt to downplay gold, markets certainly recognize its historic monetary role and its historic monetary value.

And this is one of those cases, in my view, where the markets are sending the policymakers a message. Whether or not we heed the message, the fact is we should study it carefully.

So I have great hopes on the Gold Commission. I think it is a very serious, straightforward effort and deserves prominence in the economic policy discussions in the next few years.

Senator JEPSEN. Mr. Kudlow, thank you very much. This has been one of the most informative and crisply delivered sessions we've had, and I commend you for your knowledge and your personal bearing. If you have no objection I'm going to recommend you for some appearances before some major groups to discuss the financial and monetary policy of this country.

Mr. KUDLOW. Thank you.

Senator JEPSEN. Thank you very much. The subcommittee stands adjourned.

[Whereupon, at 11:20 a.m., the subcommittee adjourned, subject to the call of the Chair.]

[The following letter, together with an enclosure, was subsequently supplied for the record at the request of Delegate Walter E. Fauntroy:]

JUNE 22, 1981.

DR. LAWRENCE A. KUDLOW,
Assistant Director for Economic Policy, Office of Management and Budget, Executive Office Building, Washington, D.C.

DEAR DR. KUDLOW: It has come to my attention that the prepared statement you presented on June 12, 1981, to the Joint Economic Subcommittee on Monetary and Fiscal Policy contained a misleading statement about the impact of public borrowing on credit markets. The statement in question occurs in your prepared statement, where you state that:

> When these credit demands are added to explicit Treasury borrowing and state and local borrowing, total new credit absorption by all levels of government and government sponsored enterprises *comprised 50 percent of all funds raised in U.S. credit market in 1980*. OMB estimates suggest that this will rise to 54 percent *of all U.S. credit market financing* in 1981. [Italics added.]

[EDITOR'S NOTE.—The figures of 50 percent and 54 percent, used in the above paragraph, were subsequently corrected upon receipt of new data to 42 percent and 46 percent, respectively, in Mr. Kudlow's prepared statement. See page 9, first paragraph, this hearing.]

The italicized statements are, I believe, incorrect, and certainly are misleading. The source of the problem is the first table in your prepared statement, which is derived from the Federal Reserve's Flow of Funds Accounts. While the Flow of Funds Accounts use the labels, "Total Funds Raised," the data are in fact net funds raised, that is the increase of total debt outstanding from one period to the next (with some adjustments). As I'm sure you would agree, for most people net increase in outstanding debt is not the same as "all funds raised in U.S. credit markets" or "all U.S. credit market financing," since "all funds raised" in common usage refers to gross borrowing in a period. Gross borrowing, of course, includes loans made from monies repaid on existing loans as well as from new funds entering the credit market from savings or other sources. Moreover, it is not necessarily the case that the distribution of the net increase in outstanding debt is the same as that for gross borrowing. For example, there could be no net increase in outstanding debt from one year to another, and hence no "funds raised" in the technical sense, yet substantial funds could have been raised by different sectors using the repayments on debt previously issued to others. Consequently, I believe that your testimony on this point is an unwarranted, and potentially deceptive, misstatement of actual credit market conditions.

This is by no means a pedantic point, for it points out the distortions that can occur from the use of net flow-of-funds figures in calculating credit absorption rates. For example, Federal borrowing (debt) could have a net increase of $100 billion while all other borrowing (debt) had a net decrease of the same amount; yet, since the "funds raised" figure for all borrowing would be zero, the Federal credit absorption rate using net flow-of-funds data would also be zero. Or, to use another example, Federal debt could rise by $1 billion while all other debt remained the same (i.e., new loans equalled repayments), yet the Federal credit absorption rate would be 100 percent using that approach. These would certainly be erroneous descriptions of the credit market as a whole. The figures you use describe less extreme circumstances, but the potential for distortion exists whenever net flow-of-funds figures are used.

Net flow-of-funds figures especially tend to overstate or understate the significance of Federal borrowing, which tends to have relatively larger or smaller increases than other forms of borrowing depending on the state of the economy and its impact on the budget. Thus, Federal borrowing tends to increase quite sharply in a recession, when tax income lags and expenditures for unemployment and other social programs increase. Such an increase, which occurred in 1974–75 and in 1980, is magnified in net flow-of-funds figures because of the slackening in private borrowing that tends to happen in these periods (although 1980 seems to be different in that private borrowing, especially short-term corporate borrowing, tended to remain high despite the recession). Private borrowing naturally makes Federal borrowing a larger component of a smaller-than-normal net increase in debt, exaggerating its actual impact in the economy.

Because of the biases that overstated Federal borrowing figures can inflict on policy decisions about Federal credit programs, I encourage you to use figures on total outstanding debt as well as those on net flow of funds. The combination is, I believe, more accurate than one set of figures alone. I am enclosing an alternative table prepared by my staff using outstanding debt figures. As you will note, direct and indirect public borrowing represents 36.4 percent of total debt in 1980, which is a lower share than any previous year except 1979. I hope you will use similar tables in conjunction with net flow-of-funds figures in any future presentation, in order to present a more complete and less misleading picture of federal and public borrowing.

Sincerely yours,

WALTER E. FAUNTROY,
Chairman, Subcommittee on Domestic Monetary Policy, Committee on Banking, Finance and Urban Affairs, U.S. House of Representatives.

Enclosure.

CREDIT ABSORPTION FOR PUBLIC SECTOR USES

[Fiscal year-end outstanding debt in billions of dollars]

	1971	1972	1973	1974	1975	1976	TQ	1977	1978	1979	1980
Total outstanding debt owed by nonfinancial sectors [1]	1,447.3	1,610.8	1,818.5	2,011.9	2,193.2	2,445.0	2,511.1	2,825.5	3,210.8	3,625.1	3,973.1
Raised under Federal auspices	465.0	505.0	552.5	577.0	642.3	740.5	759.8	839.3	933.7	1,015.4	1,139.7
Federal borrowing from the public [2]	304.3	323.8	343.0	346.1	396.9	480.3	498.3	551.8	610.9	644.6	715.1
Borrowing for guaranteed loans [3]	144.3	164.1	181.8	192.3	201.0	212.2	212.1	226.1	240.0	266.1	298.5
Government sponsored enterprises borrowing [4]	16.4	17.1	27.7	38.6	43.9	48.0	49.4	61.4	82.8	104.7	126.1
Raised by State and local governments [5]	130.3	145.7	159.4	177.3	189.7	210.3	214.0	234.7	263.2	282.8	306.4
Total raised by public agencies	595.3	650.7	711.9	754.3	832.0	950.8	973.8	1,074.0	1,196.9	1,298.2	1,446.1
Federal absorption rate (percent)	32.1	31.3	30.4	28.7	30.2	30.3	30.2	29.7	29.1	28.0	28.7
Public absorption rate (percent)	41.1	40.4	39.1	37.5	37.9	38.9	38.8	38.0	37.3	35.8	36.4

[1] 1980 fiscal year-end outstanding debt was obtained by subtracting 4th quarter 1980 unadjusted net flows from 1980 year-end outstanding credit market debt (Federal Reserve Board, "Flow of Funds Accounts," and "Flow of Funds Outstanding," February 1981). Fiscal year-end outstanding figures for previous years were derived by sequentially subtracting from that figure the net change figures from "Special Analyses, Budget of the U.S. Government, Fiscal Year 1982," p. 144.

[2] "Special Analyses, Budget of the U.S. Government, Fiscal Year 1982," p. 113.

[3] Ibid. Figures derived by sequentially subtracting the net change figures for borrowing for guaranteed loans on p. 144 from the 1980 total outstanding on p. 171.

[4] Ibid. Figures derived by sequentially subtracting the net change for Government-sponsored enterprise borrowing on p. 144 for the total outstanding figure on p. 178.

[5] 1980 fiscal year outstanding debt figure derived in same fashion as described in note 1. Fiscal year outstanding debt figures for previous years derived by sequentially subtracting from that figure the corrected net change figures for State and local governments in Lawrence Kudlow's prepared statement before the Joint Economic Subcommittee on Monetary and Fiscal Policy on June 12, 1981.

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