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THE ECONOMIC OUTLOOK, FIRST QUARTER GNP

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THE ECONOMIC OUTLOOK, FIRST QUARTER GNP

WEDNESDAY, APRIL 21, 1982

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met, pursuant to notice, at 10:05 a.m., in room 2212, Rayburn House Office Building, Hon. Henry S. Reuss (chairman of the committee) presiding.

Present: Representatives Reuss and Richmond.

Also present: James K. Galbraith, executive director; Louis C. Krauthoff II, assistant director; and Paul B. Manchester and Mark R. Policinski, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE REUSS, CHAIRMAN

Representative REUSS. Good morning. The Joint Economic Committee will be in session for a look at the economic performance in the first quarter of 1982. Dismal times are behind us, and it looks as if more dismal times lie ahead. Quarterly Statistics on Gross National Product go back to 1947. Based on the estimates which we have just received, the performance of GNP in the first year of the Reagan administration is worse than in the first four quarters of any of his six predecessors. A table which I will make part of the record shows this.

[The table referred to follows:]

Change in real GNP four quarters after inauguration

President:	Percent
Eisenhower	−2.0
Kennedy	+7.0
Johnson	+4.5
Nixon	−0.3
Ford	−0.02
Carter	+4.2
Reagan	[1] −2.2

[1] Preliminary estimate.

Source: Department of Commerce (quarterly data on real GNP not available before 1947).

Representative REUSS. The record for the first year of the Reagan administration shows a drop in real GNP of 2.2 percent, on a first quarter 1982 over first quarter 1981 basis.

Mr. Reagan has refused to accept any responsibility for the economy's dismal performance in his first year. A new alibi is produced every time the question comes up. In his news conference earlier this year, the President blamed the Carter administration. Rising unemployment, he said, was merely, "a continuation of the increase that got underway in the last several months of 1980." As a matter of fact, during the last several months of 1980 employment was growing, and unemployment was declining.

Last month, in Oklahoma City, the President shifted and blamed the ladies and gentlemen of the press for overplaying stories about unemployment. "Is it news that some fellow out in South Succotash someplace has just been laid off?" he asked the press as he complained about their downbeat attitude toward his program.

On April 15, a few days ago, the President shifted ground and blamed statisticians. In an address to eighth graders in a school in Chicago, the President denounced "the funny way of counting," which, it turns out, is simply the normal procedure used to adjust the data for seasonal influences.

It is true that the unadjusted numbers which the President was complaining about in Chicago did show a small drop in unemployment, but 3 months ago, in January—when there was a drop in the seasonally adjusted unemployment rate—the President said not a word about it. The unadjusted unemployment figures rose from 8.3 to 9.4 percent.

On April 17, in still another shift, the President blamed women: "Part of the unemployment is not as much the recession as it is the great increase in the people going into the job market. The increase in women who are working and two-worker families, and so forth." In fact, the numbers of women entering the labor force in recent months are far below the trends of the last two decades. The 300,000 new female entrants who are unemployed represent only some 15 percent of the total increase in unemployment since last July.

There you are—the Carter administration, the press, the statisticians, the women—everybody out of step but Ron. Instead of excuses, the President owes it to the American people to level with us on the economy's poor performance, and to get on with the job of achieving recovery.

We are indebted to our three expert witnesses today for the splendid statements they have prepared. Each of our witnesses is a distinguished forecaster. Now they will give us their views on the likely course of economic events, and on possible policy changes.

So we welcome Lawrence Chimerine, chairman of Chase Econometrics; Robert Gough, senior vice president of Data Resources; and Maury Harris, vice president of Paine Webber.

Before we call on our first witness, I will submit Senator Hawkins' opening statement for the record.

[The opening statement of Hon. Paul Hawkins follows:]

Opening Statement of Senator Hawkins

If inflation moderates, can lower interest rates be far behind?

I am very optimistic about the economy. Consumer prices rose 12.4 percent in 1980, dropped to 8.9 percent in 1981, and so far this year inflation has been at a 3.5 percent rate. Inflation is coming down. Interest rates are beginning to fall, wage demands appear to be moderating and the business outlook is stabilizing.

It is particularly heartening to note that wage increases have slowed. Wage increases which exceed productivity increases add to inflation. In the period 1978–80, productivity in the United States was negative—in other words, wage increases in business whose productivity was low or negative were inflationary. We must improve productivity if we are to grant wage increases. With the changes in the marginal tax rates and with the new incentives to save now in place, American workers will work harder and business will invest to enable workers to work smarter. Productivity will increase, and with inflation coming down, economic improvement cannot be far behind.

Representative REUSS. Gentlemen, under the rule, your full prepared statements have been received for the record. I would like to ask you to proceed in your own manner.

Mr. Chimerine, would you lead off?

STATEMENT OF LAWRENCE CHIMERINE, CHAIRMAN AND CHIEF ECONOMIST, CHASE ECONOMETRICS, BALA CYNWYD, PA.

Mr. CHIMERINE. Thank you, Mr. Chairman. We welcome and appreciate the opportunity to be here this morning. I will try to briefly summarize my lengthy statement, and in particular try to address the issues that you asked about in your letter.

You are correct, the economy has not performed very well for the last year or so. As a matter of fact, in my view, the economy has not performed very well for the last 3 to 4 years. Basically, we have had economic stagnation in the United States since late 1978, and the recent decline is just another episode in this up-and-down, stagnant economy.

In my view, the dominant factor in the recent decline in economic activity is both the sharp increase in interest rates that we experienced during most of 1981; second, the rather widespread and pervasive impact of rising rates on the U.S. economy. I think it is one lesson we have now learned that in today's environment, high interest rates have a much sharper adverse economic impact than they had years ago, reflecting a host of changes in the economy today. In particular, I cannot remember the last time we had a recession during which a sharp decline in State and local government spending was a major contributor. While that involves and partly reflects budget cuts and gasoline tax reductions and so on, I think a significant part of that is the increase in municipal bond rates, which has effectively priced a whole host of municipal governments out of the bond market, and caused these governments to delay capital spending projects, public works projects, and so on.

Second, a major contributor to the current recession is the sharp decline in U.S. exports, and a significant increase in imports in a number of industries, reflecting what I view to be a seriously overvalued dollar. This, in my judgment, reflects a sharp differential in interest rates between the United States and most of our major trading partners, which resulted in the overvalued dollar. Again, this is a rather unusual development for a recession in the United States. Most of the time during similar periods our trade balance improves instead of worsening like it has during the past year or so.

I think many consumers have retrenched more than they might have, because of the impact of high interest rates on home prices and the value of financial assets. Capital spending is weakening, and of course, the impact of high rates on very interest-rate-sensitive sectors directly, particularly housing, farm equipment, and so on, has been absolutely devastating. The combined effect of all of these interest rate impacts, in my judgment, explains the bulk of the declining economic activity during the last 12 months or so.

Where do we go from here? In our view, I think the current period of decline is in the process of bottoming out. There are some pluses and minuses. During the last several months, in particular, consumer spending seems to have leveled off at, admittedly, a rather depressed level, and there's very little sign of any significant pickup, but nonetheless, the decline in consumer spending has stopped.

I think you can make the same observation about housing and other credit-sensitive sectors. They're not very buoyant. Quite the opposite: they're very depressed. But at least they're not going down any further. On the other hand, capital spending, as it always does, is lagging, and as a result, capital spending in those sectors that depend on it heavily, particularly steel, is still declining. Exports are still weakening, reflecting if anything continued increases in the dollar in recent months, which has made the overvalued condition even worse. State and local governments are still in the process of curbing spending.

On the other hand—this is the third hand, now—military spending is beginning to rise somewhat more sharply. I think the inventory liquidation process has been a major factor in the decline in the economic activity during the last 3 or 4 months—inventories have been cut back very, very sharply.

In our view, based upon the feedback we're getting from many of our clients, a significant portion of that liquidation process is now completed. So we are likely to see less downward pressure on production in the next several months, as a result of inventory liquidation. That becomes a plus, as well.

When you add up the pluses and minuses, in our judgment, we are likely to see an economy that during the next 3 or 4 months will stay roughly at the level it has now reached: very, very depressed, without any significant pickup.

On the other hand, we are not likely to see too much additional decline in economic activity during the second quarter. Now, that's not good news—if you're down a 20-foot hole and you stay down there, you still have a serious problem. But at least it stops the depression fears which seem to be spreading throughout the United States, at least temporarily. We appear to be approaching the bottom.

What will happen thereafter, in my view, it seems to me that some pickup in economic activity during the second half of the year seems very, very likely, particularly in view of a combination of four factors, most of which are already in place.

First of all, the amount of fiscal stimulus from the economic program already in effect will rise dramatically in the second half of the year, particularly in the form of the second installment of the personal tax cut, the increase in social security benefits on July 1, and the acceleration of military spending, which, of course, is now beginning. These factors will provide so much stimulus to the economy that it seems hard to believe, even at today's interest rate levels, that at least some pickup in the economy will not occur.

I expect the pickup to be led by some increases in consumer spending, reflecting not only the favorable impact on purchasing power of the tax cuts and social security benefit increases, but also the sharp decline in the inflation rate, particularly oil prices, but inflation in general.

When you combine that with the tax cuts, we are going to see very sizable increases in household purchasing power, beginning with the second half of this year. We have not had this situation for a number of years in the United States. In fact, in my view it's a major factor in the current economic stagnation.

I don't think the basic family in this country has changed dramatically. They haven't spent more in recent years, because they didn't have income to spend. If real incomes rise, particularly with the household debt burden having been reduced, I think some activity led by increasing consumer spending will occur in the second half of this year, particularly after the decline in employment stops, once the inventory liquidation process is over. Add to that the military expenditure increase. Add to that the inventory liquidation, which will help production, as I mentioned a moment ago. Add to that the fact that the Federal Reserve has already eased somewhat in recent months from an extremely restrictive stance during 1981. In my judgment, a combination of these factors will produce at least some pickup during the second half of the year.

The key issue is, of course, interest rates. Both the magnitude of that rebound and its duration will depend completely on what happens to interest rates, and in my judgment, that, in turn, will depend completely on what happens to the policy mix here in Washington. If the existing policy mix is not adjusted—and when I say the existing policy mix, I mean the current administration's economic program, which will produce enormous and rising deficits, year after year, for as far out as we can see, unless significant adjustments are made, even in a growing economy, and that is part No. 1.

Part No. 2 is a Federal Reserve policy which I view as still somewhat on the restrictive side. Unless some modification is made, I think increases in interest rates are inevitable once the economy picks up—I don't know when, I would guess late this year or early 1983—which would either dramatically slow the rate of recovery or abort it completely, particularly in view of the increasing sensitivity of economic activity to interest rates these days.

On the other hand, if the policy mix is adjusted, which I would like to see, and if these future deficits are credibly reduced, so that they will decline over time, and at the same time the Fed eases up somewhat—not necessarily like they did in the 1970's—but the solution to extremely loose money is not extremely tight money. A middle-of-the-road policy by the Fed—I think that combination can actually produce some modest declines in interest rates which would supplement the other factors I discussed a moment ago and contribute to a more rapid recovery and a more long lasting recovery. Not only with a pickup in consumer expenditures and military expenditures, not only with the interest-rate-sensitive sectors showing some rebound, but in addition, within 6 or 12 months after the rest of the economy picks up, I think you will see capital spending begin to accelerate, reflecting the investment incentives that are already in place. Right now their impact is very limited, because they are being offset by high interest rates, excess capacity, weak profits, and so on.

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Once the rest of the environment improves, I think you will see capital spending pick up, sustaining the economic expansion.

That leaves one last issue: How should this compromise be brought about? Or, how should the adjustment in protecting the administration's program be made? In my judgment, it's got to come from all aspects of the budget, some reduction in discretionary programs, although I believe significantly less than the President proposed in his most recent budget; second, some attempt to slow the growth in the entitlement programs, particularly by changing the cost-of-living formulas that are used in those programs; third, some scaling back or stretching out of the military buildup.

But because I don't think those three will be sufficient by themselves, I think some change in the tax legislation is absolutely essential, either by scaling back the tax cut currently scheduled or by proposing some alternative tax increases that will partially offset those tax reductions. My own preference is to delay the third installment of the personal tax cut scheduled for 1983; second, to delay indexing scheduled for 1985 until we see what economic conditions and deficits are like at that time.

I think a credible program like this—combined with some additional easing by the Federal Reserve—will lead, along with the other forces, to a sustained economic recovery in the United States for the first time in several years.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Chimerine follows:]

Prepared Statement of Lawrence Chimerine

My name is Lawrence Chimerine, Chairman and Chief Economist of Chase Econometrics. I appreciate the opportunity to testify before the Joint Economic Committee. I will focus my remarks today on the current state of the economy and the outlook for the period ahead, with particular reference to the effects of current economic policies. In sum, I believe that while the worst of the current economic decline is over, a recovery is not likely to begin for several more months. Thereafter, large fiscal stimulus and the effects of declining inflation will combine to generate a consumer-led pickup in economic activity. The key issue is whether interest rates will rise again as the economy picks up, which would not only hold down the speed of the recovery in its early stages but would probably abort it completely during 1983. In my view, an adjustment to the current policy mix is necessary to prevent such a rise in rates and to thus to permit a sustained economic expansion for several years.

CAUSES OF THE RECESSION

The sharp decline in economic activity since last summer represents another episode in the up and down, stagnant economy which has prevailed since late 1978. There are many hypotheses as to why this latest decline has occurred, despite the optimism which was generated after the new Administration took office early last year. One hypothesis currently being offered is that the delay and reduction of the first stage of the personal tax cut was the dominant cause. However, while I believe that a milder recession would have occurred if the original tax cut had been enacted, I do not believe that the economic decline would have been avoided. **First**, the economy began to weaken last spring, well before even a July 1 tax cut would have taken place. **Second**, an earlier and larger tax cut would have generated about $32 billion of additional purchasing power in the third quarter of last year and $16 billion more during the fourth quarter. This average of $24 billion (at an annual rate) is relatively small in comparison with the magnitude of the decline in economic activity during that period, even allowing for multiplier effects. **Third**, the dominant factor in the recession was the sharp rise in interest rates which occurred during the summer of 1981 and the very pervasive and widespread impact of rising interest rates on the economy in today's environment. Furthermore, an earlier and larger tax cut might have actually caused additional upward pressure on interest rates since it was the prospects of large and growing deficits which would result from the tax cuts which was one major factor (along with very restrictive monetary policy) reponsible for the increase in interest rates at that time. In fact, as it became more apparent last summer that the tax cuts would not be scaled down sufficiently and that additional features would be added, interest rates rose further, especially in the long end of the market (see **Figure 1**).

The widespread impact of rising real interest rates can be seen in **Table 1**, which shows the change in the major components of GNP during the past four quarters. (This table was based on estimates of GNP and its components for the first quarter of 1982, since preliminary data were not yet available at the time this testimony was prepared. Total real GNP was estimated to have declined at a 4% annual rate in that quarter.) **First**, the rise in long-term rates has had a very severe impact on interest rate sensitive sectors, particularly housing and agriculture. Real residential construction expenditures are currently 26% below the level of early 1981, as rising mortgage rates have worsened what was already a serious affordability problem for home buyers. **Second**, a significant portion of the very sharp decline in net exports is in my view also related to rising and high long-term interest rates because of the sharp differences in real interest rates between the United States and most other countries (see **Table 2**). These rates have pushed up the dollar so sharply relative to other currencies during the last year that most U.S. companies are now operating at a distinct competitive disadvantage in both domestic and foreign markets, pushing down the U.S. share of world trade (see **Figure 2**). This increased sensitivity of foreign trade to interest rates is a relatively new phenomenon because of the change to floating exchange rates in recent years. The result is a significant increase in the sensitivity of economic activity to financial conditions, particularly interest rates. **Third**, the direct impact of high rates, plus the indirect effects of rising excess capacity, declining profits, weak sales, and uncertain prospects, have caused declining investment during this period. Furthermore, given the fact that investment tends to lag, the decline during the last year significantly understates the weakness in investment that will eventually occur. **Fourth**, the relatively slow growth in government expenditures is unusual for a recession period. Most unusual is an actual decline in expenditures by state and local governments (**Figure 3**). In my view, sharply higher municipal bond yields have been a significant factor in declining municipal government expenditures because many such governments have been effectively priced out of capital markets and have thus had to delay public works and other projects. Many of those who have in fact borrowed at recent rates are now experiencing such increases in interest costs that other expenditures have had to be reduced. In addition, some governments have had to resort to tax increases to fill the gap, adversely impacting the economy by retarding spending elsewhere. Even consumer spending has been retarded by high interest rates. The resulting weakness in home prices and prices of financial assets has sharply reduced household wealth, causing many families to retrench. Furthermore, rising interest rates now appear to be a major factor causing reduced confidence, which has also caused weaker consumer spending.

As mentioned above, the delay and reduction in magnitude of the first installment of the personal tax cut may have contributed to the severity of the recession somewhat because it led to a more restrictive fiscal policy during most of 1981. In fact, since the military buildup did not begin during that year and since the tax cuts were relatively small, the sizable budget cuts actually produced full employment budget surpluses during most of the year. However, this factor was fairly small relative to the interest rate effects discussed above. The supply-side argument that economic activity is being delayed until the full reduction in marginal tax rates is in effect is also not a valid explanation—this is a demand side recession.

IS THE RECESSION OVER?

The continued slide in economic activity during the first quarter, as well as several other recent developments, have led to spreading fears of a depression in the United States; some analysts are even suggesting a worldwide depression. However, while real GNP did drop sharply again during the first quarter, recent data suggest that the worst may be over, although a sharp rebound does not appear in sight as of now. The next few months will likely be characterized by several crosscurrents which will result in little change for second-quarter GNP—our current forecast is for an increase of only 0.8%.

A. Consumer spending will likely experience only a small increase. On the plus side, large tax refunds and declining oil prices will significantly bolster household purchasing power, as will the absence of additional Social Security tax increases. In addition, recent sharp declines in employment as a result of inventory liquidation are probably over (to be discussed further below), also implying a distinctly better performance for real incomes. On the negative side, we expect some rebuilding of savings following the sharp decline in the saving rate in recent months (**Figure 4**). Furthermore, auto sales will probably weaken somewhat because of the absence of new model introductions and the expiration of rebate programs. The net effect is likely to be very small increases in consumer spending in the quarter, although significant advance buying in anticipation of the July 1 tax cut could result in better performance than I am forecasting. It is important to note that consumer spending has already been improving somewhat in recent months, despite the decline in real GNP (see **Figure 5**).

B. With mortgage rates stabilizing, we expect the recent pattern of relatively flat housing starts to continue. This nonetheless represents an improvement from the sharp declines of last fall. Furthermore, in addition to recent starts, data on housing permits, sales of both new and existing homes and mortgage commitments also suggest that housing activity has bottomed.

C. Inventories will be liquidated at a slower rate than in recent months, exerting less downward pressure on production. High inventory-sales ratios in some sectors are now primarily a reflection of low sales levels rather than large stocks and will not be materially reduced until sales improve. As **Figure 6** shows, this is the normal cyclical pattern. Even in autos and other consumer durable goods industries, inventories have been reduced significantly in recent months and stocks are at relatively low levels. It is important to note that even if there is some additional inventory liquidation in the months ahead, production levels will actually rise if the amount of such liquidation is less than what has occurred in recent months, assuming stability in sales.

D. Military spending is now beginning to rise more sharply in response to the increase in defense orders in recent months (see **Figure 7**).

E. Capital spending will decline, reflecting falling operating rates and a severe profit squeeze. As shown in Table 3, even the most recent plant and equipment survey shows an expected decline in the second quarter. We expect the decline to be more severe, as indicated by recent weakness in orders for nondefense capital goods and commercial and industrial construction contracts (**Figures 8** and **9**).

F. Exports will drop further in view of the recent strengthening of the dollar, which has added to its overvalued condition.

As mentioned above, these developments will net out to a sideways movement in aggregate economic activity with second-quarter GNP likely to show little change. Of most significance is that the expected flattening in economic activity will likely reduce some of the depression fears which have recently spread. Such fears have been fueled not only by recent declines in some economic statistics but by the sharp decline in oil prices. Furthermore, weakening gold and other commodity prices and a sharp decline in the stock market have added further to these fears. We continue to believe, however, that the risk of a serious depression is very small and that these recent developments are explained by other factors. While demand for oil continues to decline, reflecting conservation, fuel substitution, relatively mild weather after the January freeze, and significant efforts to reduce inventories, prices are falling primarily because OPEC is finding it difficult to implement additional production cuts on top of the nearly 40% decline in OPEC output since 1979. Worldwide oil consumption during this period has dropped by about 15%, and, because of increased production elsewhere, the decline in

OPEC output has been far larger. In retrospect, it is most surprising that prices held firm during this period instead of falling; the reason was that OPEC countries were willing and able to cut production. Now, however, additional production cuts are proving very difficult. Many African producers have cut output so sharply that they are adamant against additional cuts, and Iran is attempting to increase output in order to alleviate a serious financial crisis. What is most important is that petroleum usage does not seem to be falling any faster than it did previously and therefore declining oil prices should not be interpreted as indicative of a worldwide depression and an associated collapse in demand. One added factor in oil markets is that price reductions are now feeding on themselves in a manner similar to the price leapfrogging which occurred when demand outstripped available supply during the Iranian crisis; this results from even stronger efforts to liquidate inventories as prices fall and as carrying costs remain high. The decline in oil prices is, in fact, a positive factor in the economic outlook in that it will prevent a more serious recession by bolstering household incomes, reducing business costs, and alleviating the need for additional restrictive policies, although a scaling back of energy-related investments will act as a partial offset. Just as occurred on the upside when oil prices were exploding, the price of gold has dropped sharply in response to recent weakness in oil markets. The reason is clear; reduced OPEC surpluses will not only make it difficult for many OPEC countries to purchase additional quantities of gold but may also force many to be net sellers. Lower worldwide inflation resulting from the decline in oil prices is also adding to the downward pressure on gold prices. Finally, it appears that the Soviet Union and other Eastern Bloc countries, prompted by the need to generate foreign exchange, are sellers of gold. The decline in gold prices appears to be affecting other commodities as well, particularly silver and other metals, duplicating the pattern when oil prices were rising.

The depression fears also ignore some of the major structural changes that have taken place in the United States economy since the 1930s, as well as the outlook for economic policy. **First**, changes in banking laws, as well as increased protection for deposits through the FDIC and other government agencies, will likely prevent the kind of financial collapse that occurred in the 1930s. In addition, margin rules and other regulations governing the purchase and sale of securities did not exist during the 1930s. **Second**, even with budget cuts and tightened eligibility standards, the automatic stabilizers in effect today, such as unemployment insurance, various welfare programs, and the progressive income tax, will be major factors preventing a sharper decline in demand. **Third**, the money supply fell by about one-third during the 1930s and while this in part reflected deposit withdrawals, a strong central bank could have taken steps to offset that. Even with a relatively restrictive posture currently, the Fed is not likely to allow the money supply to fall sharply. **Finally**, government spending comprises a much larger share of economic activity now than it did in the 1930s, and it will not be curtailed sharply. In addition, a highly stimulative fiscal policy program is now in place, unlike the restrictive fiscal policies which were adopted during 1931 and 1932, which worsened the economic contraction.

Of course, even a flattening out of economic activity instead of continued decline would still leave the economy in serious condition, with several industries and regions in particular facing unprecedented problems. Corporate liquidity is in its weakest condition in the postwar period and bankruptcies are already rising rapidly and will rise even further in the absence of an improved economic environment. Thus, it is essential that policies designed to produce lower interest rates and a sustained economic recovery be implemented as early as possible.

DEFLATION

The recent significant easing in inflation and the decline in oil and commodity prices have generated hopes of outright deflation during the period ahead. However, deflation during the next several years is not likely for a number of reasons.

1. Wages continue to rise, although the rate of increase is moderating significantly. As shown in **Figure 10**, the rate of increase in adjusted average hourly earnings has moderated to 7-1/2%, which while well below the near 10% peak early last year, will still exert significant upward pressure on prices. Furthermore, continued increases in health care and other fringe benefits will cause nonwage labor costs to rise. One example of the fact that labor costs are likely to continue to rise during the next several years is the recent UAW contract agreement with Ford, an agreement which will result in labor cost increases of more than 5% per year during its life, despite significant concessions. While this is about one-half of the rate of increase that would have occurred had the prior contract been extended, it nonetheless still represents a sizable increase (a) for an industry in major distress; (b) in which labor costs are between 60% and 70% above the national average; and (c) in which labor costs far exceed those of their major foreign competitors. Even larger increases will occur in industries which are not as depressed or in which existing contracts are not being renegotiated. Wages are continuing to rise in nonunion industries as well in order to prevent a widening of the already large gap between union and nonunion earnings.

2. Some rebound in commodity prices is likely when interest rates and the U.S. dollar decline because of rising demand, relatively low inventories of commodities, and the large military buildup. The latter will boost wages of certain types of skilled labor, including machinists, engineers, and programmers.

3. A significant portion of the recent deceleration in inflation is the result of a severe squeeze on profits (see **Figure 11**); these are likely to rise somewhat during the next several years.

The inflation rate during the next several years nonetheless will remain far below that of recent years, with increases in the CPI likely to average in the 7% range (see **Figure 12**). This will reflect: (1) the continued impact of foreign competition on wages in many industries; (2) the sizable excess capacity in most sectors, with the principal exception of those related to the military buildup; (3) the absence of significant increases in oil prices for several years at least; and (4) modest improvements in productivity following the declines of the late 1970s.

A SUMMER RECOVERY?

I continue to believe that some pickup in economic activity is likely during the summer months, reflecting four critical factors. **First**, as shown in **Figure 13**, fiscal policy will become very stimulative in the second half of this year after being neutral or somewhat restrictive recently. This will reflect a number of factors, the largest being the second installment of the personal tax cut which takes effect on July 1. This will bolster after-tax income by approximately $35 billion. In addition, Social Security benefits will rise by about 7-1/2% on July 1, amounting to about $12 billion, and defense spending will rise sharply. **Second**, monetary policy has become less restrictive than during most of 1981. As shown in **Figure 14**, the monetary base has been growing by between 5% and 6% on a year-over-year basis recently, up from 4% in late 1981. This has already been reflected in an acceleration in the growth of M1. **Third**, the slowdown in inflation discussed previously, including the substantial impact of lower prices for imported oil, will be a major stimulant for the economy, by bolstering purchasing power and by reducing business costs. **Fourth**, the inventory liquidation process is likely to be largely completed within the next several months.

The recovery will be led by a pickup in consumer spending, reflecting the favorable effects of the factors discussed above on household real incomes. Some of these factors are illustrated in **Table 4**, which shows the change over time in total personal taxes, as well as expenditures for energy. As can be seen, the total increase at an annual rate in the second half of 1982 will fall to about $10 billion from almost $80 billion in both 1979 and 1980. These two dominant factors will improve household purchasing power so significantly that some improvement in expenditures is likely. The table does not include the increase in Social Security benefits in July, nor the positive effects resulting from slower inflation in other categories, which will also add to real incomes. An increase in consumer spending, combined with higher military expenditures, will be sufficient to provide some economic pickup even if real interest rates stay at current levels. The decline in economic activity in recent months and the stagnation of recent years primarily reflects the movement from low interest rates to high interest rates. However, we now appear to be approaching a new equilibrium level of activity based on current rates. Furthermore, many factors are in place for this pickup to be the beginning of a sustained expansion over a number of years. This would reflect a high level of fiscal stimulus (even with some spending cuts and tax increases), as well as a continued pattern of moderate inflation and rising real incomes. In addition, once consumer spending picks up, rising utilization rates and profits in many industries will considerably improve the outlook for investment, particularly in view of the investment incentives already in place. Thus, it is possible that investment spending will be rising significantly within six to twelve months after the expansion begins, thereby prolonging the expansionary process.

The major factor which can prevent this favorable scenario from materializing is interest rates. Without some decline from current levels, the rate of economic growth will be held down by the absence of any recovery in housing and other interest rate sensitive sectors. Furthermore, a continuation of the current policy mix threatens to push rates even high later this year once the economy picks up and private credit demands rise—this would likely abort the recovery shortly thereafter.

NEED FOR A POLICY ADJUSTMENT

One element in the current policy mix is the extremely poor outlook for the federal deficit for the years ahead—the other is the Fed's restrictive policy of recent years. As **Table 5** shows, the economic program currently in place, including large tax cuts and military increases, will steadily add to deficit pressures year by year for as far out as one can see. The table is based on Administration estimates—more realistic estimates of the static revenue loss from various features of the tax cut, of the savings on the expenditure side from various program changes, and of the cost of military weapons would produce even high estimates of future deficits. Furthermore, sizable offsets to various spending cuts are likely to occur. In my view, even with 4% real growth, the federal deficit for fiscal year 1983 will reach $150 billion and will rise steadily thereafter in the absence of significant changes from current law. Arguments that these deficits will not cause interest rates to rise fall into the following categories:

1. **Future deficits will be a smaller and declining share of GNP than eperienced historically.** This is not correct, however, when a more realistic estimate of future deficits is made rather than the Administration's budget projections. The Administration's projection of small declines in future year deficits is primarily the result of unrealistic and inconsistent economic assumptions, overestimated savings from program changes, inadequate inclusion of offsets to benefit cuts, savings from management initiatives that will probably not occur and underestimated revenue losses from various tax cuts. Furthermore, many of the cuts in social programs that were included in the budget will not be passed by the Congress since they will reduce real spending for nondefense, nonentitlement programs by an average of 7% per year between now and 1986. Furthermore, current law future deficits as a share of GNP will be significantly higher than during any previous recovery period.

2. **Increased savings resulting from the tax cut will finance the deficits, preventing higher rates.** The historical evidence indicates a much smaller savings response to tax cuts than the Administration expects. In fact, as already pointed out, after the initial increase in savings following the first installment of the tax cut, the saving rate has declined steadily. Furthermore, tax cuts which are used to finance the deficit would not be available to finance consumer spending, thus preventing any significant economic rebound.

3. **These deficits are smaller than those in Japan and Germany.** This is, of course, true but irrelevant. The savings rates in those countries are three to four times higher than they are in the United States and have been so traditionally. The issue is not the size of U.S. deficits relative to other countries but the size of those deficits relative to the available supply of funds within the United States.

4. **These deficits will be financed by an inflow of funds from overseas.** However, net inflows of funds for financial investment from overseas have never been large enough to approach the requirements that future deficits would impose. Furthermore, higher interest rates would be necessary to encourage more foreign investment in the U.S.; this would be self-defeating because they would exert additional upward pressure on the already overvalued U.S. dollar, further eroding our competitive position in world markets, and they would weaken domestic demand as well.

5. **Lower inflation and marginal tax rates will encourage a substantial shift from tangible assets into financial assets.** While this undoubtedly is being attempted by many, the economy as a whole cannot convert what it has already consumed into savings. What will be changed is relative prices, which will encourage some additional savings at the margin. Again, however, this is likely to be insufficient to finance deficits of the magnitude expected, particularly since the effect of all-time high real interest rates on the rate of return on savings is far exceeding the impact of lower marginal tax rates, and additional savings have not yet developed.

Thus, the markets appear to be completely unimpressed by these arguments and still do expect that potential future deficits will exert upward pressure on rates and crowd out private borrowing. In addition, money growth of less than 6%-7% would be insufficient to permit an economic recovery as it would continue the recent pattern of

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sharp declines in the real money supply and exert additional upward pressure on interest rates.

A continuation of the combination of high interest rates and a depressed economy would: (a) jeopardize longer-term economic prospects despite the favorable factors discussed previously by causing further declines in both profits and operating rates, forcing business tax cuts to be channeled toward rebuilding liquidity rather than to finance new capital spending; (b) prevent the needed correction in the exchange rate of the U.S. dollar, keeping exports weak, imports extremely high in many key industries, and increasing the likelihood of more protectionist measures throughout the world; (c) force additional cuts in public works programs; (d) result in a continuation of the wide disparity in regional economic performance; and (e) probably increase the bankruptcy rate even further.

WILL TAX INCREASES MAKE THE RECESSION WORSE?

I believe that a compromise on the budget designed to sharply reduce future deficits, and some further easing in monetary policy, is necessary immediately to bring down interest rates. The budget compromise will have to include both spending cuts and increases in taxes relative to current law. Speed is so essential that I would suggest that the specifics are of secondary importance, although my preference on the tax side would be to postpone the third installment of the tax cut scheduled for July 1983 and delay indexing indefinitely. It is essential that future deficits be reduced from the near $120 billion that will occur this year. In particular, a credible deficit of about $80-$90 billion by 1984 would be acceptable to financial markets because it would be smaller than the current deficit, but would still be large enough to provide for some stimulus. To achieve that level, spending cuts and tax increases (relative to current law) of about $90 billion for 1984 alone will be necessary. A program far less than that will be disappointing to financial markets. Bringing the deficit down more sharply and more rapidly than that, as would be the case with some of the recent proposals made in the Congress, would be equally inappropriate because it would result in fiscal policy that would be too restrictive.

It is also critical that the Fed make greater efforts to bring rates down even if they cause M1 growth to somewhat exceed current targets. Such a shift in monetary policy, provided that the budget outlook is improved, seems appropriate in view of the sharp deceleration in the underlying inflation rate, the change in oil markets, the fact that a significant portion of the acceleration in inflation in the late 1970s was due to declining productivity which is likely to be aggravated by continued tight money, fragile financial conditions in many industries, and extremely high unemployment.

Such a policy compromise will significantly enhance the outlook. **First**, significant reductions in future deficits would bring down real interest rates. The positive effects of declining rates would more than offset the adverse effect of reduced fiscal stimulus by improving the trade balance (by bringing down the U.S. dollar and increasing our share of world trade); stimulating housing, agriculture and other credit sensitive industries; and improving consumer spending. Consumption would rise not only because of the lower cost of consumer credit, but because improved confidence and increases in the values of homes and financial assets would encourage consumers to spend a larger fraction of rising real incomes—too much savings would actually slow the recovery process, given the underutilized state of the economy. In addition, declining rates would increase municipal government access to credit markets and improve the investment climate. In sum, in a world of relatively fixed money growth, excess fiscal stimulus has a negative multiplier because of its effects on interest rates, and the direct and indirect adverse impacts of rising rates on economic activity. **Second**, a budget compromise should encourage the Federal Reserve to adopt a less restrictive monetary policy. **Third**, fears that any new deficit-reducing actions will worsen the current recession are misplaced because: (a) the changes will be directed toward 1983 and beyond, (b) large fiscal stimulus will still remain, and (c) an early favorable response in financial markets is likely. **Fourth**, tax cuts scheduled for future years are not being spent now and therefore are not slowing the current recession. In fact, large deficits are creating such uncertainty that many investment decisions are being delayed. Furthermore, if conditions permit, it is always possible to restore those tax cuts at some point in the future. Thus, these policy changes would actually help insure against a deeper recession. Finally, it would maintain the basic elements of the Administration's economic program, including sizable personal and business tax reductions, significant cuts in nondefense spending, a large military buildup, and reduced money growth relative to the late 1970s, but would avoid excessive hardships caused by massive cuts in social programs. If the policy mix is adjusted as suggested, I believe that the combination of fiscal stimulus, declining interest rates, and lower inflation will generate a sustained economic expansion for several years.

Delaying the third installment of the tax cut can also be justified by the fact that the easing of inflation is significantly reducing bracket creep. It may be necessary to substitute something in return—one candidate would be an extension of the maximum contribution for IRAs, by tying the maximum contribution to a percentage of income. This would have several advantages. **First**, it would prevent the current maximum $2,000 contribution from being eroded by inflation over time. **Second**, it would allow people in higher income categories to contribute more. **Third**, the marginal tax rate on additional income which is saved in the form of an IRA would be extremely low. **Fourth**, by encouraging more use of IRAs, it will help offset the slower growth in Social Security benefits that will likely emerge in the years ahead.

FORECAST SUMMARY

Table 6 represents a summary of my forecast for the next several years based on the assumption that a policy compromise is reached. More specifically, the assumptions underlying the forecast are:

- **Taxes:** Personal income taxes will be increased by about $40 billion relative to current law by July 1983, either by delaying the third installment of the personal tax cut or by offsetting tax increases. In addition, some excise and corporate income tax increases will be enacted effective 1/1/83, totaling about $10 billion at an annual rate. Neither the Social Security tax base nor the rate will be altered from existing legislation.

- **Government Spending:** Federal expenditures (NIPA basis) will equal $803 billion and $863 billion in fiscal years 1983 and 1984. These estimates include reductions in entitlement programs, other nondefense expenditures and the military buildup, totaling about $23 billion in 1983 and $50 billion in 1984; nevertheless, they are $40 billion and $53 billion above current Administration budget projections.

- **Money Supply Growth (M1B)** will average 6% during the next three years, slightly higher than the top of the Fed's targeted range. The weak state of the economy, reduced inflation, and deficit-reducing actions will encourage the Federal Reserve to adopt a less restrictive stance.

- **Interest Rates** will decline modestly during the forecast period in response to a more favorable deficit outlook. The rate on 90-day Treasury bills will average 12.7%, 12.2%, and 11.0% in 1982, 1983, and 1984, respectively.

- **Oil Prices** will decline during the course of 1982 and rise 0.2% and 10.7% in 1983 and 1984. Petroleum demand is likely to decline somewhat further in 1982, following the sharp declines of recent years and then rise only modestly thereafter.

- **Food Prices** will rise by 5.8% in 1982, 7.4% in 1983 and 7.9% in 1984 with virtually all of these increases resulting from nonfarm costs. The extremely favorable outlook for grain supplies will prevent any sharp surge in grain prices.

- **International Economic Activity** will improve moderately during the forecast period in response to increased stimulative measures and stronger exports. The dollar will decline slowly relative to most currencies.

The highlights of the forecast are:

- **Real GNP** will fall an additional 3.9% in 1982.1 and then rise slightly in 1982.2, reflecting a bottoming of the recession. A moderate recovery will begin in the second half of the year in response to increased fiscal stimulus. For the year as a whole, real GNP will be down by 0.7%. Real GNP is expected to rise by 4.0% and 3.9% in 1983 and 1984, respectively.

- **Consumer Spending** will continue to be erratic during the next several months, but will begin to accelerate later this year, however, in response to additional tax cuts, continued modest inflation, a reduced debt burden and strong pent-up demand. Real outlays will rise by 4.4% in 1983 and 3.7% in 1984 after a relatively small 1.8% increase in 1982.

- **Auto Sales** will weaken somewhat in the next several months, as rebates are phased out. The outlook for the next several years is more favorable as more cars are scrapped and operating costs grow far more slowly. Smaller increases in prices resulting from wage concessions and other cuts in labor costs will also stimulate sales, although the impact will be small at first. Sales will average 8.6, 10.3 and 11.1 million units in 1982, 1983 and 1984.

- **Investment Spending** will remain sluggish through most of 1982 as a result of weak final demand and declines in corporate profits, which are offsetting the favorable effect of recently enacted investment incentives. These incentives will begin to stimulate investment during 1983 as overall economic activity improves. Fixed business investment in real terms will decline by 2.3% in 1982, but will rise by 4.2% and 6.1% in 1983 and 1984.

- **Housing Starts** will not experience a significant recovery until the second half of 1982. Mortgage rates in real terms are likely to remain relatively high, delaying the pickup. Starts will average about 1.06 million, 1.43 million, and 1.66 million in 1982, 1983 and 1984, respectively.

Industrial Production is stabilizing, although continued efforts to liquidate inventories in many industries and cutbacks in capital spending will prevent a significant rebound for several months. Total output will decline by 3.7% in 1982, but will rebound by 7.8% and 6.4% in 1983 and 1984.

Unemployment will continue to increase in response to production cuts, and will surpass 9% before beginning a gradual decline. Unemployment rates will stay relatively high throughout the forecast period, however, in response to a rising labor force, small increases in productivity and only a moderate economic recovery.

Consumer Price Inflation will continue to be moderate during the next several months in response to favorable energy supplies, slower growth in wages and cyclical factors. Even after the recession ends, consumer prices will rise only in the 7% range reflecting the relatively favorable outlook for oil prices, some pickup in productivity growth and only modest increases in food prices. Increases in the CPI will average 7.0%, 6.8% and 6.9% in 1982, 1983 and 1984, respectively.

Table 1
GNP and Its Components
(1972 Dollars)

	Actual 1981.1	Forecast 1982.1	Change 1981.1-1982.1	% Change 1981.1-1982.1	% of Decline
GNP	1516.4	1483.7	-32.7	-2.2	-
Personal Consumption	960.2	964.9	4.7	0.5	-14.4
Fixed Nonresidential Investment	162.0	159.3	-2.7	-1.6	8.3
Housing	51.0	37.5	-13.5	-26.4	41.3
Change in Inventories	-1.4	-7.2	-5.8	-	17.7
Net Exports	50.9	33.6	-17.3	-	52.9
Government Purchases	293.6	295.5	1.9	0.6	-5.8
Federal	111.2	117.8	6.6	5.9	-20.2
State and Local	182.5	177.6	-4.9	-2.7	15.0

Table 2
Real Interest Rates*
(%)

	Eurocurrency	Inflation	Real Interest Rates
United States	15.0	8.9	6.1
Britain	13.6	12.1	1.5
France	20.3	14.0	6.3
Japan	6.8	5.0	1.8
Switzerland	6.3	6.6	-0.3
West Germany	9.4	6.2	3.2
Canada	15.9	12.2	3.7

*As of March 24, 1982

Table 3
Expenditures for Plant and Equipment,
U.S. Nonfarm Business
(Billions of 1972 Dollars)

1980.3	157.36
1980.4	155.61
1981.1	159.94
1981.2	157.31
1981.3	160.25
1981.4	156.92
1982.1*	155.30
1982.2*	155.23

*Based on January-February Department of Commerce Survey.

Table 4
Changes in Personal Taxes and Energy Expense

	1978	1979	1980	First Half 1981	Second Half 1981	First Half 1982	Second Half 1982
Taxes							
Federal	24.8	36.6	26.4	22.1	16.0	0.3	-5.5
S&L	7.5	6.7	10.1	5.0	5.6	4.8	4.4
Soc. Sec.	8.5	11.0	7.2	13.0	3.1	6.6	4.1
Subtotal	40.8	54.3	43.7	40.1	24.7	11.7	3.0
Energy							
Fuel Oil & Coal	1.1	4.3	3.8	0.2	0.5	0.5	0.7
Gasoline & Oil	4.6	15.6	20.7	5.1	3.3	-0.3	2.0
Elec. & Natural Gas	4.3	4.9	8.3	0.9	6.1	6.5	4.5
Subtotal	10.0	24.8	32.8	6.2	9.9	6.7	7.2
Total	50.7	79.1	76.5	46.3	34.6	18.4	10.2

Table 5
Tax and Spending Changes—Reagan Administration Estimates
(Billions of Dollars)

	Fiscal Years 1981	1982	1983	1984	1985	1986
Tax Cuts—1981	0.2	38.3	91.6	139.0	176.7	237.1
Individual Income Tax Reductions	—	28.2	75.4	113.1	137.6	180.1
Business Tax Cuts	0.2	9.3	13.1	21.6	33.1	49.5
Other	0	0.8	3.1	4.3	5.9	9.5
Increases in Defense Spending	0.5	11.9	30.2	42.1	56.9	71.7
Other Budget Increases	1.6	0.2	1.8	2.1	2.7	2.3
Budget Reductions	6.4	29.7	86.0	112.2	128.5	144.7
Already Enacted	6.4	27.1	45.0	47.5	48.0	50.7
Currently Proposed	—	2.6	43.0	64.7	80.5	94.0
Revenue Changes Proposed	—	0.2	9.7	17.0	17.3	18.9
Tax Revisions	—	—	7.2	13.5	13.5	14.8
User Fees	—	0.2	2.5	3.5	3.8	4.1
Net Fiscal Thrust	-4.1	20.3	27.9	54.0	90.5	147.5
Current Law	-4.1	23.1	80.6	135.7	188.3	260.4

Table 6
Forecast Summary
Major Economic Indicators
(percent change)

	1980	1981	1982	1983	1984
Gross National Product	8.8	11.4	6.6	11.4	10.9
GNP in 1972 Dollars	-0.2	2.0	-0.7	4.0	3.9
Total Consumption, 1972$	0.5	2.5	1.8	4.4	3.7
Fixed Nonres. Investment 1972$	-3.0	2.5	-2.3	4.2	6.1
Government Purchases, 1972$	2.9	0.6	0.9	0.1	1.2
GNP Deflator	9.0	9.2	7.3	7.2	6.8
Consumer Price Index	13.5	10.3	7.0	6.8	6.9
Corporate Profits Before Taxes	-3.8	-4.8	-16.7	16.6	8.4
Corporate Profits After Taxes	-2.7	-4.5	-14.1	9.1	4.7
Unemployment Rate (%)	7.2	7.6	8.9	8.0	7.3
Prime Commercial Bank Rate (%)	15.27	18.87	16.17	15.39	14.17

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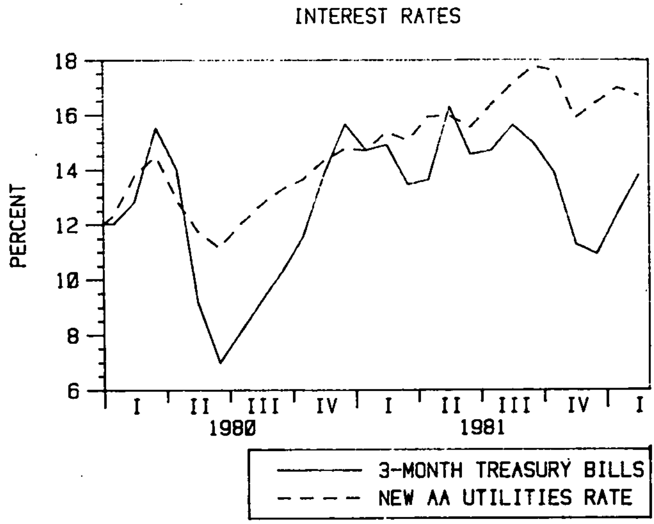

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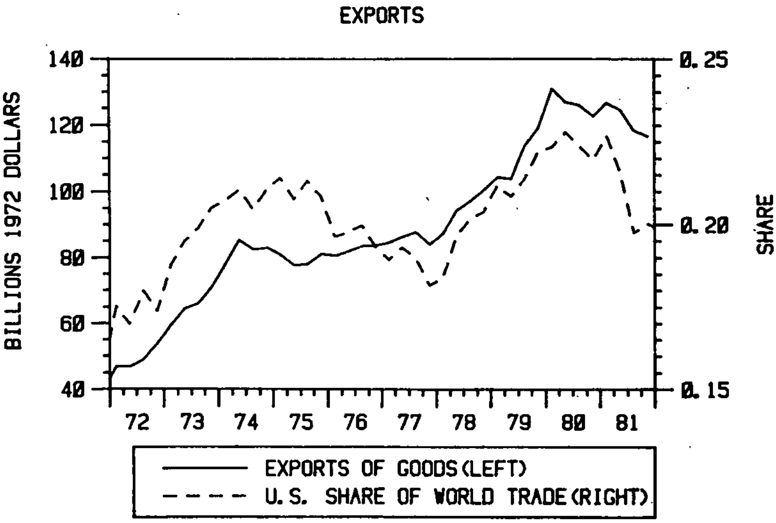

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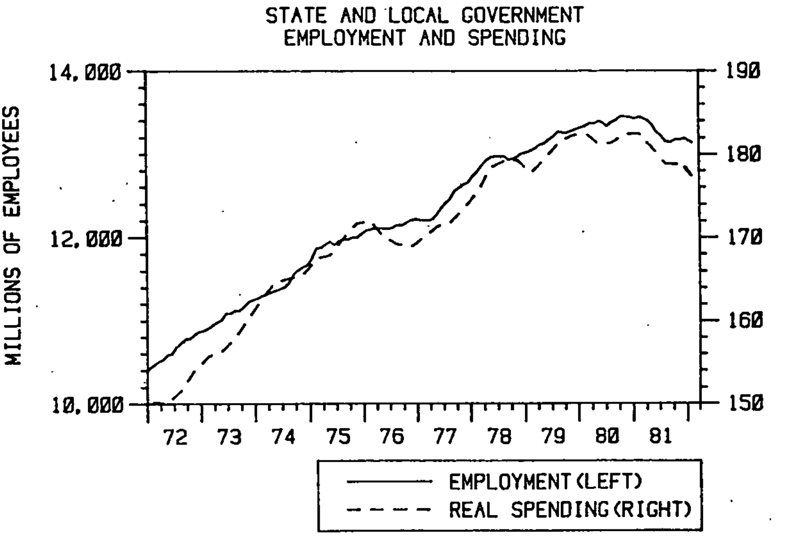

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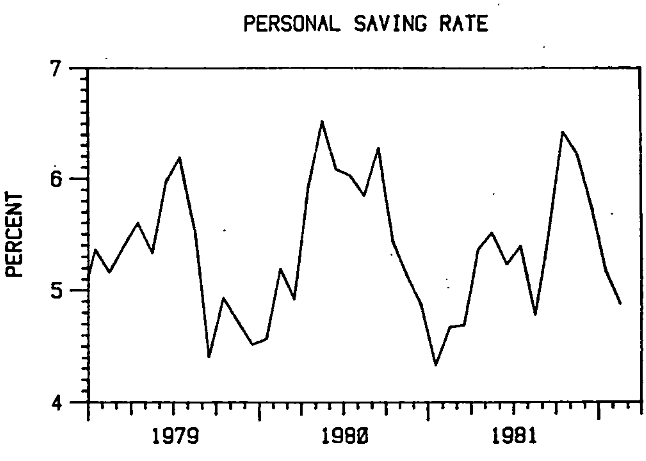

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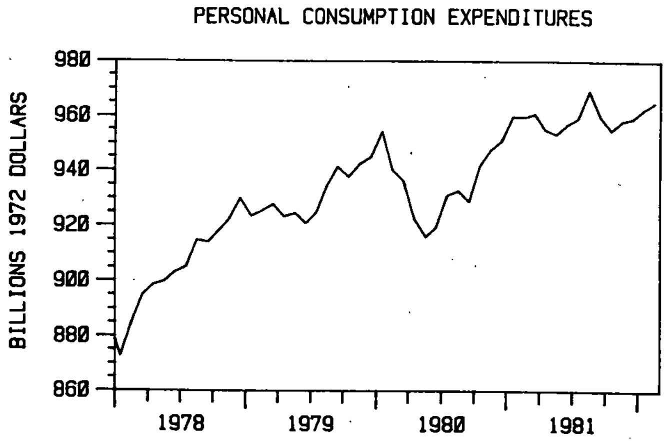

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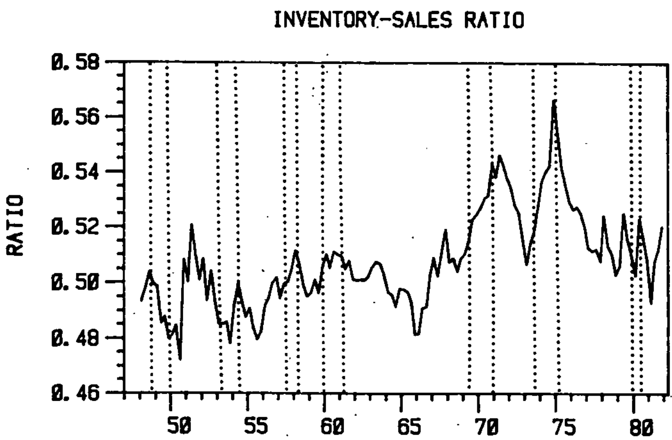

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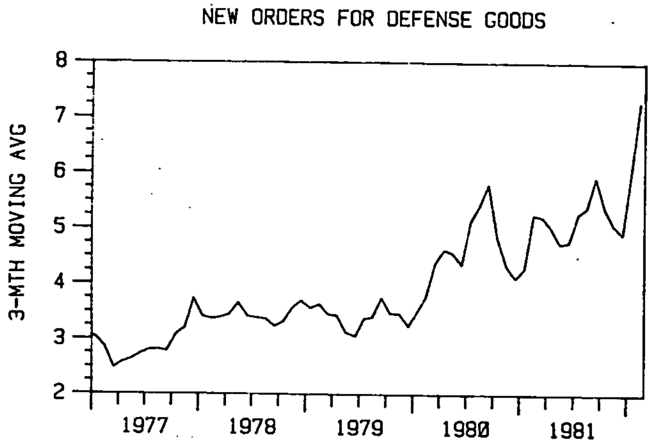

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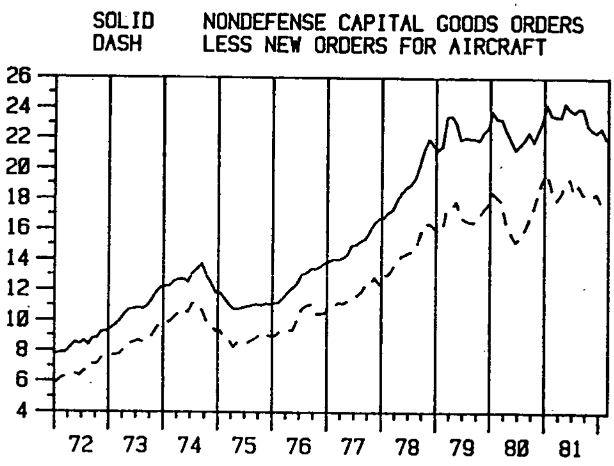

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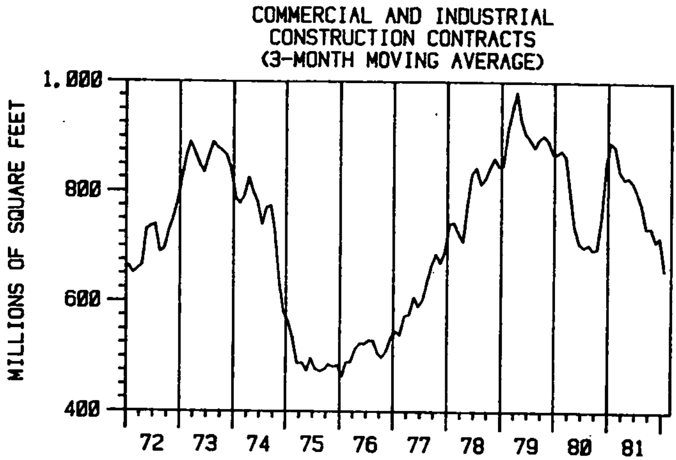

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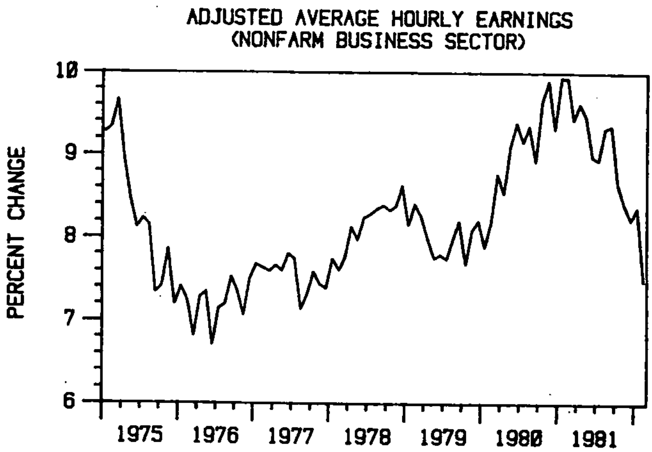

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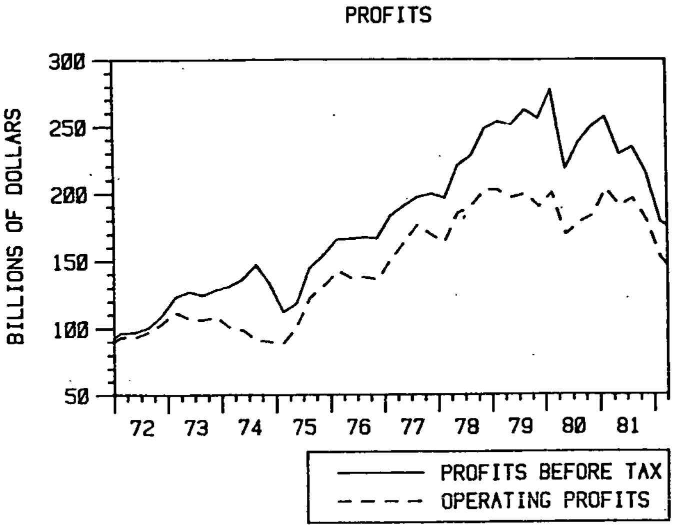

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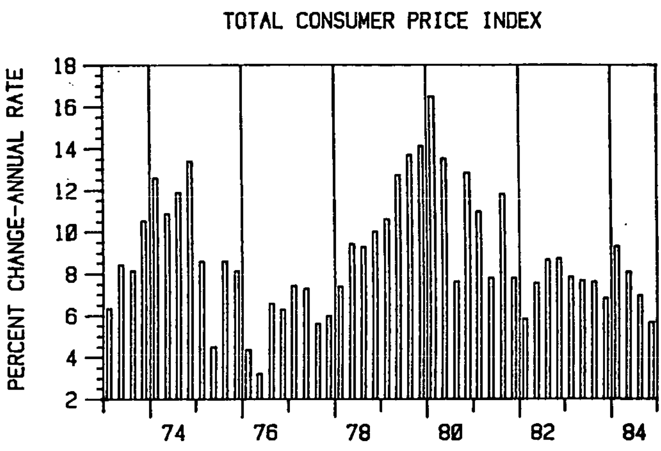

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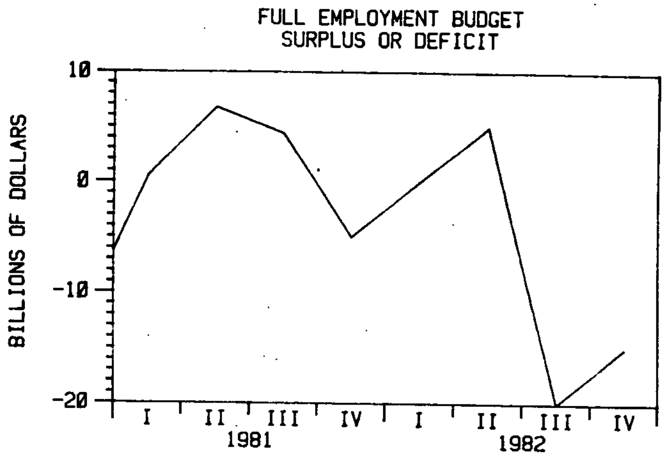

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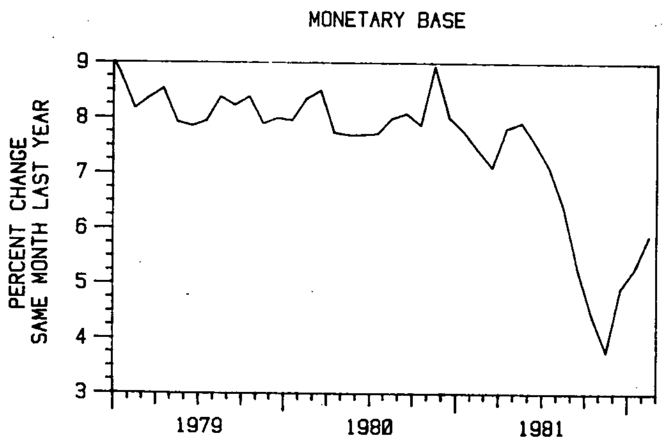


Figure 14

Representative REUSS. Thank you, Mr. Chimerine.
Mr. Gough.

STATEMENT OF ROBERT A. GOUGH, SENIOR VICE PRESIDENT AND SENIOR ECONOMIST, DATA RESOURCES, INC.

Mr. GOUGH. Thank you, Mr. Chairman. I welcome the opportunity, also, to discuss the U.S. economic outlook with this committee today. I will limit my remarks to a summary of my prepared statement, which concentrated basically on three questions.

When will the recovery take hold? Can it be sustained? And what can policy do to insure a greater likelihood of sustainability?

I agree with Mr. Chimerine's remarks that—barring any unforeseen circumstances over the next 2 to 3 months—that it would be difficult for the economy not to show some signs of strength by the summer months. And the reason for this, in my opinion, also hinges on four factors: No. 1, the enormous infusion of purchasing power that is coming forth from the tax cut, and from the social security benefit increases in July. Historically, the size of the tax cut is unprecedented. The rate reduction that it implies, of course, is not. So consequently, the response that we expect from that tax cut will be enough to propel the economy into a recovery mode, but not enough to cause problems in the credit markets.

A second factor which the upturn in the economy in midyear is predicated on is the fact that we assume that the American consumer will respond traditionally to the large fiscal stimulus. We believe that the American consumer will spend a large fraction of the tax cut and the response in the U.S. savings rate will not be as great as it has been, for example, in the past. The one that comes to mind most readily is the big increase in the savings rate after the 1975 tax cut.

The reason that we believe that the consumer will respond traditionally to this particular tax cut is twofold: No. 1, the American consumer is very able to buy right now. Household balance sheets have been restored enormously over the last 2 years. Debt positions are nowhere near as out of line as they were 18 to 24 months ago. If you look at the fraction of revolving credit to disposable income, that reached a peak level of about 18 percent in the latter part of 1979. That has been restored to about 15 percent in the last several months.

If you also adjust that data for the fraction of credit card usage, which is in the form of a cash substitute—unfortunately, the way the Government collects data on consumer credit usage is to ignore the mode of repayment, so consequently, if you adjust the consumer credit numbers for what is really a sizable amount of usage of credit cards that never incurs interest, and therefore is not strictly debt, then you reduce that credit burden ratio even further, to about 13 percent, which is really no higher than it was 5 to 6 years ago.

So the upshot is that the American consumer is very, very able to spend, at the moment, much more so than in the last 12 to 18 months.

A second reason we believe that the consumer will respond traditionally to this particular tax cut is that it is highly unlikely the consumer will be willing to spend at around midyear.

It is curious to note that buying plans in the last 2 to 3 months across most of the major consumer surveys have all been revised downward. In fact, the buying plans were up in the latter part of 1981, at a time when perhaps one would have thought that consumers would have postponed things.

The fascinating reason why these buying plans have been revised downward is precisely the opposite reason that led consumers to accelerate their expenditure behavior in 1978, 1979, and 1980; namely, they expect that inflation will likely go lower over the next 2 to 4 months, and so, consequently, they are forestalling purchase plans in the hope of catching prices at the lowest level possible before they are likely to reaccelerate slightly as the recovery takes hold.

So a combination of consumer ability and consumer willingness to spend around midyear makes it highly possible that the economy will turn up somewhat some time during the summer months.

A third reason, or a third factor, behind a midyear upturn is extended capacity on the part of the Federal Reserve. If the Federal Reserve begins to get compulsive again about its monetary targets and therefore causes interest rates to rise again, it is not likely that the recovery in the summer months would be anything to brag about. But if the Federal Reserve can look upon the monetary data a little bit more liberally and a little bit more broadly than it has in the last 12 to 18 months, then it is likely that interest rates will be able to stay more or less where they are or come down about another 100 basis points over the next 2 to 3 months, allowing therefore a lot of consumer durable purchases, which are typically financed, to be realized.

And a fourth reason behind the recovery around midyear is the fact that we believe that inflation rates will and must remain low in order for consumers to be willing to spend. And the likelihood that inflation will remain low over the next several months is quite high.

Home prices have stabilized and will continue to be low or show very, very small increases over the next several months. We do not expect much of a problem with energy prices. Agricultural prices are benefiting by large carryover stocks.

So, consequently, a lot of the major price indexes that we face are exhibiting very, very favorable results. So when you put all those four factors together, it is very hard to envision an economy that would not respond somewhat during the summer months.

The key question then becomes: Can this recovery be sustained, or, essentially, what are the risks behind these assumptions? Two come from policy, and one comes from the economy at large. The two major risks that we face in the policy arena are continued large Federal budget deficits which will crowd out capital formation late this year and early 1983, and they run the risk of aborting the recovery just about the time it is beginning to gain momentum.

A second reason, or a second risk, is the fact that the Federal Reserve possibly could remain tough, could exhibit some compulsion about sticking to their monetary targets, and if they do that, then interest rates run the risk of increasing quite a bit by year end, also posing a risk of aborting the recovery.

A third set of events could possibly occur in the economy which would also tend to delay the recovery, and those surround the inventory decumulation which has currently been taking place over the last several months. If interest rates remain high, there is a possibility that these large carrying costs that corporations face could be viewed as too high, and therefore, the inventory decumulation could continue.

Second, business balance sheets are in terrible shape. They have been now for the last 12 to 15 months. This is a major constraint which will cause capital spending increases to be delayed until perhaps late this year or early next year.

And, third, the cautious consumer buying plans that we have seen over the last 3 to 4 months could be maintained if interest rates remain high or if inflation happens to get slightly worse.

The third question that I concentrated on is: What can be done? I think it imperative that we effect some kind of a budget compromise at the moment, one which will hopefully entice the Federal Reserve to be less compulsive about its stated targets and to interpret the monetary data a little bit more liberally.

The exercises that I engaged in, in the paper I submitted, show a broad range of different types of policy that could be enacted. Considering the alternative sense of policies shows very clearly that compromises do matter, and they matter quite a bit.

The various forms of compromises are discussed in the paper, and it clearly shows that a broader and eclectic set of policy changes, one from all areas of the budget, including defense, including social security, including the tax program, have the most beneficial effect if you put them all together. If we get some type of compromise from all parties, we can benefit the most from a reduced deficit and therefore a smaller crowding out.

Thank you.

[The prepared statement of Mr. Gough follows:]

Prepared Statement of Robert A. Gough

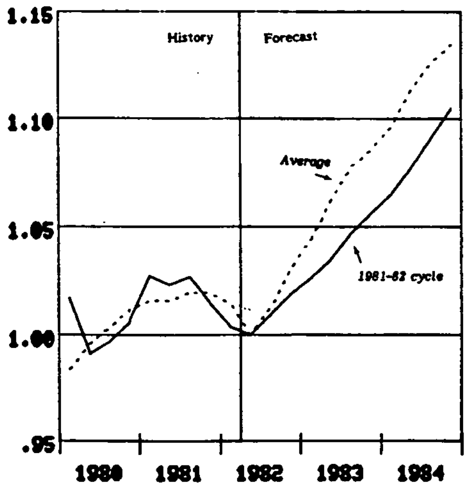
Three major questions govern discussion about the economic outlook. When will the recovery take hold? Can it be sustained? And what can be done to reduce the risks of another downturn in the next two years? This statement examines these issues in terms of both current policy parameters and possible policy alternatives.

THE ECONOMIC OUTLOOK

A review of the evidence of recent weeks suggests that the current business cycle has yet to reach bottom. Automobile sales in early April are down again. Housing activity continues low, and with mortgage rates still too high for most buyers, the housing market is not likely to improve for at least two or three more months. Retail sales continue sluggish, with reported buying plans across all major consumer surveys below those of late last year. Industrial production continues to fall, as do capacity utilization rates. The March declines in production were widespread across manufacturing industries and utilization rates in most industries are now at their lowest levels in seven years. Labor market conditions have continued to deteriorate through March. And perhaps the worst piece of recent data, the latest week's huge jump in the money supply, is not the type of news needed to calm skittish financial markets. Through March, therefore, the outlook for real activity continued to deteriorate.

There are substantive reasons, however, to suggest that an upturn in the economy should begin during the summer months. The latest DRI forecast shows the economy expanding at a 3.6% real annual rate of growth over the last two quarters of the year, low by historical standards, but more easily sustainable than the typical 7 to 9% rates of advance in the early stages of recoveries (Chart 1). The current DRI projections are somewhat more cautious than those of the administration (Table 1). DRI looks for real growth of 3.8% over the two years following the mid-1982 tax cuts; the administration projects 5.1%. Our inflation figure for the next two years averages 7.0% for the GNP deflator; the Administration projects an improvement to 5.6%. Our estimate for the Treasury Bill rate for next year is 12.4%; the Administration assumes 10.5%.

Chart 1
*Real Gross National Product**



** Data indexed to the trough quarter of real GNP: 58:1, 60:4, 70:4, 75:1 and 82:2*

Table 1
Economic Forecasts 1982-1984
(Calendar Years)

	1982 Reagan Budget	1982 DRI*	1983 Reagan Budget	1983 DRI*	1984 Reagan Budget	1984 DRI*
	(Percent change, 4th quarter over 4th quarter)					
GNP						
Current Dollars	10.4	6.7	11.0	10.9	10.0	11.5
Constant (1972) Dollars	- 3.0	0.4	5.2	3.7	4.9	4.6
GNP Deflator	7.2	6.3	5.5	7.0	4.9	6.5
GNP						
Current Dollars	3,160	3,088	3,524	3,409	3,883	3,788
(Percent change, year-over-year)	8.1	5.6	11.5	10.4	10.2	11.1
Constant (1972) Dollars	1,513	1,488	1,591	1,537	1,670	1,601
(Percent change, year-over-year)	0.2	-1.5	5.2	3.3	5.0	4.2
GNP Deflator (1972=1)	2.089	2.075	2.215	2.218	2.325	2.365
(Percent change, year-over-year)	7.9	7.1	6.0	6.9	5.0	6.7
Unemployment Rate (Percent)	8.9	9.2	7.9	8.9	7.1	8.1
Interest Rate, 3-Month Treasury Bill (Percent)	11.7	12.0	10.5	12.4	9.5	11.2

THE LOGIC OF THE FORECAST

A mid-year turnaround in the economy is predicated on four factors:

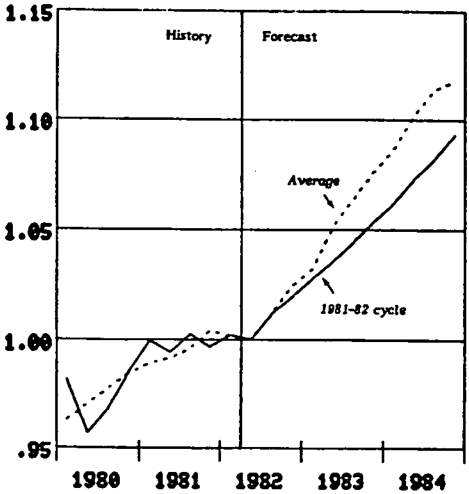
- *an enormous injection of consumer purchasing power from the 10% tax cut and the escalation of social security benefits;*
- *a traditionally sizable consumer spending response to the fiscal stimulus;*
- *extended Federal Reserve compassion, even in the face of periodic jumps in the money supply;*
- *and continued low rates of inflation.*

Burgeoning federal deficit estimates, falling utilization rates, and poor corporate balance sheet conditions have weakened the prospects for recovery of business investment in 1982. Cuts in non-defense spending, including state and local government spending, have also eliminated the government sector as a source of strength this year. And the strong dollar has largely offset lower oil prices. As a *result, the recovery hangs critically on the role of the household. This is not unreasonable. The sizable increase in household purchasing power from the $39 billion personal tax reduction and the $12 billion increase in social security benefits will, if the past is any guide, cause a sizable increase in consumer spending. The increase is large enough to fuel a consumer-led recovery (over 80% of the increased spending in the second half of 1982 is attributable to increased household spending), but not so large as to put undue strains on credit markets.*

At the aggregate level, the spending response is slightly below historical averages (Chart 2). Although the size of the tax cut is unprecedented, the net rate reduction is not. The personal rate reduction, the reduction in the capital gains tax, and miscellaneous special provisions will produce a decline in the personal tax rate from 14% to 13% in the third quarter (Chart 3), and push real disposable income up at a 9% annual rate in the third quarter and another 3% in the fourth (Chart 4). This is sufficient, however, to boost real consumer spending to an average 3.8% rate of growth in the second half of the year, and 3.2% in the first half of 1983, both below the 5.2% first year average of the last four recoveries.

History aside, the current condition of household balance sheets suggests that consumers are well positioned to spend in response to a tax cut. Credit-to-income ratios are now down to nearly 15%, compared to almost 18% during their late 1979 peak. After adjustment for the sizable percentage of credit cards used as a cash substitute (purchases which never incur interest charges), the credit burden ratio is closer to 13%, little different from what it was 5 to 6 years ago. Consumers are also likely to be more willing to spend by mid-year. Many consumers' buying

Chart 2
Real Total Consumption*



* Data indexed to the trough quarter of real GNP: 58:1, 60:4, 70:4, 75:1 and 82:2

Chart 3
Effective Federal Personal Tax Rate During Selected Tax Cuts
(Proportion, SA)

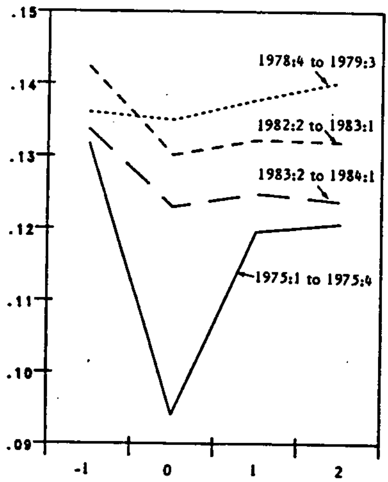
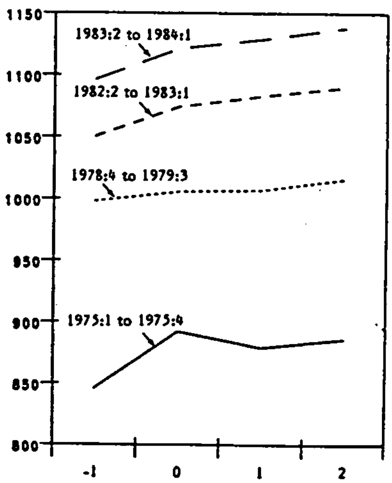


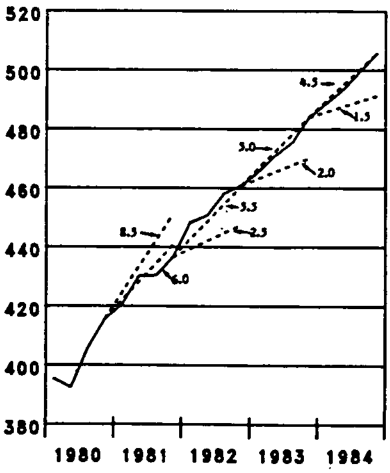
Chart 4
Real Disposable Income
During Selected Tax Cuts
(Billions of 1972 dollars, SA)



plans are currently being forestalled in expectation of lower inflation rates. The present round of improvement in inflation, however, is likely to have run its course by mid-year, when energy prices stop falling and the tax cuts stimulate demand.

Another major factor affecting a mid-year turnaround in the economy is the Federal Reserve. Given the plight of the thrift industry, the severity of the recession, and the projected size of the federal deficits, the recovery hinges significantly on the willingness of the Federal Reserve to interpret monetarism somewhat more liberally than it has over the last two years. To reduce interest rate volatility, the Fed must look at various monetary aggregates and not attempt to fine tune the money growth path beyond what is feasible (Chart 5).

Chart 5
M1 and Its Targets:
History and Forecast
(Billions of dollars, SA)



By late this year and early next year, the Fed's interpretation is likely to be somewhat more conservative once again. While the prime rate drops to a projected 14.7% by early summer, it should rise once again to 16.2% by early next year in response to a recovering economy and a large volume of Treasury financing. As reserve slippage is inevitable in a system replete with a smorgasbord of deposit instruments, there is always the danger that the money supply could run higher over the next few months, and that the Federal Reserve will raise interest rates even more. However, because inflation has improved dramatically and real interest rates are still at their highest levels ever, it would clearly be imprudent of the Federal Reserve to be compulsive about monetary targets at this time.

The final key factor behind a projected mid-year upturn in the economy is that inflation remain low. Continued low rates of inflation will also help to spur consumer spending after the tax cut takes hold. The dramatic improvements in the major price indices of recent months have been due to cyclical forces, some relief from OPEC, and the tough anti-inflation monetarist policies of the Federal Reserve. As Table 3 illustrates, the stability of home prices and mortgage interest rates (the clearest effects of the tough Federal Reserve policies) have contributed the most to the slowdown in consumer prices. High interest rates have also served to reduce energy demand, both here and abroad, causing the inflation in domestic energy prices to fall the most of any consumer price category, contributing 3.3 percentage points to the improvement in the overall consumer price index.

Table 2
Core Inflation Unwinds
(percent change, two year averages)

	1979-80	1983-84
Core Inflation Rate	9.0	6.7
Unit Labor Cost Trend (weight .65)	7.7	6.2
Equilibrium Wage Gains	8.5	8.0
Actual Wage Gains	8.5	7.3
Productivity Trend	0.8	1.7
Actual Productivity Gains	-0.5	2.1
Capital Cost Trend (weight .35)	11.3	7.8
Actual Rental Price of Capital	10.7	10.4
New High-Grade Corp.Bond Rate (Level)	11.2	12.7
Price Deflator-Nonres. Investment	8.9	7.0

Table 3
Sources of Improvement in the
Consumer Price Index

	Annual Percent Change		Contribution to Slowdown (Percentage points)
	Dec. 78- Dec. 80	Nov. 81- Feb. 82	
CPI - All Items	12.9	3.7	9.2
Food and Beverages	10.0	5.9	0.8
Energy	27.4	-1.1	3.3
Gasoline	35.1	-13.2	2.8
Heating Fuels	37.0	4.2	0.4
Electricity and Gas	15.3	12.1	0.1
Home Ownership	18.1	2.0	4.3
Home Prices	13.6	0.3	1.4
Finance, Taxes, Insurance	25.4	1.3	2.9
All Other	11.7	5.0	0.8

As a result of these forces, the core inflation rate has already improved from 9.3% of two years ago to 8% in the current quarter. A slowing in wage gains and capital costs has also helped. Once the recovery gains momentum, however, the inflation outlook will not remain quite so favorable. Industrial prices will be boosted by the defense boom, by the restoration of more normal profit margins, by some increases of energy prices, and by a weakening of the dollar. Continued moderation in wage gains is likely to persist, as major collective bargains will be *held down by tough times in many industries. Whereas overall compensation rose at 10% in the last half of 1981, it appears headed for the 7 to 8% range over the next two to three years. With a moderation in capital costs and a better unit labor cost trend in prospect, a core inflation rate in the 6.5 to 7% range is clearly emerging.*

The effects of these positive forces will not be lost quickly, and in fact, will be prolonged by other factors. Capital cost trends should continue to improve. The DRI interest rate forecast calls for reduction in real rates of interest from the current 8% to about 4% by the end of 1984. The new depreciation schedules and the new safe-harbor leasing provision will also help to lower the capital cost trend. Shocks to inflation should also be minimal over the next two years. Most industrialized economies have adjusted to the high energy prices of the late 1970's. In fact, a further decline in real energy prices is more likely over the next twelve to eighteen months than an increase. Natural gas deregulation could offset some of the declines in oil prices, but if any form of quick deregulation is avoided by the Administration and the Congress, then the energy factor should be a minor source of shock inflation over the next year or two. Agricultural prices also should not be a problem due to large carryover stocks for the major crops and increasing competition in world export markets. Finally, excess demand in the economy should cause minimal problems for inflation as the recovery takes hold. As a result of the typical 2 to 4 quarter lag between aggregate economic activity and overall price performance, much of recession's effect on inflation still lies ahead and should moderate prices well into 1983.

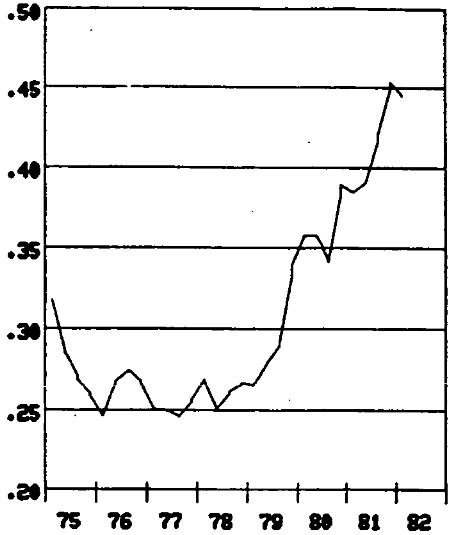
RISKS TO THE OUTLOOK

While there are strong arguments for the recovery to begin about mid-year, there are fewer and less convincing reasons why it should continue uninterrupted for the next two and half years. First, and perhaps most ominous, is the fact that the country is facing the largest deficit-to-GNP ratio in post World War II history. Although some individual years may have shown larger dificits, no four year presidential interval approaches the level now in prospect. The public debt is now certain to rise from $1.0 to $1.5 trillion during the first Reagan term. Additionally, these deficits are occuring at a time when the financial system has been weakened by years of worsening business balance sheets and excessive public borrowing. The risks that these deficits pose are large. The boost in capital costs created by crowding out could, if not viewed sympathically by the Federal Reserve, quickly abort the recovery and mitigate the supply-side effects of the Reagan tax programs.

A second risk, and no less disasterous in its implications, is a collision between a stubborn monetary policy and a federal budget short of compromise. The likely new record level interest rates that such a scenario would produce would stop the recovery short and jeopardize the expected supply-side miracles expected of the current tax program. All sectors of final demand would be affected adversely, with business fixed investment and housing showing the quickest and most damaging effects. Consumers would obviously also be discouraged by this environment, as inflation would be somewhat worse.

A final set of risks exists outside the policy arena. First, because of the fear of continued high interest rates, the inventory decumulation of recent months could persist longer than expected, possibly into the early summer months. The reduction in orders that this would include would certainly weaken the economy and be a signal to other sectors of prolonged problems. Second, business balance sheets continue to be in extraordinarily strained conditions (Chart 6). If interest rates fail to improve significantly over the next two-to-three months, the business reaction could simply be to drop investment spending even more than anticipated, thus further prolonging the recession one more quarter. Third, in such an environment, consumers could remain cautious even after the tax cut, in anticipation of lower inflation and due to uncertainty about the future health of the economy. Such a set of events would result in a recession lasting into the early fall months and a recovery beginning only slowly in the latter part of the year when the inventory deculmulation ends, housing begins to respond to significantly lower interest rates, and consumers restrain their response to improvements in real disposable income. Although the recovery would certainly gain momentum in the early part of 1983, the economy would still not be in the same position by 1984 as it would be if the recovery had started sooner. The main reason for the disparity would be that the federal budget deficit would be so much larger due to lower receipts in 1982 and early 1983 that it would crowd out a significant amount of investment over the next twelve to eighteen months.

Chart 6
Debt Service as a Percent
of Cash Flow
(Nonfinancial corporations)



THE BUDGET AND MONETARY POLICY

The projected federal budget deficits total a record $273 billion over the next three years, based on Administration estimates. Treasury issues are also estimated to total $369 billion over the same period. The DRI forecast shows considerably larger deficits than the Administration projects, $383 billion on the unified basis, with a huge $508 billion of accompanying financing. When issues of government sponsored agencies are included, the DRI forecast shows $588 billion of Federal financing from 1982 to 1984 (Table 4). The DRI estimates are larger for several reasons. The Administration's budget includes tax increases which have failed to pass in previous Congresses, and which are not being aggressively

Table 4
The Federal Budget Deficits and
Treasury Financing
(Billions of dollars, fiscal years)

	1982	1983	1984	Cumulative Total
Unified Budget Deficit				
Reagan Administration*	98.6	91.5	82.9	273.0
DRI	120.6	134.1	128.7	383.4
Treasury Issues: On and Off Budget				
Reagan Administration*	130.3	124.2	114.4	368.9
DRI	169.6	177.8	160.6	508.0
With Government-Sponsored Enterprises				
Reagan Administration[1]*	179.9	177.6	131.9	489.4
DRI	189.8	220.5	178.1	588.4

[1]1984 estimate of government-sponsored enterprises unavailable from Budget; DRI estimates used.

Source: Budget of the U.S. Government, Special Analysis E, and DRI INTERIM041982.
*February, 1982

pushed by the Administration. It also includes a set of outlay reductions which are not likely to materialize. The differences in economic assumptions also cause some small differences in the deficits.

The prospects of continued high deficits and a record volume of Treasury, off-budget, and government sponsored agency financing will keep both nominal and real interest rates high over the next twelve to eighteen months, contributing substantially to the subpar characteristics of the recovery. In the extreme, it is possible that the economic expansion could be aborted if financial markets remain nervous about continued high deficits. A reacceleration of inflation under the large fiscal stimulus could also exacerbate financial market conditions, raising expectations of a strong Federal Reserve response. What are the propects for improvement? It is not likely that all the bad news from the budget has already been discounted by the financial community. It is also not probable that substantial Congressional adjustment to the budget can succeed without the cooperation of the President. Finally, significantly lower inflation rates which would provide an easy solution to the current budget dilemma will not likely occur over the coming months, particularly as the recovery gets under way. Consequently, a compromise on both budget and monetary policies appears more important than ever to prevent negative effects on the financial markets later this year and in 1983, resulting in a halt to the economic expansion.

THE REWARDS OF COMPROMISE

Opponents of a budget compromise argue that concessions, either on the tax or expenditure side, will jeopardize the time schedule of Reaganomics while offering *little help to the economy. Opponents of a more lenient monetary policy argue that a faster money growth path will jeopardize further inflation improvement while offering little relief to the credit markets in the near term. Both argue that what is needed is more patience.*

Tables 5 and 6 summarize the results of various compromise simulations performed with the DRI quarterly model of the U.S. economy. Twelve simulations were run, combining a mix of monetary and fiscal policy scenarios. The exercise dramatizes the significant differences in the budget deficit, inflation, and overall growth in the economy caused by changes in monetary policy, nondefense expenditures, and taxes. Three different tax alternatives were tested. The first alternative assumes that the current tax program is unchanged. The second assumes a tax scheme in which only the final portion of the current personal tax cut program is removed. The third alternative assumes that the present tax program remains in place but that an excise tax and gasoline tax are added. Excise taxes on liquor and tobacco are assumed to account for new receipts of $6 billion and $12 billion for fiscal years 1983 and 1984, respectively. An additional $7 billion is assumed to be raised via excise taxes on various luxury items by 1984. Finally, a 10¢ hike in the gasoline tax is included (Charts 7, 8, 9, 10).

Two expenditure patterns are also imposed. One assumes that nondefense expenditure cuts total $22 billion in 1983 and $45 billion in 1984, while the second assumes that additional expenditure cuts are made in both defense and nondefense categories of $15 billion over the same two-year period. The significance of this second scheme is that cuts are also made in social security.

Table 5
Alternative Policy Options

	1984 Deficit	1984 Inflation[1]	1984 Unemployment	Real GNP[2]
DRIBASE (M1B Growth = 4 1/4%)				
Small Expenditure Cuts[3]				
No Tax Change	-117	6.5	8.1	4.1
Recind Tax Cut[4]	-96	6.4	8.4	3.4
Excise Tax[5]	-103	6.4	8.6	3.5
Large Expenditure Cuts[6]				
No Tax Change	-110	6.4	8.6	3.5
Recind Tax Cut[4]	-90	6.3	8.9	2.9
Excise Tax[5]	-97	6.3	9.0	2.9

Table 6
Alternative Policy Options

	1984 Deficit	1984 Inflation[1]	1984 Unemployment	Real GNP[2]
MODRATE (M1B Growth = 4 3/4%)				
Small Expenditure Cuts[3]				
No Tax Change	-89	6.7	7.6	4.4
Recind Tax Cut[4]	-68	6.6	7.9	3.8
Excise Tax[5]	-76	6.6	8.0	3.8
Large Expenditure Cuts[6]				
No Tax Change	-82	6.6	8.0	3.9
Recind Tax Cut[4]	-62	6.5	8.3	3.2
Excise Tax[5]	-71	6.5	8.4	3.3

Footnotes:

(1) Implicit price deflator for GNP.

(2) Average annual growth, 1982:2 to 1984:4.

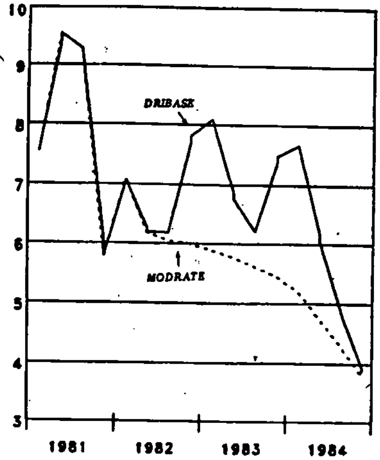
(3) Nondefense cuts of $22 billion in fiscal 1983 and $45 billion in fiscal 1984.

(4) $45 billion.

(5) $25 billion excise tax and $0.10 gasoline tax, effective 1982:4.

(6) Defense cuts of $6 billion in fiscal 1983 and $9 billion in fiscal 1984 with additional nondefense cuts of $10 billion in fiscal 1983 and $15 billion in fiscal 1984.

Chart 7
The Real Short-Term Rate of Interest*



* Federal Funds Rate Minus the year-over-year change in the personal consumption deflator

Chart 8
Money Supply
(M1B, Billions of dollars)

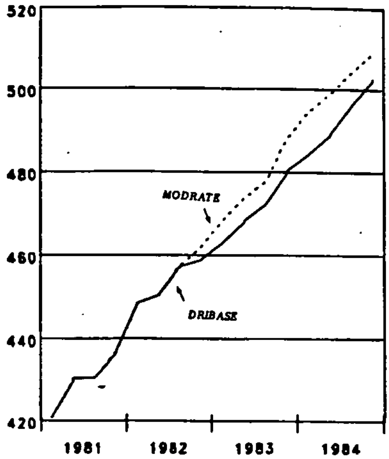


Chart 9
Automobile Sales
(Millions of units)

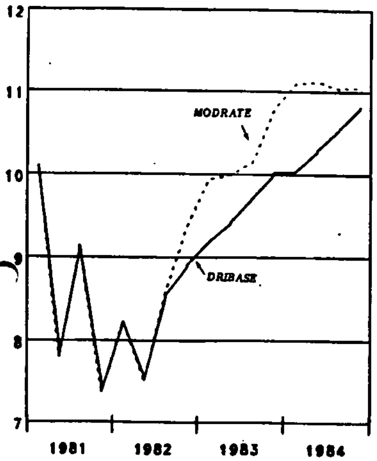
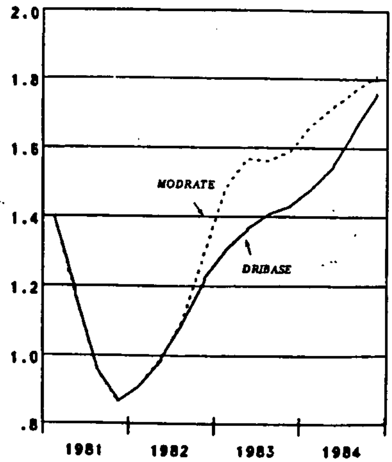


Chart 10
Housing Starts
(Millions of units)



These alternative fiscal policy scenarios are imposed on two alternative Federal Reserve strategies, a moderate money growth path (assumed to be 4.2% between 1982 and 1984) and a more liberal path (4 3/4%).

The following observations stand out from the excercise. First, compromises do matter; various combinations make sizable dents in the Federal budget deficit while conceding little to, or even improving, overall growth. Second, while a more liberal monetary policy does lose something to inflation, it goes a long way toward reducing strains in the economy. Finally, neither type of policy can go it alone. A compromise from both policy arenas is clearly in order. A moderate form of monetarism combined with both tax and expenditure concessions will yield the largest benefits to the deficit and financial markets of all policy combinations, while sacrificing no more than 1% to inflation over the next two years.

Any compromise will clearly be better than none. Table 5 summarizes the effects of various budget compromises only. Under this type of compromise, reductions in the size of the deficit would be fully reflected in lower interest rates, promoting both a supply-side response and a pickup in activity in key interest sensitive sectors such as housing and automobiles, The extent to which crowding out affects private capital formation depends on economic conditions. In 1982, the deficit is less damaging, because the recession is holding down private credit demands. Once the economy recovers, however, crowding out becomes more problematical, but not enough to prevent a recovery with a modest growth trend over the next two years. It is clear that even an improvement in the budget alone would have sizable benefits to the economy.

Table 6 summarizes the results of combining a more liberal monetarist position with the various budget compromises. In the case of large expenditure cuts combined with a postponement of the 1983 10% personal tax cut, and a more liberal monetary policy, real GNP grows slightly faster over the next two and a half years. Improved strength is exhibited in housing, business investment, and consumer durable spending, particularly automobile sales in 1983. Housing starts are up an average 140,000 units over the two years, real business fixed investment is up 0.6%, and automobile sales are up 400,000 units in 1983, but later show the effects of the postponed tax cut. Interest rates are also lower, with the ninety-day Treasury bill rate down about 100 basis points a year, and the new issue rate for high grade corporate bonds off 30 basis points. The budget deficit is sharply lower, by $55 billion in 1984.

CONCLUSION

The case for improving the proposed budget and for compromising the current easy fiscal/tight monetary policy mix is now overwhelming. Such a compromise would be a major step in relieving pressure on the financial markets and reversing the declines of key interest sensitive sectors in the economy over the last year. By increasing excise taxes, postponing the 1983 portion of the personal tax cut, and reducing both nonmilitary and military spending, the Reagan administration would go a long way towards enhancing the prospects for higher capital formation, productivity growth, and less inflation in subsequent years. The severe financial strain plaguing much of the non-financial corporate sector, state and local governments, and the thrift industry would also be eased, and threats of wide-spread banckrupcies would diminish.

I recognize the difficulty of having the Congress play the lead role in rescuing the budget and effecting a compromise between fiscal and monetary policy without the President's endorsement. The damage, however, to the U.S. economy from persistent unprecedented high rates of interest can hardly be questioned now. Despite the political odds, my hope is that the Congress, the Administration and the Federal Reserve will see the risks of not compromising, and will exercise pragmatic leadership in coming to grips with these risks to avert a series of budget disasters and a premature end to the recovery.

Representative REUSS. Thank you, Mr. Gough. Mr. Harris.

STATEMENT OF MAURY N. HARRIS, VICE PRESIDENT, ECONOMIST, PAINE WEBBER, INC.

Mr. HARRIS. Mr. Chairman and committee members, more than ever the American economy has come to be viewed as Wall Street's hostage. High interest rates are seen as the main stumbling block to a healthy economic recovery, either in the financial community, or we in the financial community are frequently cast as doubters somehow or other holding up interest rates.

Now, as an economist working with a major brokerage house, I share in the conviction that investors are acting in ways to maintain high interest rates. However, they are doing so neither because of cynicism and neither because of misunderstanding of current public policies. Instead, monetary and fiscal policies have generated doubts and incentives which have discouraged the prudent investor from parting with his money at low interest rates, and until these doubts and incentives change I think that high interest costs will preclude a healthy growing economy.

Before focusing on why investors are holding out for higher interest rates and what we can do about it, let me briefly review why I think that interest rates are so crucial to the American economy. The current recession stems largely from the sharp jumps in interest rates that accompanied the sharp 1980–81 business recovery. Overpricing of the construction and automobile industries also played a role, but when we finish measuring the current recession, my judgment is that high interest rates will emerge as the primary causal factor.

Indeed, what really is intriguing about that term "business downturn" is that it hasn't been any weaker, given the steep levels of interest rates. My own view here is that a combination of the so-called creative financing in the construction industry, as well as the boost to household incomes from high interest earnings, have prevented the recession from being any worse.

I think that these two factors, coupled with the tax relief, will preclude a more sustained recession, with low double-digit unemployment. In my view, currently the economy appears to be bottoming out. I don't think the real GNP is going to change significantly in the second quarter for a couple of reasons.

First of all, most of the damage from high interest rates has already been done to industries like housing and appliances. Also many households may be spending in advance of the July tax cut by drawing down their savings balances, and with diminishing inventory disinvestment, I think that a very small uptake in real GNP is possible this quarter.

When we go on to the third quarter, the depressing effect of today's high interest rates on the economy will be temporarily hidden. I expect the GNP to go up at a 5- or 6-percent annual rate. Among the key stimulants, we have the 10-percent cut in income tax rates, the social security cost of living increase, and the termination of business inventory liquidation.

However, I would want to emphasize that the tax and transfer payment stimulus is a one-shot affair. It is mainly going to move the economy from one plateau to a moderately higher plateau. Sustained stronger economic growth will require further stimulus to household income.

Important contributors to income expansion, such as the growth of State and local spending, the growth of exports, and home building recovery will largely be absent. Thus, after a third quarter spurt real GNP growth should begin slowing in the final quarter.

Now, looking out beyond 1982, whether the economy can grow fast enough to reduce unemployment is going to depend entirely on interest rates. They have to again become affordable for the consumer, provide profitable business investment incentives and allow the dollar to seek the level that is going to make exports competitive again. Otherwise, economic growth will remain erratic and low.

It seems to me that the sectors affected by high interest rates have enough impact on employment that it's very hard to see how you are going to have strong economic growth without these sectors pitching in.

In summary, then, low interest rates are the key to the sustainable health of economic expansion, higher productivity and living standards to capital formation. As I said earlier, investors are going to be parting with their money at lower interest rates until the doubts and incentives that produce their monetary and fiscal policies are changed.

With regard to investor doubts over fiscal policy, my consulting with a variety of individual and institutional investors has provided me with a close view of their anxieties. It is hard to describe the typical investor nowadays, but many are expressing some, if not all, of the following doubts.

They are concerned about possible congressional acquiescence to large Federal deficits on the rather controversial grounds that they may not be quite at a record fraction of the gross national product.

Frequently, I hear many doubts about the advisability of such a quick defense buildup. It could involve inflation in particular industries and budget cost overruns.

The bottom line with investors is that triple digit deficits produce a Treasury financing calendar that is simply mind-boggling to investors. If it is possible at all to typify investors' anxieties over fiscal policy today, I would simply say that they are more concerned about deficits than many professional economists.

Professional economists view the deficit as filling in for absent private credit demands rather than crowding out credit demands. However, it is investors and not economists who are betting money in the stock and bond markets today.

Now, alleviating these investor anxieties over fiscal policy will require a multifaceted approach. For starters, I think that investors would react quite favorable to a slower pace of defense spending increases. They would also react favorably to a reduction of the indexation formulas for various transfer payments. In addition, I think the securities markets will respond constructively to an oil import surcharge.

Now, if you reduce or eliminate the 10-percent income tax cut scheduled for mid-1983, I think that would also be greeted enthusiastically by people in the bond market. My own judgment, though, is that the economy sorely needs this tax relief, and by just reducing the proposed defense spending increases, by reducing indexation in the various transfer payments, and by enacting the oil import surcharge, I think you could achieve enough to cap and even modestly reduce today's high levels of long-term interest rates.

Still, even if you do all these things on fiscal policy, these actions alone are not going to be enough to generate a stimulating level of interest rates.

Now, with the postrecession level of inflation still as uncertain as it is, it is very difficult to say just how many percentage points long-term rates have to fall before they start stimulating the economy. What is for sure, though, is that Federal Reserve policies are keeping short-term interest rates very high. And there is a limit to how much, whatever you do with fiscal policy to drop interest rates, as long as such Fed policies persist.

I think these policies have made cash "king" for various investors, and are a main reason for continued high overall interest rates. In my working with many investors, the clearest theme is that investment in cash—short-term, interest-earning assets—has become extremely attractive, and parking your money in short-term market funds will remain popular as long as these yields remain well above the single-digit yield that investors currently earn in stock and bond investments.

I think this attraction to cash goes a long way toward explaining why long-term interest rates have stayed so high. It has been no mystery over the past year why we are seeing higher long-term rates for a given level of short-term rates. That is because the Federal funds rate, the interest rate on overnight money continues to stay high. That keeps money market rates high. The longer the money market rates stay high, the more confident investors feel about keeping their money parked short. They don't want to go into the bond market. In my view, that is one of the main reasons for the long-term interest rates staying high.

The reason the short-term rates have stayed so high is primarily because of Federal Reserve policies. As you all know, there have been some important changes in Fed policies over the last 2½ years. The Fed now adjusts the discount rate structure and open market operations more aggressively in response to undesired monetary overruns.

Also, what the Federal Reserve is doing is that they are permitting much more interest rate volatility than in the past. They are no longer paying the funds rate in overnight money, and by no longer paying the funds rate in overnight money the Fed has allowed a lot of short-run volatility in money market rates. This creates the risk factor and uncertainty premium which gets built into higher interest rates.

My conclusion is that Federal Reserve policies are the primary reason for today's high interest rates. The widely cited budget deficit problem is due importantly to Federal Reserve policies that initially kept interest rates high, because these policies weakened the economy and weakened tax collection and helped to raise interest expenses on the Federal debt.

I don't think that the Fed ever intended to keep rates this high; however, their policies have importantly contributed to that result. Now, in judging these policies, I think we should never forget that the related recession and the strong dollar related to high interest rates have done much to bring inflation down.

However, a monetary policy that is successful in fighting inflation is not going to be successful in generating any kind of economic recovery that is going to be sustainable. I think that renewed economic expansion should take priority now. If we allow another year of stagnation or economic decline, perhaps we could make more progress on inflation than I see right now.

My judgment would be if the recession starts this summer, then we are going to have 5 to 6 percent inflation for the first 18 months of an economic recovery. If we postpone that recovery another year or so, you are going to make more progress on inflation. I simply don't believe at this point in time that it is worth the cost.

In my view, a sustained healthy economic recovery will require a monetary policy that works as follows: Early in the recovery I think that the Federal Reserve should react slower to short-lived, above-target money supply expansion. However, more aggressive efforts should be made to reduce interest rates when the monetary aggregates fall under the midpoints or even the tops of the Federal Reserve's target ranges.

On the other hand, if the Fed continues with their recent policies, short-term interest rates will remain high and volatile. That is simply because there are a number of reasons why the monetary aggregates are volatile.

One of the most important sets of reasons, though, is the measurement problems, the problems of seasonal adjustment. The monetary aggregates never seem to stay on target long enough for the Fed to continually bring down interest rates. Before long the aggregates are picking up and going up above target, and here goes the Fed tightening up on their open market operations again.

My own personal opinion is that the Federal Reserve cannot stabilize weekly, monthly, and perhaps even quarterly money supply growth. Given that opinion, I only see one way out of this problem. when the money supply periodically goes over target and the Fed has to tighten up on rates again. My solution is this: I think the Federal Reserve should back off temporarily from a policy of quickly reacting to over-target monetary expansion. If the Fed's open market operations and discount rates were not formed so rapidly and so strongly in response to short-run upswings in the money supply, I think that many investors would take such things in stride.

Of course, the Federal Reserve needs to respond eventually if substantial undesired monetary overruns and annual targets are not self-correcting. However, this is a very important point. My judgment is that in today's environment many, though not all, money overruns are in fact going to be self-correcting before very long, and that is for this reason: the major inflation slowdown should reduce the growth of the public's monetary demands to a range more nearly consistent with the Fed's modest annual money supply target ranges.

So, in this setting, with slower inflation slowing down the public's demand for money, your temporary upward monetary deviations from target will be largely due to two things: The measurement problems; and temporary shifts in the public's money holding practices. Such deviations are likely to be self-correcting before many quarters have elapsed.

Still there will be some instances where the monetary overruns are not self-correcting, and the Fed ultimately has to react by firming up the discount rate and open market operations. However, considering the large margin of unused resources in today's economy, failure to quickly address overtarget monetary expansion would not have serious inflationary consequences. Now I realize that my suggested policy of responding slowly to excessive monetary growth, but responding rapidly to inadequate growth is only appropriate on a temporary basis during a recession and early recovery phase. Eventually the Fed has to return to more timely and symmetrical responses to money overruns and shortfalls. And that will become necessary as the past equalization in job recovery.

Now if the monetary policies which I'm suggesting don't succeed in getting interest rates down low enough and if inflation were still not a problem, then the Federal Reserve might have to consider some further options. One strategy might be temporarily to raise the annual money supply targets. Another option is to again peg the Federal funds rate. If they did that, that would reduce the volatility and uncertainty premium in interest rates; however, both strategies would be quite controversial at first with investors, and I think that my recommended policy is a more plausible, widely accepted first step.

Now, without doubt, even my recommendations will be controversial among the strict monetarists. They probably read more mischief than I do into short-run money spurts, even at this stage of the business cycle, but considering the tremendous range of economic opinion, you're never going to have a monetary policy that satisfies all investors. However, I think that most investors would commit long-term funds at much lower rates, if the yield incentive to stay in cash were reduced, while inflation remained low.

To conclude, Mr. Chairman and committee members, high interest rates were necessary to slow the economy and inflation. However, American business, labor, and Government have had about as much of the recession as they can stand. Public policies must now reduce interest rates and get the economy moving again. I think that this can be done. With additional fiscal balancing and some temporary changes in the Fed's open market operation procedures, you will find bond investors willing to accept lower interest rates. Thank you.

[The prepared statement of Mr. Harris follows:]

Prepared Statement of Maury N. Harris

Mr. Chairman and Committee Members. More than ever the American economy is viewed as Wall Street's hostage. High interest rates are the main stumbling block to a healthy economy. And we in the financial community are frequently cast as doubters somehow holding up interest rates. As an economist working with a major securities firm, I share the conviction that investors are acting in ways that maintain high interest rates. But the forces motivating such behavior are neither cynicism nor misunderstanding of current public policies. Instead, monetary and fiscal policies have generated doubts and incentives which have discouraged the prudent investor from lending money at lower interest rates. And until these doubts and incentives change, high interest costs will preclude a healthy economy.

The Economy

Before focusing on why investors are "holding out" for higher yields and what we can do about it, let me briefly elaborate on why interest rates are so crucial to the American economy. The current recession has stemmed largely from the sharp jumps in interest rates accompanying the short 1980-81 business recovery. Overpricing in the construction and automobile industries also played a role; but when we finish measuring the current recession, my judgement is that high interest rates will emerge as the primary causal factor.

Indeed, what is really intriguing about the business downturn is that it has not been much deeper considering the steep levels of rates. My view is that a combination of creative financing in the construction industry and the boost to household incomes from interest earnings prevented the recession from being even worse. These factors, along with tax relief, have and will preclude a more sustained recession with low double-digit unemployment.

Currently the economic decline appears to be bottoming out. Real GNP should not significantly change in the second quarter. Most of the damage from high interest rates has already been done in industries such as housing and appliances. Many households may be "spending" the July tax cut by temporarily depleting savings. With diminishing inventory disinvestment, a small uptick in real GNP is possible.

In the third quarter, the depressing effect of today's high interest rates on the economy will be temporarily hidden as real GNP rises at a 5% to 6% annual rate. Among the key stimulants will be the 10% cut in income-tax rates, the annual Social Security cost-of-living increase and the end of business inventory liquidation. But the tax and transfer payment stimulus mainly will move the economy from one plateau to a modestly higher one. Sustained stronger economic growth requires further stimulus to household income. And some important contributors to income expansion such as growth of state and local spending, exports and home building will be absent. Thus, after its third-quarter spurt real GNP growth will begin slowing in the final quarter to a below-normal pace.

Looking beyond 1982, whether our economy can grow enough to reduce unemployment depends on interest rates. They must again become affordable for the consumer, provide profitable business investment incentives and allow the dollar to seek a level making our exports competitive again. Otherwise, economic growth will remain erratic and low. Sectors affected by high interest rates--construction, household durable goods, capital spending, net exports--have enough impact on employment that it is hard to imagine a strong, sustainable recovery in income and spending without them. Moreover, what growth that could occur at near today's rate levels would not be capital goods oriented. Without growing business investment in the latest technologies, U. S. workers' productivity and, hence, living standards will be limited.

In sum, lower interest rates are the key to sustainable, healthy economic expansion and higher living standards through capital formation. But as I said earlier, investors will not part with their money at much lower interest rates until the doubts and incentives produced by monetary and fiscal policies are changed.

Fiscal Policy

With regard to investor doubts over fiscal policy, my consulting with a variety of individual and institutional investors has provided a close view of their anxieties. It is hard to describe the "typical" investor nowadays but many are expressing some, if not all, of the following doubts. They are concerned about possible Congressional acquiescence to large Federal deficits on the controversial analytical ground that the deficits may not be a record fraction of GNP. Frequently, I hear doubts about the advisability of a quick defense buildup that might ignite inflation in particular industries. There are also concerns about defense cost overruns about which little could be done once the goods are ordered. In addition, many investors question the political feasibility of continual cuts in nondefense spending. The bottom line is that triple-digit deficits produce a Treasury financing calendar that is simply mind boggling to many investors. If it is possible at all to typify investors' anxieties over fiscal policy, I simply would say that they are more concerned about deficits than many professional economists who see the deficit filling in for absent private credit demand instead of crowding out the private sector. But it is the attitudes of investors and not economists that count most in the capital markets.

Alleviating investor anxieties over fiscal policy requires a multi-faceted approach. For starters, investors would react favorably to a slower pace of defense spending increases and a reduction of the indexation formulas for various transfer payments. In addition, the securities markets would respond constructively to an oil import surcharge. Reduction or elimination of the mid-1983 10% income-tax cut also would be greeted enthusiastically by debt market participants. However, I think that the economy sorely needs such income-tax relief. By just reducing proposed defense spending and indexation and enacting an oil import surcharge, enough would be achieved to cap and even modestly reduce today's high long-term interest rates.

Current Monetary Policy

Still, the above suggested fiscal actions alone probably would not generate a stimulative level of long-term interest rates. With the post-recession level of inflation still so uncertain, it is hard to say how many percentage points long-term rates must drop to become stimulative. What is for sure is that Federal Reserve policies are keeping short-term yields very high, and there is a limit to how much fiscal actions can reduce long-term rates if such Federal Reserve policies persist. These policies have made cash "king" for many investors and are a main reason for continued high overall interest rates.

From my experience with investors, the clearest theme is that investment in cash--short-term, interest-earning assets--has become extremely attractive. And parking money in short-term money market instruments will remain popular as long as these returns stay well above the single-digit yields earned historically by many stock and bond investors. This attraction to cash goes a long way toward explaining high long-term interest rates. It should be no mystery why long-term yields over the past year have become higher versus short-term rates. When the Federal funds rate, the key determinant of short-term money market yields, first hit the high teen's in early 1980, investors did not view cash as a very attractive long-lived alternative to bonds and stocks. Subsequently, though, the Federal funds rate returned to the high teen's twice--in late 1980 and again in mid-1981. Consequently, investors have come to view high money market rates as a more frequent occurrence. As a result, they have demanded higher returns on longer-term bonds.

This persistence of historically high money market rates that fluctuate but remain in the teen's is importantly related to the changes in Federal Reserve policies beginning in October 1979. As you know, since that date the Federal Reserve System has been adjusting the discount rate structure and open market operations more aggressively in response to undesired monetary growth. Also, the Federal Reserve no longer pegs the interest rate on Federal funds; but its actions nevertheless importantly impact the Federal funds rate and other closely related money market rates. The discount rate plus surcharge, if any, has almost always been the base from which Federal funds are priced. There are other funds rate determinants but they work within the context of a broad trading range determined by the discount rate structure and Federal Reserve open market operations. In this setting, with the discount rate remaining at 12% and open market operations having been firmed since the late Fall of 1981, it should come as no surprise that money market rates still fluctuate near the mid-teen's. Apparently continuing concerns over the behavior of the monetary aggregates and prospective Federal deficits have kept the Federal Reserve from lowering the discount rate structure this year despite a recession, high unemployment and falling inflation.

And it is not only the Federal Reserve's discount rate and open market operations policies that are keeping rates high. Also, by no longer pegging the Federal funds rate, the Federal Reserve is permitting transient supply-demand factors to whipsaw the funds rate. Thus, the Federal Reserve is tolerating more volatility and uncertainty now than when Federal funds were pegged. And this leads to a higher risk premium being built into yields.

I believe that such Federal Reserve policies are the primary reason for today's high interest rates. The widely-cited budget deficit problem is due importantly to Federal Reserve policies that keep rates high. These policies weakened the economy and thus tax collections, and also helped to raise the interest expense on the Federal debt. I do not believe that the Federal Reserve ever intended for rates to be this high. However, their policies have importantly contributed to this result.

In judging such policies, we should not forget that the related recession and strong dollar have combined with weak food and energy pricing to trim inflation well into single digits again. However, a monetary policy that was appropriate for fighting inflation will not be successful in permitting much of an upturn. Renewed economic expansion should take priority now. A longer recession or stagnation would trim inflation below the 5% to 6% that I forecast for the initial year and a half of a moderate economic recovery. But the financial structures of many American businesses simply are not designed to weather the storms of prolonged economic weakness. Moreover, American workers should not be forced to continually live with today's degree of job uncertainty. Even more inflation improvement through further recession or stagnation would be a Pyrrhic victory.

Monetary Policy Recommendations

In my view, a monetary policy allowing for a sustained, healthy economic recovery could work as follows. Early in the recovery, there should be slower Federal Reserve reactions to short-lived, above-target money supply expansion. But more aggressive efforts should be made to reduce rates when the monetary aggregates fall under the midpoints of their target ranges. On the other hand, if the Federal Reserve continues to react quickly to above-target monetary expansion with a firming of the discount rate structure and a tightening of open market operations, it will be difficult to bring interest rates substantially and sustainably under today's high levels. That is simply because measurement problems and swings in the public's money holding practices ensure very volatile short run money growth. As a result, the various monetary aggregates never seem to stay within or under the Federal Reserve's target ranges for long; thus, the Federal Reserve never continually eases the discount rate structure and open market operations by substantial amounts. Before long the monetary aggregates are picking up again and along follow interest rates. Either the Federal Reserve firms its credit policies or rates rise in anticipation of this firming. Since I do not believe that the Federal Reserve can stabilize weekly, monthly or perhaps even quarterly money growth, I see only one way out of this problem. That is for the Federal Reserve to back off temporarily from a policy of quickly reacting to over-target monetary expansion. If the Federal Reserve's open market operations and discount rate policies were not firmed so rapidly and so strongly in response to short run money swings, then many investors also would start to ignore such data.

Of course, the Federal Reserve would need to respond, eventually if substantial undesired monetary overruns from annual targets were not self-correcting. However, my judgement is that in today's environment many, though not all, money overruns would be self-correcting before long. That is mainly because the major inflation slowdown should reduce growth of the public's monetary demands to a range more nearly consistent with the Federal Reserve's modest annual money supply target ranges. In this setting, temporary upward monetary deviations from the target ranges would be largely due to measurement problems or transient shifts in the public's money holding practices. Such deviations are likely to be self-correcting before many quarters have elapsed. Still, some quarterly money overruns might not be self-correcting. They ultimately would necessitate a firming in the discount rate and open market operations. However, considering the large margin of unused resources in today's economy, failure to quickly address over-target monetary expansion would not have serious inflationary consequences.

My suggested policy of responding slowly to excessive monetary growth but responding rapidly to inadequate growth is only appropriate on a temporary basis during a recession and early recovery phase. Eventually a return to more timely and symmetrical responses to money overruns and shortfalls would become necessary as capacity utilization and jobs substantially recover.

If the above suggested policies did not succeed in getting rates down enough and if inflation were still not a problem, the Federal Reserve then might consider some further options. One strategy might be to temporarily raise the annual monetary target ranges. Another option is to again peg the Federal funds rate. That would reduce the volatility and uncertainty premium in interest rates. However, both strategies would be quite controversial for investors and my recommended policy is a more plausible, widely acceptable first step.

Without doubt even my recommendations will be controversial among strict monetarists. They probably read more mischief than I do into short run money spurts even at this stage of the business cycle. But considering the tremendous range of economic opinion, no monetary policy will satisfy everyone. However, I think most investors would commit long-term funds at much lower rates if the yield incentive to stay in cash were reduced while inflation remained low.

To conclude, Mr. Chairman and Committee Members, high interest rates were necessary to slow the economy and inflation. However, American business, labor and government bodies have had as much of a recession as they can stand. Public policies must now reduce interest rates and get the economy moving again. This can be done. With additional fiscal balancing and some temporary changes in the Federal Reserve System's operating procedures, you will find bond investors and "Wall Street" accepting lower interest rates.

Representative REUSS. Thank you, Mr. Harris, Mr. Gough, and Mr. Chimerine, for three remarkably fine and helpful statements.

Stop me if I misunderstand you, but I think all of you have given us essentially the same view of the economic outlook. You've said the present situation is miserable, produced by a mismatch of policies—too tight monetary, too loose fiscal policy. You've said that the July 1 tax decrease, the July 1 increase in cost-of-living allowances, plus the working down of inventories due to the fact that there is a certain point beyond which they cannot go, will mean a slight upturn. But granted the continuation of present policies, higher interest rates are soon going to overtake us again, and we'll be right back in the same slough of stagnation that we've been wallowing in for many months.

Granted there are differences in details between you three witnesses. That's not surprising, but I think it is significant that your central vision is identical. You also have agreed that the devil in the flesh which must be exorcised is not only a silly fiscal policy, but a silly monetary policy, and that we have to do both. I think you would agree that if we don't clean up our fiscal act, then the whole thing is so depressing that fooling around with the Fed is probably not even good medicine. But on the assumption that Congress and the administration will come to our senses and get future deficits under control, you agree that we need also to do something about current Federal Reserve monetary policy; is that a fair statement?

[No response.]

Representative REUSS. I hear no dissent.

MONETARY TARGETS

As you perhaps know, I and other members of this committee have been saying for some time that the corset in which President Reagan and, indeed, Chairman Volcker have encased the Federal Reserve on its money supply targets is simply too tight. As you know, right in the teeth of a sharp recession, the Fed and the administration reduced the money supply targets from 3½ to 6 percent, which they were last year for M_1 to a 2½ to 5½ percent range for 1982. You're also familiar with the fact that the Fed so far has, fortunately for all of us, failed quite miserably to meet those targets and, as of today, with more than a quarter of 1982 used up, they are over the top of their target.

I would address my first question to Mr. Harris, because he is a member of the Wall Street community and, therefore, speaks with considerable knowledge of the views of financial market participants.

The Federal Reserve has tended in other election years throughout the last generation to talk a tight money game so as to placate the monetarists and the tight money crowd, but, in fact, they have created quite inflationary bouts of new money in violation of their talk. In other words, vote dry, but drink wet. If they do that once again, they may succeed in hoodwinking the conservative tight money crowd and hoodwinking certain liberals who say, "Well, isn't it great, they're now producing new money at a very rapid rate," but they don't hoodwink the money markets and Wall Street where there are people who are perfectly capable of seeing through such chicanery; and the result will be very sad.

Mr. HARRIS. A couple of points, Mr. Chairman. First of all, my judgment is that a good part of the money supply increase that we've seen this year, especially what we saw in early April was largely due to technical difficulties in measuring the money supply rather than any direct Federal Reserve attempt to simply pump up the money supply. I simply don't believe that they have tight enough control over the money supply to pump it up for any kind of political purposes, even if they wanted to do that. And I'm sure they don't want to.

Representative REUSS. Let me be very clear. I did not accuse them of doing it. Take an alcoholic who promises his wife or a friend that he'll only take four drinks a day, and by noon he's had three of them, and is starting on his fourth. The prognosis for the rest of the day does not look very good. It may be due to technical difficulties that he had the 3½ drinks. So it isn't all that encouraging really that here we are with May coming in, and the Fed has been well over its targets. That means either that they have to reduce money supply growth for the rest of the year to an unconscionably low level like 2 percent, which brought us into this recession, or they go merrily on debauching the targeting system.

I agree with you that errors for a week, a month, or even a quarter aren't serious; would you agree with me that for a year you ought to be hitting the target?

Mr. HARRIS. I would agree that on an annual basis, if they seriously overrun the money supply targets that that definitely is going to spook the financial markets.

Representative REUSS. That was my only question.

Mr. HARRIS. They would spook the financial markets.

One more point though. We're in a period of recession now, where the turnover of money or the velocity of money is unusually low. Normally coming out of a recession, monetary turnover picks up, which means that you don't need as much money to finance as much GNP. I would look for that kind of pick up in monetary turnover in the second half, so that the money supply growth rates at least don't look nearly, nearly as bad in the second half as they look right now.

But make no mistake about it, if you go over the annual target ranges for a substantial period of time, by a substantial amount, you're going to spook the financial markets.

Representative REUSS. Fair enough.

Now turning from the testimony of our Wall Street expert, let me ask the whole panel this question. I and many others of us on the committee feel that the Fed erred and the administration erred in encasing the money supply in this supertight corset. It was unnecessary. The progression schedule for a slow, steady diminution of the money supply, which was contained in President Reagan's February 18, 1981, economic recovery program, and which the Fed agreed to and the Congress agreed to, would have said that the 6.6 percent M_1 growth of 1980 should have fallen in stages to become a 3.3-percent rate of growth by 1986, which is about right, from there to eternity. But instead of doing that, instead of getting on a nice plan to 6.6 percent M_1 growth in 1980, 6.0 percent in 1981, and 5.5 percent in 1982, they jammed on the breaks and went to a 2.3 rate of monetary growth last year, which was about 10 years ahead of schedule.

Now it is for that reason that we have pleaded and besought the administration and the Fed to loosen up that corset. So far we have persuaded, to her great credit, Governor Nancy Teeters, but the other 11 members of the open market committee are continuing on this course.

Wouldn't you agree, Mr. Chimerine, that a modest loosening of the corset, but still staying on the long-run target, would be a good thing and a better thing than ad hoc corruption of the targeting process by, as I put it, voting dry and drinking wet?

Mr. CHIMERINE. Mr. Chairman, I would agree with you about your characterization of policy last year. It was very restrictive. I'm not sure the Federal Reserve at the beginning of the year set out deliberately to restrict money growth to 2.2 percent. They can't control it that well, and I think at the end they were disappointed it turned out that weak, although I think the thrust of their policy last year was to err on the side of a low money growth number rather than a high money growth number. So the risks clearly were in that direction, although their preference would be, I think, for a number somewhat higher.

By the same token, I think you have to give them some credit over the past 4 or 5 months, and the fact that I think they have eased up somewhat, in the sense that No. 1, they're allowing for a larger increase in the monetary base, which they can control more effectively than they did during 1981. Second, they are not responding as significantly now as they would have a year or two ago, whenever the money numbers, for whatever reason, jump somewhat above their target range, including, in the last week or so.

I think many people in the markets may have anticipated a much sharper response, had they known this $7-billion increase in the money number was going to be reported on Friday, yet the Fed, recognizing the technical difficulties in measuring the money supply, and I think, also realizing the rather disastrous state of many industries, poor corporate liquidity, the need to get some recovery, high unemployment, I think is now going in the other direction. They are likely this year to err on the high side.

I guess my biggest concern with your statement is that, no, I don't think the markets would respond very badly this year to a money number increase of 6 or 6½ percent instead of the 2½ to 5 percent target. I think it would respond badly if money growth was 9 or 10 percent, like it might have been 5 or 6 years ago, but something, a point or two above the current targets, which I view as too restrictive in this environment, I don't think would bother financial markets at all. In fact, I think it would help lead to lower interest rates.

Representative REUSS. Well, I quite agree with you, but I want to be sure my question has been understood.

I think this country ought to be run by as sensible and nonfraudulent rules as possible. To run our money supply system as you would a floating crap game is really not a very good way to conduct a government. Therefore, wouldn't it be good for the Fed to say, "Look, we believe now in May 1982 that the 5½ percent ceiling we imposed on the money supply is in error. Therefore, we are modestly raising the upper level of our targets," to whatever figure Mr. Chimerine suggested. I believe I heard 6½ to 7 percent. And the Fed could say, "We're not necessarily going to use all the leeway we're giving ourselves, but in the interests of a nonfraudulent monetary policy, we think we should amend the targets."

Wouldn't the market say, "That's a fine and honorable thing the Fed has done, and we feel better"?

Mr. CHIMERINE. I think the Fed, Mr. Chairman, has two options. The first option is to make a public statement of the type you described, by telling everyone that for this year we've raised the targets from 2½ to 6½ percent, or whatever.

Representative REUSS. I didn't say that. The present target zones are 2½ to 5⅕ percent.

Mr. CHIMERINE. Right.

Representative REUSS. It is my belief that for credible targets, the top of that should be, say, 5½ percent. All right. That's all I'm suggesting, and that they say we will try once again to hit the best rate within that rather broad band. But we are raising the ceiling so that we may not be in a position to give false signals to the markets by having a ceiling and then proceeding to exceed it all the time.

Mr. CHIMERINE. I understand what you're saying, Mr. Chairman. What I'm saying is that the Fed can really respond to that. If that is our desire, and I think it is, particularly since I believe the Fed now believes that the current M_1 numbers, in particular, the target you described, the M_1 numbers are probably overstating the underlying real growth of money in the economy, because a whole range of technical factors are probably pushing the numbers up more rapidly, you know, that we could adjust for that, that the numbers would suggest.

The Fed could do that in two ways. They could say publicly, we are now modifying the range up from 2½ to 5½, to 2½ to 6½ to allow for that, or they can just not make a public statement but act that way. that is, when the money numbers exceed the 5½-percent top of the range, not tighten, not pull back on reserves like they've done in the past.

I think ultimately it would have the same effect, because the markets would come to realize that, and I think that the markets are in the process of beginning to realize that already.

So I'm not sure you have to announce it publicly. The key thing is how they behave, and I think it's essential that they not every time that money number exceeds the 5½-percent top of the target, that they do not rush out there and pull back on reserves. To me that's harmful.

Representative REUSS. Maybe we need a panel of moral philosophers rather than econometricians, because I think the moral philosopher would say, the Government should not, as a matter of policy, kid the people for moral reasons, and indeed, as the public gets smarter—and it is getting smarter—for political reasons. But again, I'm not a moralist either.

Mr. CHIMERINE. The only problem with that, Mr. Chairman, is the fact that it gives the public the impression that they can always control money growth within that target range. And they can't always do it.

So the worst thing to do, I think, is to announce a new range and then line up even a quarter of a point above the new range.

Representative REUSS. If I were the Fed, I would coat my new announcement with a humility that isn't always evident in Fed pronouncements. I would do that by saying what you said, but add that in view of the fact that the Fed is flirting with 6 percent M_1 growth—they'd like to make an honest woman of themselves and tell it like it is.

Mr. Gough, what do you think about this great moral question?

Mr. GOUGH. Well, I think, Mr. Chairman, that you would agree that there is a time and place for a tight corset, but I think that that time and place is over.

And I also think that the time and place for playing semantic games with the public is over. I think if the Federal Reserve came forward and stated, however, humbly, that the target ranges have been revised upward, that would go a long way toward mitigating the potential for spooking the financial markets, as Mr. Harris has said.

However, I do think that in order for them to come forward in that manner, that it would be wise to give them a little bit of quid-pro-quo-type of budget compromise ahead of time.

Representative REUSS. Absolutely. I want to reiterate what I tried to make clear in the question I put: all of this is predicated on getting control over future deficits and a sound budget policy, whether obtained by compromise or by force majeure, as the case may be.

Mr. GOUGH. I agree with Mr. Chimerine that it's very difficult to control the money supply that tightly, but I do think that we would go a long way toward reducing the nervousness of the financial markets if there was a statement made rather than continuing on an above target type of program, because in that type of an environment you maintain the nervousness of the financial markets as to what the Fed might or might not do.

Representative REUSS. Mr. Harris, would you agree with Mr. Gough that a modest statement by the Fed along the lines just described would be helpful?

Mr. HARRIS. I would just briefly add, Mr. Chairman, that the Fed should probably do a better job of explaining why the monetary aggregates go over the long-term targets in the short run.

And as I said in my statement, I would hope that they would cool it in the short run and wait for the aggregates to slow down.

In the second half of the year I'm looking for two things that I think are going to slow down the money supply. I am looking for 5 or 6 percent inflation, which means that money demands aren't growing that fast anyhow, and I'm looking for an increase in money turnover.

So the money supply may be slowing down anyhow in the second half of the year and the whole corset issue may start to fade away.

Remember the whole issue of the targets not being adequate came when we were talking about at best getting down to 7 or 8 percent inflation, and if you were going to have any real economic growth, those targets looked ridiculous.

My forecast of from 5 to 6 percent inflation in the second half of the year—which is what we had in the second quarter, if I'm correct about that—then the money supply with a little bit of velocity increases is in as much of a corset as we have had.

Representative REUSS. But you, as a careful forecaster, certainly don't get your back up at my suggestion that the Fed—even though it takes fully into account the happy likelihood of less inflation and greater velocity reducing the need for a higher M_1 growth figure—nevertheless could guard against the mishaps that occur so often in forecasting and guessing about the future by modestly relaxing the corset.

Mr. HARRIS. I would think the best idea would be to keep the target where it is this year, but to tolerate above-target growth.

In other words, if you have a 5½-percent top this year and it comes in as 6½-percent, I think they can tolerate that or even 7 percent, and point out that last year they were under target.

I think that could be easily explainable. You were under target on M_1 last year, so you came over target this year. I think that would be perfectly acceptable.

Representative REUSS. So you would favor a Fed two wrongs make a right press conference, saying, 'We goofed last year and we're going to goof this year, but it all averages out."

The only trouble is that we in Congress have a little old law called House Concurrent Resolution 133 in the Humphrey-Hawkins Act, which says—maybe it's all a mistake, but it says—the Fed shall tell us the targets for the year; it shall tell us the range of aggregates which they in their good judgment believe are the proper ones.

But you say it's perfectly all right for them to hedge that and say, "Well, we're going to have these targets: one year we are going to be way under and the next year way over, and don't worry about it."

Mr. HARRIS. I think they're going to have to explain to the public what's important about money supply growth is what happens over many quarters, more than just 4 quarters in a year. So that I think the Fed's performance should be judged by monetary behavior over maybe 2 years rather than just 1 year.

Representative REUSS. I don't necessarily quarrel with that. What I don't know about monetary policy will fill a book, but what you say would require a change in the laws of Congress.

We have set this up—fools that we were, perhaps—on a 1-year basis. You're suggesting we change that and go to 5 years or 2?

Mr. HARRIS. No, perhaps over a 2-year basis would be more appropriate than a 1-year basis.

BUDGET COMPROMISE

Representative REUSS. Well, I think we ought to and we'll consider that. I raise another question, which was inherent in the testimony of several of you: You all said that you devoutly hoped for a compromise between the President and the Congress on the budget. And fervently do I pray for that myself.

In asking for a compromise, I take it that you mean a real compromise that actually accomplishes, in a credible manner, outyear deficit reduction; not something, which on careful reading, either is not going to be enacted or which just doesn't add up.

The way I've loaded the question, you really have to say yes, but is there anybody who doesn't say yes to that?

[No response.]

Representative REUSS. All right, then I come to my real question, if it turns out a few days from now that such an honest compromise, as opposed to a fictitious one, is not forthcoming, wouldn't it be a good idea if the Congress took the matter into its own hands and enacted, by artful linking to debt ceiling legislation, a genuine, broad-based, everybody-must-tighten-his-belt-future-deficit-reduction fiscal policy? Isn't that better than either subscribing to a phony compromise or walking away and doing nothing with the budget process so fractured and the future deficits highly uncertain?

Mr. CHIMERINE. Yes, Mr. Chairman. I think obviously it would be better, and I think for a number of reasons: First of all, no matter what the Fed does, even if they ease the way we've described, for example, if M_1 growth is 6 or 7 percent, even if they pay less attention to the money numbers and do more interest rate targeting, in my own judgment there's absolutely no way to finance the deficits—realistic deficits we're looking at during the years ahead, not the ones in the administration budget. Those cannot be financed, in my view, without upward pressure on interest rates.

I can take you through all the arguments that will be made that they can be financed, but I'm very hesitant in accepting any of those arguments. So it seems to me it is absolutely essential, even after the Fed eases—if the Fed eases somewhat—it is essential that those deficits be brought down. Not only brought down, not only reduced, but as you suggest, credibly.

If all that comes out of this is a 2-cent a pack tax on cigarettes, I don't think the market's going to respond very well, to put it mildly.

As a matter of fact, I think the lesson we've learned in recent years is how well the markets have anticipated precisely this issue. And I'll take you back, in fact, to almost a year ago to last summer. Despite the easing of inflation that was beginning at that time—despite the fact that the recession had already begun—interest rates kept rising sharply last summer, particularly at the long end of the market. And in my judgment they were rising because they saw that the Congress and President were going to enact this full tax cut and were adding new features to it, and they recognized that in the future these deficits would be extremely large as a result.

And I guess I have to disagree in part with Mr. Harris. While he's absolutely right that high interest rates and a weak economy are partially responsible for these deficits, future-year deficits will rise predominantly because of an imbalance in the existing administration or the existing program.

That has to be eliminated, it has to be eliminated credibly. And unless those deficits are brought down year by year in a credible fashion, I think the markets will respond very badly all over again.

In fact, they did it again in January right before the message came out when they started realizing that the budget would not address the issue.

So it is absolutely essential that this take place. And the kind of program required to do it on a credible, believable basis is very, very substantial. We're talking about a massive amount of cutbacks in spending or tax changes from current law—not small amounts.

Representative REUSS. Thank you, Mr. Chimerine. Do either Mr. Gough or Mr. Harris want to comment on my proposition, which was that if the only compromise forthcoming is a phony one, then Congress ought to earn its salary and take the bull by the horns and use such constitutional means as are available to it to save the Nation economically by taking steps to get the budget deficits under control, and thus permit and encourage the lower interest rates that the economy needs?

Mr. GOUGH. I agree. I would only add that a weak compromise actually might be worse than no compromise at all, because no compromise at all would at least tell the financial community that we are sticking to a particular ideological path, whereas a weak compromise is too much of a fence-straddling procedure.

Representative REUSS. Mr. Harris.

Mr. HARRIS. Mr. Chairman, I would generally agree with what you said, I'd just add two points: I spend a lot of time talking to investors, and just to emphasize how important the deficit is to investors, it's only economists who look at the deficit as a fraction of the gross national product and say it's not so bad.

I have yet to run into any major institutional investor who buys that argument. In fact, they're very concerned about the deficits. From what I fear from our clients, they would rather see the deficit cut, though, with trimming spending, rather than raising taxes again.

Representative REUSS. Thank you.

Congressman Richmond, you've been very patient, and would you now take as much time as you like and preside for a moment. I'll be back.

Representative RICHMOND [presiding]. I certainly appreciate that, Mr. Chairman. Thank you.

SURVEY OF SPENDING PLANS

Let me do something I've never done in the 8 years I've been in Congress. Let me take a survey of people in the room—there are 80 people in this room, I'd say it is a pretty good cross section of the United States. We have young people, middle-aged people, old people like I am. How many people—and I'd really be grateful if everyone, including the press, would participate. How many people in this room have any plans for making a major purchase in the next 6 months? When I say major purchase, I mean something which would probably have to be done on credit—a house, an automobile, a motorcycle, a boat, a videotape recorder, a major appliance for your house—something that is really going to squeeze.

How many people in this room—would you please raise your hand—how many people have any plans for making a major purchase this year?

[Show of hands.]

Representative RICHMOND. We have 14 people out of 80 that are planning to make major purchases. Gentlemen, I listened to your remarks. All three of you seem to be in agreement. But let me bring a few facts you didn't mention: First of all, I think no one mentioned investor confidence.

In my opinion, the average American investor has little or no confidence in American securities at the moment. The Dow Jones average, as you know, continues to be about as low as it's been for the last 15 years.

Fifteen years ago I wagered—I had a little wager with the president of the New York Stock Exchange that the Dow Jones wouldn't go over 1,000. And in the last 15 years, as you know, it's done little or nothing. And the stock market has done little or nothing.

That's our major investment opportunity. When people really have great faith in the American way of doing business, they invest in stocks. And they're really not doing that now. Most of the investment now is institutional—tax receipts.

I think we're all forgetting that when you have a situation of recession—and we're all talking about recession, we're all talking about a rather poor outlook—everyone is forgetting, including our own Congressional Budget Office, including the Federal Reserve, including the administration, including you three gentlemen—human nature.

You're forgetting the fact of what a corporation does when it sees that its earnings are not particularly good and are not better than the prior year—and I say this from good experience of running a company myself—for 9 years our company had earnings better—15 percent better—than the prior year—9 straight years.

Obviously, we tried very hard to show that record. But then you hit a year of recession; what do you do? You clean house, and in my opinion, tax receipts this coming year will be far below the levels predicted, because I'm sure most corporations and most businesses will use this recession we're in—I think it's much more than a recession—to clean house.

They figure, what the heck, every dollar I pay the Government could very well stay in our Treasury; we're paying anywhere from 17 to 25 percent for our money, let's just not show as many profits as we usually do—let's pay lower taxes, let's clean house, let's write this down, let's write that down.

I think that's going to happen this year and that's going to materially reduce the income to the U.S. Government, and nobody has taken that into account—backlogs.

I see no end to this recession; in fact, I see it worsening because backlogs in many of the companies that I'm involved in, which sell to the three major industries in the United States—automotive, farm equipment, and housing—continue to go down. We don't do it in the defense business, but in the three major industries I see nothing but declines.

No one's mentioned the farm sector, no one's mentioned the fact that a large percent of all the capital in the United States is invested in farm-related activities.

Now there isn't a farmer in the United States who can afford to go out and buy himself a piece of equipment. I don't even know how he's going to buy his seeds and fertilizer so he can get a crop in this year. He sure as heck is not going out and buy any new equipment.

What happens to the John Deeres, the Allis-Chalmers, and the International Harvesters?

Capital investment: Last year, the Congress finally modernized the capital investment structure. It should have been done years ago. At that time we had the most antiquated depreciation schedule of any industrialized country in the world. So finally we brought it up to date, thinking that this would inspire capital investment.

What's happened? Capital investment hasn't gone up, it's gone down. Our country is becoming less and less competitive in the world markets.

Fewer and fewer manufacturers are willing to get 20-percent money and invest it in new equipment. Now, if you happen to have some money in your treasury, fine, I think those people are buying new equipment.

But if you have to go out and borrow money, nobody can really show that it's realistic to pay 20 percent for money—and you know it comes to 20 percent by the time you borrow your money from a bank and have a compensating balance. Even if you have top credit, you're in the range of 19 to 20 percent.

Now what about the poor folks that aren't top credit? You can imagine what they're paying. I shudder to think.

I had a visit with the president of Bristol-Myers recently, and I said, "How's business?" Now, that's a very steady company. It's just a high quality consumer goods company, Bristol-Myers; right? They make Vitalis and Ban deoderant, all manner of products that you think are just the most depression proof products in the world. That division does a volume of $400 million and he said, "Well, business isn't so good."

I said, "What do you mean, business isn't so good? Have people stopped using underarm deoderant?"

He said, "No, what's happened is our distributors, our merchants, instead of keeping five different sizes and three different flavors, are down to two different sizes and one different flavor." In other words, they, themselves, can't afford them. The little storekeeper can't afford the 25 percent it costs him or her to maintain that piece of inventory on the shelves. As a result, they are materially cutting down their line. Sure, the storekeepers are still keeping Ban on their shelves, but they're not keeping it in as many different sizes as Bristol-Myers sells. As a result, Bristol-Myers, for that division that you would consider relatively depression proof, the fellow tells me that he will be very happy if his volume this year is as large as his volume last year. In other words, he, effectively, will drop volume this year on a product which I would consider almost depression proof, and of course, his profits are going to go down.

And I think another problem that's bothering the American people and will have a great, great deal to do with our ever getting out of this recession, is our lack of foreign policy. The average American is scared to death. Nobody in the United States knows what our foreign policy is because we don't have one. And I think the average taxpayer-consumer is probably more inclined to hold on to his or her money right now and see what happens, because I think everyone is worried. And for all those reasons, while I agree with your remarks, I feel that I'm much more negative than you folks are.

Mr. CHIMERINE. Congressman, I'd make several observations. First, I think you did a very good job of articulating the current economic situation: things are bad; capital spending is falling; the farm business is a disaster; and I think at least I mentioned earlier there is no question the economy is very, very depressed; and high interest rates, by reducing the incentive to invest, by depressing commodity prices, by pushing up the dollar, have been the dominant factor in creating this situation. And I think this is the message we all tried to bring earlier, that if we're ever going to get out of this and see a sustained economic pickup for a number of years, which is necessary to get us out of this situation, that we've got to bring interest rates down. I don't think anybody here disagrees, and that's what we talked about.

INTEREST RATES AND DEFICITS

Representative RICHMOND. How do you bring interest rates down when the deficit next year, no matter what Congress does, is going to be much higher than anyone expects it to be?

Mr. CHIMERINE. Because I think it isn't so much the absolute deficit in any given year. The deficit this year is very high, as well, but part of the deficit simply results from the fact that the economy is weak and you always have a large deficit when the economy is weak. The key issue is to get the deficit falling during the periods when the economy will start to pick up again, hopefully 1983, 1984, 1985, and beyond, instead of allowing the deficits to continue to rise during those years as they will under current law.

Representative RICHMOND. You know, Mr. Chimerine, I am just a simple little businessman. All I know is American savings come to roughly $200 billion a year. If the U.S. Treasury, in its infinite wisdom, grinds out $130 or $140 or $150 billion worth of Treasury bonds and they have to go to auction, I don't see how, in a million years, we are ever going to get the interest rates down.

Now, I agree with you folks that until interest rates get down to well below 12 percent this Nation will never be able to get started again because people won't be buying houses or cars, and manufacturers won't be able to buy new equipment. I think everything is tied to interest rates.

Now, with the receipts that I suspect will be much lower than we expect, we're going to have to grind out Treasuries. You see, we don't have the Japanese system where the workers themselves support their government at 5¾ percent with savings bonds. That's something we used to have, but no one does it anymore.

So all I want to know is: how are we going to continue supporting this Government, these high defense bills and everything else we have, on Treasury bonds that we have to auction off to the highest bidder?

Mr. CHIMERINE. I think, again, we are fundamentally agreeing. The only disagreement I can sense is the fact that if you're arguing that because of this recession which is still continuing—hopefully it's bottoming out, it's certainly a depressed economy—that tax receipts are falling in response and that that's pushing up the deficit, you're absolutely right. The point I'm making is that that is not the same kind of deficit and doesn't have the same impact as the deficits in future years will because—well, by the same token, one of the reasons the economy is weakening, nobody is borrowing, nobody is buying anything. The farmer isn't buying equipment, he isn't borrowing to do it. If nobody is buying an automobile, he's not financing an automobile.

So what I am saying is, in this environment, the decline in private credit demand has been so sharp that this year's deficit can be financed. I'd like to see it smaller, but it isn't the critical issue. The critical issue is the deficits in future years which, if they rise at the same time, and you want the farmer out there borrowing and you want the corporation financing the capital expenditures project and you want the consumer to buy a new car or a new house, there won't be enough for everybody to get around, if the Treasury keeps taking a larger and larger fraction of that.

So I think we've all seen that to avoid the situation of higher interest rates and, in fact, to bring them down and promote a longer lasting recovery, two things have to happen. As you suggest, first, those future deficits have to be reduced by either cutting the military or any of the other ways you'd like to do it, and second, that the Fed has to be a little less restrictive so there is more credit available. I don't think we're fundamentally disagreeing, but the confidence issue is a typical phenomenon at this stage of the business cycle.

Everyone is gloomy when you see your neighbor laid off, when your profits are going down. Frequently confidence lags, and if you use the argument that weak confidence now would preclude an economic recovery, we'd never see any recession end.

The key is that a number of fundamentals are getting better; inflation, inventories, fiscal stimulus, and so on. If we can, at the same time, adjust existing policies to bring down interest rates as well, then we can see a better economic environment, more spending, and a return to better confidence.

STAGFLATION

Representative RICHMOND. Mr. Chimerine, some thoughtful financial experts feel that this stagflation we're in won't end for the foreseeable future.

Mr. CHIMERINE. Some feel that way. I think they're not looking at——

Representative RICHMOND. I am inclined to agree with them.

Mr. CHIMERINE [continuing]. I tend to disagree primarily because—let me contrast the situation now, Congressman, with 3 or 4 years ago. Look at what the economy was facing back in 1978 and 1979. First of all, real incomes, or household incomes were falling for a number of years. The debt burden for most families was absolutely enormous, by far the most it's ever been in the United States.

Representative RICHMOND. What was the interest rate?

Mr. CHIMERINE. Savings were depleted, interest rates were moving up.

Representative RICHMOND. But what were the interest rates?

Mr. CHIMERINE. Interest rates were in the process of moving up sharply.

Representative RICHMOND. They were still within a reasonable range.

Mr. CHIMERINE. I think, Congressman, 3 or 4 years ago they were starting to move up into the levels that we have been experiencing in recent years.

If you look at the situation now, we've got inflation moderating dramatically, we've got oil prices coming down, we've got a reduced debt burden for most families, real income, at least for those people still working, is going to rise, we've got tax cuts in place, productivity is no longer falling on an underlying basis as much as it was at that time; there are a number of reasons to be reasonably optimistic. The problem is interest rates, and that's strictly a policy issue.

Representative RICHMOND. Mr. Krauthoff just gave me the schedule showing me that interest rates through the first half of 1979 were well below 10 percent.

Mr. CHIMERINE. Yes, but since that time they've been rising steadily. That's my point. We started to enter a period during which interest rates were moving on an upward trend which was an additional factor depressing the economy during this period. If we can start moving them down in the other direction, combined with the other favorable developments that have taken place, I think we do have prospects for ending this stagnation.

Representative RICHMOND. Mr. Gough.

Mr. GOUGH. I think the answer to your question about what do we do, is simple. We begin—I think we have to effect some kind of a budget compromise. I think we have to impress upon the Federal Reserve that they must interpret the monetary data more liberally, they are not going to get dramatic changes in the deficit in the very near term. But in the process of moving toward those changes, I think we have to talk seriously about a very substantive compromise in the budget. By that I mean something minimally, like postponing the 1983 personal tax cut, for example.

Representative RICHMOND. Which is something, as you know, the President is dead against.

Mr. GOUGH. He's dead against.

Representative RICHMOND. Our chairman said that he believes the Congress ought to do its job and eventually come up with a budget. However, we all know that this Congress can't override a Presidential veto. Unless we get the President to go along with this congressional budget which, up to now, he's obviously shown no willingness to do, he'll veto it and we're back to square 1 again, and I'm seriously worried about the fact that we're in a terrible recession. It's going to get worse, not better.

I'm worried about the Nation's farmers, particularly. The unemployment level, as you know, is much higher than the Labor Department tells us because there are so many people that are out of the employment market that have never gone into the employment market: High school dropouts that have never had a job—they may go into probably the millions, and there are so many part-time workers that are included as employed, people who perhaps work 20 hours a week at minimum wage. So I think the unemployment figures in the Nation are much higher than we are given to believe, and what bothers me most is I don't see any light at the end of the tunnel.

I would have thought right now that intelligent manufacturers, seeing what Germany and Japan are doing to the United States and to the world in general, would use this period of slack business to improve their quality, to put in new equipment, to tighten up their labor contracts, to modernize their buildings. It seems to me now is the time for the Nation's business to use this pause to clean house, and I see very, very few manufacturers doing it, and it scares me to death.

Mr. GOUGH. I think I would classify myself as being a little bit more pessimistic than Mr. Chimerine, for while I agree that there are some substantive reasons why the economy should increase in the second half of the year, I feel that there are very, very few reasons why that recovery should be sustainable for the next 2½ years. I think the risks are very, very high that we could easily cycle like we have in the last 24 months for the next 2 to 3 years, and that would come about if we don't have some kind of a budget compromise and if the Federal Reserve continues to argue that a tight corset is something that we need over the longer run, which we don't.

Another point that I want to make is that the distinction between inactive and passive deficit which is often talked about recently is correct academically, but I think, practically speaking, that too much is being made of it. Even though it's true that the deficit this year is not causing the terrible problems that it probably will cause when the economy begins to expand, nevertheless, the deficit is large and it's there. I liken it to a huge dog on the front porch of a house. If you don't want to go into the house, you don't want to enter the property, the dog doesn't pose a problem. But the point is that the huge dog is there, so if you want to go into the house or into the property, you've got to deal with that dog. And if you're a corporation and you want to go into the capital markets, you must face the crowding out impact of the deficits. So whether or not the deficit is active or passive, it's a problem.

STOCK PRICES

Representative RICHMOND. Mr. Harris, from the investment community, doesn't it disturb you that the Dow Jones for years and years and years has registered no improvement, meaning that the American investor has very little confidence in his own industrial complex?

Mr. HARRIS. Congressman, I believe—first of all, I certainly am disturbed that the stock market and the bond market remain as depressed as they have been. There are many reasons for this. One of the most important reasons now is that so many investors now view cash as being king. As long as you have a simple bank policy that is going to hold on to a 12-percent discount rate and let CD's fluctuate between 14 and 15 percent, as long as the central bank is going to allow money market rates to stay in the midteens, even if an investor has all the confidence in the world in the economy, the easiest thing to do is to keep your money short term, and that's what we're doing.

Representative RICHMOND. Mr. Harris, I don't think it's the central bank as much as it is a fact of life. If this Government is going to run a $150 billion deficit, we have got to get it somewhere. There's only one place we can get it, and that's by printing Treasuries. We auction them off and that's what causes high interest rates.

Mr. HARRIS. There are numerous factors that affect interest rates: one of them is Treasury financing needs. What the Federal Reserve System, what it does with its discount rate and its open market operations are, in my judgment, also extremely important, so the fact that investors aren't enthusiastic about stocks and bonds now, I don't know that that reflects a tremendous lack of confidence in the economy, it reflects that investors are taking the easy way out; that they're sticking with cash, which has become king. And investors aren't going to be moving out into stocks and bonds until the central bank does something to bring rates down and until fiscal policy changes course.

ECONOMIC FORECAST

Representative RICHMOND. Mr. Chimerine, I hate to say I told you so, but when you testified here back last October, you indicated that you didn't feel the recession was going to be too extensive. Now you've changed your mind, I take it, in 6 months?

Mr. CHIMERINE. Events have changed my mind, yes.

Representative RICHMOND. What events particularly changed your mind? As I recall, last October I was just about as pessimistic as I am today, and I think we had a dialog about it.

Mr. CHIMERINE. I believe you're right; you were.

Mr. RICHMOND. I really respect you, Mr. Chimerine. I want to know: You seemed quite positive then, on October 21, that we were coming out of this recession, as did the Secretary of the Treasury who was here.

Mr. CHIMERINE. I did not say that, Congressman. What I did say was that the economy would remain weak and would decline.

Representative RICHMOND. You said I think it's likely that we can avoid a serious recession.

Mr. CHIMERINE. Yes.

Representative RICHMOND. That's October 21. Six months later, I think you'll have to agree, we're in a serious recession.

Mr. CHIMERINE. Absolutely.

Representative RICHMOND. Now, what happened to change your mind?

Mr. CHIMERINE. I'll tell you what happened. Two things: No. 1, interest rates stayed up much higher and longer than I thought; second, the effect of those interest rates on the economy in terms of weaking the economy turned out to be much more serious than I thought. There's just no question that over these last 6 months since I was here last, the decline in the economy was much more severe than I expected, although I think that a more accurate characterization of what I said 6 months ago was not that I thought the economy would do well. I just didn't think it would fall as rapidly as it has.

Again, it gets back to interest rates, and I think that's why we've talked so much all morning about how absolutely essential it is that a shift in the current policy mix be made in order to bring these interest rates down. That is the dominant factor stifling the economy and it will limit the recovery—it will prevent it completely unless interest rates are brought down, unless the policy mix is adjusted. I think that's fundamentally what we've all been saying all morning, so I think on that point we are in agreement.

Representative RICHMOND. I don't think it's a matter for the policy mix to be adjusted. I think it's a matter for the Congress, the administration, and the President to understand that the interest rate will never come down unless we get hold of these deficits.

Mr. CHIMERINE. I agree. That's exactly what we have been saying, and I think the lesson of the last 6 months shows how important it is to do that, because the impact of these high rates is now so widespread in the economy—you're absolutely right—it's destroying the farm sector, it's killing housing, autos, capital spending, you know, throughout the system, and not only that, it seems to me that 1983 is the key year, because if we don't do something to get rates down and a better economic environment in 1983, all the more favorable longer term prospects, I think, will dissipate. There won't be anybody left to either produce the increase in demand that might take place in 3 to 4 years. If profits fall any further, then corporate tax cuts are going to be used mostly to rebuild liquidity rather than to finance new investment. The thrifts are going to be out of business.

I think the more we prolong the kind of steps that are necessary to—however, you want to describe it, bring deficits down, ease up on the Fed—that combination, and bring interest rates down, the longer we jeopardize long-term prospects, let alone continuing, recurring, economic stagnation. So I think we are fundamentally in agreement.

Representative RICHMOND. Thank you.

Thank you, Mr. Chairman.

FISCAL YEAR 1982 DEFICIT

Representative REUSS [presiding]. On April 20 the press reported that some of the supply-side economists at the Treasury had analyzed the deficit figures for the first 6 months of fiscal 1982, that is, through March 31, and concluded that the deficit for 1982 is going to be $25 to $35 billion below the official $100 billion estimate. They base this happy prediction on surprisingly large revenues and surprisingly low outlays to date.

Do any of you have any views on whether that happy prediction for fiscal 1982 is going to pan out or not?

Mr. GOUGH. Well, I am not yet familiar with the details of that press release. Nevertheless, I think it's quite optimistic, mainly because of the fact that the Treasury's economic assumptions are far more optimistic than most of the economic projections that are being made by, I think, any member that has testified before this committee today.

Representative REUSS. They, of course, did base their projection on what had actually happened in the first 6 months of fiscal 1982, and in fact, revenues were somewhat larger and outlays were somewhat smaller than many people had anticipated.

The real question, therefore, is whether 6-month base is sufficient to make a 12-month projection.

Mr. CHIMERINE. Yes, Mr. Chairman. We have looked at that, and in our view it would be very, very dangerous to reach the conclusion that what happened during the first 5 months of the fiscal year will prevail throughout the fiscal year. And I don't think the actual deficit will turn out to be as much below, you know, the projected number as that kind of extrapolation would suggest—for a number of reasons, predominantly some seasonal factors in the flow of receipts and expenditures right now.

Second, should those people who owe taxes—it looks like there's some fast repayment of those taxes now because of the increased penalty. I think refunds, for those people getting refunds, particularly those individuals will be larger this April and May than they have been in the past, because not all the withholding from the 5-percent personal tax cut last October, not all of that got reflected in withholding.

There are a number of these kinds of factors, Mr. Chairman. Our calculations are that the deficit is going to wind up much, much closer to the current projection than that kind of calculation would suggest.

Representative REUSS. I am delighted to see, in the back of the hearing room, a fine body of young Americans from the Browning School of Milwaukee, Wis., who by some happy coincidence have made their way here——

[Laughter.]

Representative REUSS [continuing]. You're very welcome.

SEASONALLY ADJUSTED STATISTICS

By another coincidence, just a few days ago, the President was in a school in Chicago, Ill., and he there told the elementary school students that—and I quote—"Statisticians in Washington have funny ways of counting." He was referring to the fact that the Bureau of Labor Statistics, which is the organization in Washington that keeps these figures, reported that on a seasonally adjusted basis unemployment fell.

Let me ask you gentlemen, in analyzing monthly trends in unemployment, do you believe it's useful to have both the seasonally adjusted and the unadjusted data before you, which is what the Bureau of Labor Statistics does? Would you agree that in making comparisons to stick to either the seasonally adjusted or the unadjusted data, and not, so to speak, mix the apples and oranges?

Mr. GOUGH. I would very much be disappointed if a key series like that were discontinued. I think it's very helpful to look at monthly data both seasonally adjusted and seasonally unadjusted.

The seasonally adjusted data, however, become a little bit more suspect in a more volatile environment, if the seasonal adjustment factors are not continually updated. In a much smoother economic environment, seasonal factors are—it's much more credible to extend those seasonal factors into the future. But in a volatile economic environment, unless you keep those seasonal factors very, very up to date, the mathematical credibility of those numbers is brought into question.

Mr. CHIMERINE. Mr. Chairman, while I would agree, I don't think what happens in any particular month, whether it's up a tenth or two or down a tenth or two, is all that critical.

The key fact is this: Unemployment is extremely high by any measure, and it has risen substantially during the last year or so, and whether it went up a tenth or two—adjusted or unadjusted—last month is not the key issue.

Representative REUSS. Mr. Harris.

Mr. HARRIS. I would agree that it's very important to look at both the seasonally adjusted and not seasonally adjusted numbers. From time to time, the Labor Department does have difficulty coming up with adequate seasonal factors, and it's very helpful to me to have both sets of data.

However, it's obvious, when we're making comparisons over time, you either have to stick to not seasonally adjusted numbers or, preferably, seasonally adjusted numbers. So I would agree with your statement.

Representative REUSS. Thank you.

CONSUMER OUTLAYS

Yesterday, gentlemen, the Commerce Department reported that personal outlays in March fell by more than $4 billion. That's at an annual rate, of course, not adjusted for inflation. Does this suggest that consumers, probably due to the recession, are getting more cautious about spending?

Mr. GOUGH. I think that the answer is that the consumers have become a lot more sophisticated about spending. They are postponing buying plans now. They are not incapable of buying. They are very capable of buying right now. But they are looking at the inflation rates, I think, very definitively, and seeing that the inflation trend has been down over the last few months, and therefore are in the process of postponing purchasing of major household items in the hope of catching the price of those items at a much lower level.

So, I don't think that that necessarily is a discouraging piece of news, because of the fact that if you look at the overall household balance sheet, it's not in bad shape.

Mr. CHIMERINE. Mr. Chairman, can I respond? I would fundamentally disagree, because I think the truth of the matter is when you look at the numbers over the last several months, even with the slight decline in March, consumer spending, if anything, has trended up during the last four to five months. It does wiggle and waggle from month to month, and you can't really read in a lot in that particular month.

For example, one factor that held down in March was the sharp decline in gasoline prices, which has reduced outlays on gasoline, and I don't think that's because people have decided not to buy gasoline now, they are waiting until June until prices are lower—well, you can't drive your car today on June's consumption.

The fact is, I think, an accurate reading of the data would suggest that in recent months consumer spending has been reasonably stable. It's going to be up a little one month. It will be down a little in one month. But with our limited ability to measure accurately, and the seasonal factors right now, I think that a more likely description would be we have reached some sort of stability, at least temporarily, in consumer spending. It's not rising, but it's not falling.

Representative REUSS. Mr. Harris.

Mr. HARRIS. Congressman Reuss, I would add that these are, of course, inherently volatile numbers on a monthly basis—these personal consumption expenditure numbers. Just as our friends at the Fed have trouble measuring money supply on a monthly basis, so do the statisticians who measure personal consumption expenditures. You can't judge a trend from 1-month numbers.

I did point out in my prepared statement, though, that there is a possibility that this quarter consumers will be spending in advance of the tax cut. The way you do that, of course, is by temporarily saving less. So with the tax cut coming up in July, there's a fair chance that the savings rate actually comes down in the current quarter, and that helps to hold up consumption—but don't read too much into one month's statistics.

Representative REUSS. So, the three of you are saying that consumers do have a reserve of real demand for that which the economy can produce, and that if we here in Washington will in the weeks ahead get our acts together, remove the disquieting future budget deficit factors, and gently nudge the Federal Reserve into a somewhat less tight position, as a result of responsible deficit reducing and budgetary action, that that action will do a world of good for the most sharply stricken elements of the economy—housing, construction, automobiles, farm, many other sectors—and that that, coupled with the sleeping giant of consumer expenditures, could well put us back on a track of reasonable growth and reasonable falling of unemployment, and still contain inflation.

Is that a fair statement of something implicit in all your answers?

Mr. CHIMERINE. Yes, Mr. Chairman, I would agree with that, and as a matter of fact, I think it's very important to make one other observation. The kind of budget compromise at least that I would like to see, and the recommendations I made even 6 months ago when we talked about it last, would not completely eliminate the fiscal thrust embodied in the current economic program. There will still be ample fiscal thrust. We may scale it back somewhat. There will still be massive incentives for investment and so on, while still leaving, I think, the possibility of lower interest rates, because in today's environment, the excessive fiscal stimulus just pushes up interest rates, instead of pushing up the economy. It becomes self-defeating.

So I think the answer to your question is "Yes." Consumers in the past have responded when purchasing power rises. I think interest rates are coming down, and this helps their psychology and their attitudes, and they will spend a significant fraction of the increased income that they're going to get, and that will be the trigger for a general economic recovery during the next several years.

Representative REUSS. Any substantial disagreement with that on the part of either Mr. Gough or Mr. Harris?

[No response.]

Representative REUSS. Well, on that note, then—while all is vanity and vexation of spirit at the moment, all is not lost—if we get our act together and do sensible things we might yet in this Congress perform something useful to be remembered.

I want to thank you all for your remarkably constructive assistance to us and thank Congressman Richmond for his ever-faithful attendance and participation, and declare us now in adjournment.

[Whereupon, at 11:50 a.m., the committee adjourned, subject to the call of the Chair.]

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