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FIRST AND SECOND QUARTER GROSS NATIONAL PRODUCT ESTIMATES

HEARINGS

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

NINETY-EIGHTH CONGRESS

FIRST SESSION

MARCH 21 AND JUNE 21, 1983

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AFTERNOON SESSION

FIRST AND SECOND QUARTER GROSS NATIONAL PRODUCT ESTIMATES

MONDAY, MARCH 21, 1983

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

The committee met, pursuant to notice, at 11 a.m., in room 2200, Rayburn House Office Building, Hon. Roger W. Jepsen (chairman of the committee) presiding.

Present: Senator Jepsen; and Representatives Hawkins and Holt.

Also present: Bruce R. Bartlett, executive director; Charles H. Bradford, assistant director; and Paul B. Manchester, professional staff member.

OPENING STATEMENT OF SENATOR JEPSEN, CHAIRMAN

Senator JEPSEN. We welcome to this Joint Economic Committee hearing today Mr. Robert Dederick—is that the correct pronunciation?

Mr. DEDERICK. Deed-rick.

Senator JEPSEN. Pardon?

Mr. DEDERICK. Deed-rick.

Senator JEPSEN. Dederick, Under Secretary of Commerce for Economic Affairs.

We meet in an atmosphere of good economic news today. This is a continuation of the good economic news that we have been hearing for some time now. The Commerce Department's Bureau of Economic Analysis estimates that real gross national product is rising at an annual rate of 4 percent during the first quarter of 1983. Now we realize that this is only a preliminary estimate based on half the data that will go into the final revisions in the next few months, but it is, indeed, good news.

The final revision for the fourth quarter shows that real gross national product fell 1.1 percent in the last quarter of 1982. That's a far cry from the more than 5 percent decline of a year ago, and an improvement over the estimate of a 2.5-percent decline made on January 19, and the 1.9 percent decline made on February 22, 1983. Thus, recently, each new estimate of gross national product has shown an improvement. I trust the same will hold true for the first quarter of 1983 and that today's estimate is conservative and understates the underlying strength of our economy. In any case, today's estimate of a 4-percent rise in real gross national product for the first quarter of 1983 is very good news, indeed.

Coupling the first quarter flash estimate of gross national product with the good news coming from housing, industrial production, durable goods orders, leading economic indicators, and from inflation, interest rates, and productivity, I hereby declare that the 1981–82 recession is over, and we are beginning a strong recovery.

Mr. Dederick, I do not know whether you will be quite that emphatic. But I hope you can assure us that an earlier administration forecast of a 3-percent raise in gross national product for 1983 is below the mark and that the economy is going to perform better than that in 1983. We all know what growth rates of 5 or 6 percent, compared to 3 percent, can do to reduce unemployment and budget deficits.

So we look forward to your testimony. Congresswoman Holt, do you have any opening statement?

Representative HOLT. No, Mr. Chairman, I have no statement. I say welcome to our guest today.

Senator JEPSEN. I had both the good fortune and the honor to travel and appear in the same meetings with Mr. Dederick, discussing our economic concerns and our economic problems, as well as our economic changes with the sister nations in England and in France and Italy, a few weeks ago. Mr. Dederick was an outstanding spokesman and representative and stood out with flying colors for this country over there. We had an interesting time with some sympathy and understanding in England. We got a tongue-lashing in France and they blamed us for all the problems in the world. In Italy, they all kind of felt that we had some of the same problems and we all ought to work together to solve them.

Those were, I think, some very interesting and very helpful meetings that we had and I appreciated everything that you did at that time. I welcome you now and you may proceed.

STATEMENT OF ROBERT G. DEDERICK, UNDER SECRETARY FOR ECONOMIC AFFAIRS, DEPARTMENT OF COMMERCE

Mr. DEDERICK. Thank you very much, Mr. Chairman, both for those kind remarks and for inviting me here today.

As you pointed out this morning, the Commerce Department's Bureau of Economic Analysis released its second revision of GNP and its preliminary estimate of corporate profits for the fourth quarter of 1982. The data reflect what now appears to have been the final wave of the 17-month recession. Real GNP did fall at an annual rate of 1.1 percent in the fourth quarter. Major sources of weakness included a postwar record decline in business inventories and a further setback in business fixed investment. But partly offsetting these declines were real gains in personal consumption expenditures, residential construction, and Government purchases of goods and services. Net exports showed little change.

The fixed-weighted price index for GNP, excluding the effects of the Federal pay raise, rose at an annual rate of 4.5 percent in the fourth quarter. This broad measure of inflation was down from a 5.9-percent rate in the prior quarter and below the 4.9-percent average rate of increase during the first three quarters of 1982.

Before-tax corporate profits from current production edged up in the fourth quarter by 0.8 percent, following a rebound of 7 percent in the prior quarter. The fourth quarter gain was more than accounted for by foreign earnings of U.S. corporations. Profits from domestic activities suffered a modest setback of 2.2 percent, stemming from weakness in the nonfinancial sector.

Now based on the limited statistics presently available, and "best-guess" judgments on missing pieces of information, the BEA has, as you said, made a projection of first-quarter GNP. I used the word "projection" advisedly, since virtually all of the data for March and much data for February are not yet available. We treat the so-called "flash" estimate differently from data releases because of these limitations.

In BEA's judgment, real GNP is rising at an annual rate of 4 percent this quarter. Much of the rebound represents stepped-up production to slow the rate of inventory liquidation, which was so heavy in the fourth quarter. Final demand appears to have posted a small advance with increases in personal consumption expenditures and residential construction more than offsetting declines in net exports of goods and services and Government purchases.

Business-fixed investment showed little change. Benefiting from lower energy prices, the fixed-weighted price index is projected to rise at an annual rate of only 2.8 percent. This measure should be distinguished from the implicit GNP price deflator, which is affected by changes in the composition of GNP. As in the past, the two measures can differ from one another. Preliminary estimates for the first quarter GNP in detail will be released on April 20, while revised estimates will be made in May, June, and once again in July, as more information becomes available.

Now, as regards both inflation and economic activity, the flash report is highly encouraging. To be sure, one quarterly increase in real GNP does not necessarily signify the beginning of recovery from recession. Indeed, modest gains in real GNP during the middle two quarters of 1982 did not mark the end of the recession. Nonetheless, evidence is accumulating that a cyclical turning point occurred late last year—most likely in December—and that a period of sustained economic growth is, in fact, now underway.

The recent sequence of economic events is strong evidence that the recession's trough has passed. Heavy liquidation of inventories, as in the fourth quarter, is customary in the late stage of recession. This typically leads to a pickup in new orders for manufactured durable goods, a phenomenon which we saw occur in December and January. Strengthening of new orders induces renewed growth in production and employment. And in the current case, industrial production did begin to edge up in December and the gains in January and February, taken together to smooth out weather-related distortions, were impressive. Nonfarm payroll employment turned up strongly in January, and this surge was only partially reversed in February despite the adverse weather conditions in the survey week.

Now the National Association of Purchasing Management's monthly survey of about 250 firms, a measure which we follow closely in the Commerce Department, points to a substantial improvement in industrial business conditions during January and February—and similar to previous gains that occurred when the economy was emerging from recession. And, as you pointed out, recovery is also occurring in the homebuilding industry. Indeed, the housing rebound has exceeded virtually everybody's expectations.

The composite index of leading economic indicators, which is also produced by the Commerce Department's BEA, and which has been signaling economic recovery for a number of months during 1982, posted a strong and broadly based gain in January. The index may be flat or even down in February, but once again, I think that averaging the 2 months would be appropriate. Finally, the composite index of coincident economic indicators, which basically defines peaks and troughs of the business cycle, now appears to have hit bottom in December. All four components of the index were up in January, and though there may be some hesitation in the data to be released for February, I believe the underlying trend is clearly up.

Now looking ahead, the economic prospects for the remainder of the year appear to be favorable. Thus, on a fourth quarter to fourth quarter basis, real GNP should post a solid gain, larger than the advance which we earlier envisaged. Increased inventory investment alone may contribute about 2 percentage points to real GNP growth, reflecting a shift from the massive inventory cutbacks at the end of last year to a modest rebuilding of stocks by the final quarter of 1983. With the January and February housing starts running 37 percent above their fourth quarter 1982 average, residential construction also is going to be a strong positive force. In real terms, expenditures are likely to rise by at least one-third over the course of the year. Real consumer spending should move higher, too, paced by increased purchases of autos and other consumer durables.

Now partly offsetting these gains, business fixed investment will probably decline somewhat further. Now this is normal experience because this sector normally follows changes in the rest of the economy. But with the rest of the economy turning up, I expect business fixed investment to turn upward, too, in the second half. As in the early stages of other postwar expansions, net exports may well weaken. Imports, stimulated by the U.S. recovery, are probably going to rise more rapidly than our exports, which, remember, are heavily dependent upon recovery abroad. Finally, I look for little change in total Government purchases. Increased defense outlays will be balanced by net reductions in other purchases, especially those of the Commodity Credit Corporation.

Now there are, to be sure, downside risks in any forecast, and this one is not an exception. As we learned just last year, tentative signs of recovery are not always a certain forerunner of sustained growth. However, I believe that a repetition of the events of the second half of 1982 is highly unlikely. The economic fundamentals are much more favorable than they were at that time.

First, and most importantly, interest rates are far lower than they were last summer; between June and March, the bank prime rate fell 6 percentage points; the yield on Aaa corporate bonds dropped by over 3 percentage points; and commitment rates on home mortgages declined nearly 4 percentage points. Lower interest rates already have stimulated growth in the homebuilding and auto industries, and these gains will work their way into other sectors.

Second, and, obviously related in part to the interest rate decline, common stock prices have moved sharply higher. Consumer balance sheets have improved accordingly.

Third, the combination of larger-than-usual tax refunds resulting from overwithholding in 1982, this year's tax cut, and the drop in oil prices will bolster consumer purchasing power and spending.

Fourth, as a result of the recent wave of liquidation, business inventory levels are much lower than last spring. With excess holdings having been drawn down, substantial reductions during the remainder of this year are unlikely.

And finally, real exports, which plummeted between the second and fourth quarters of 1982—really took a dramatic plunge—appear to be leveling off. Now we don't look for any sudden near-term burst of strength, but the worst seems to be past.

Now a sharp rise in interest rates could still abort the recoveries in credit-sensitive components of demand and, hence, the general recovery, but I see no real reason to anticipate such a development. To be sure, the monetary aggregates have been rising rapidly in recent months, but this was to be expected, given the introduction of new types of deposit accounts. There is a tremendous amount of churning going on.

As the aggregates return to their target growth rates, it will be in an environment of very low inflation. Increases in prices and costs have been reduced to levels that prevailed under controls in 1973, and in some cases even lower. In view of the widespread excess production capacity in the economy, I see little danger of a re-ignition of inflation for a considerable period ahead.

In sum, I am confident that an economic recovery is now underway. The prospects for a sustainable, long-term expansion are better now than they have been in many years.

Thank you very much, Mr. Chairman.

Senator JEPSEN. Thank you, Mr. Dederick. Of all the known economic indicators which measure the health of an economy, so far this year, taking these first 3 months or the first 2½ months, are there any that you know of that have not been in a positive position?

Mr. DEDERICK. Well, I can't say for sure that there wouldn't be one negative statistic, if I were to go look for it very hard. But, certainly, the indicators which we follow have been almost universally positive.

Now there has been some distortion because of the weather. The January numbers were made somewhat stronger, it would appear, than fundamentals might imply by the fact that there was unseasonably favorable weather. The February numbers were somewhat weakened by the same phenomenon.

It's best to take the two numbers together. When you do, across a broad spectrum of the numbers, they are clearly positive. Employment, man-hours, industrial production, this national survey of purchasing agents, which I mentioned, that's up very dramatically, housing, of course—yes, a very broad spectrum. Some of the lagging indicators, which one would expect to be still coming down, still are at last report. But that is a normal phenomenon, because they lag the economy.

Senator JEPSEN. One of the major ones, of course, was unemployment. We know what the dramatic drop was early this year, and then it held last month. If you wanted to take that average, you'd find movement in the right direction.

I have noted, even by the most severest critics of both this administration and, seemingly, those who want to make the American people feel generally that their glass is going to always be half full—I mean half empty—rather than half full. Even with the reports coming and extending from them, there's an admission that economic recovery is moving in the right direction, that it has begun.

The question now is the strength and duration of the economic growth, whether recovery will re-ignite inflation.

And regarding inflation worries, are economic conditions and policies such that the economy could grow for several years at a fairly good clip, say 5 percent or more, without a breakout in inflationary fires?

Would you want to comment on that, please?

Mr. DEDERICK. Well, sir, I think we could certainly have a solid recovery for a number of years without serious inflation problems. Now what the precise number would be, at the moment, I'm not exactly certain. There's too much imprecision in this area. But certainly, the 4 percent, which the administration has forecast in its longer term estimates, does not imply problems, in my views, and I would find that 5 percent is unlikely to re-ignite inflation, too, at least for several years.

Basically, there is a tremendous amount of excess capacity in this economy in the industrial sector. And our work at the Commerce Department has suggested that inflation is held in check as long as there is substantial excess capacity. And even with a good, solid recovery of the sort you are pointing to, we would still have excess industrial capacity for several years and that would be favorable from the point of view of holding down inflation.

So I would say, yes, that we can have a good, solid recovery and inflation should not be re-ignited for several years down the road, at worst.

Senator JEPSEN. Well, I hear economists and people from the financial community and other areas that project the trend and the general direction of the economy saying that we are going to have more of a permanent recovery and that it's going to be sustained and that we won't have this yo-yo, up-and-down effect that we've had in the past, I'd like to examine that just a little bit.

You know, this recession has been addressed as being one that's a little longer than most. How do recessions end? Do they simply die of old age? That is, if we do nothing about a recession, would it come to an end by natural forces at some point in time?

Mr. DEDERICK. I think the same seeds that sow a recession also contain grains that start a recovery. As a recession begins, some of the cost distortions begin to abate, and we begin to get a more balanced cost structure. Interest rates come down automatically in a recession, and this lays the groundwork for a recovery, along with the built-in stabilizers of the Federal budget.

Senator JEPSEN. Well, we've seen in past recessions where there has been an attempt to print their way out of them. We have loosened up on money. We have passed all kinds of bills from the Congress to assist the economic recovery. And we've found time after time—and I think the records are very clear—that when Government attempts to move and push and help out and do something to accelerate the recovery, you get sometimes activities that have a very definite negative effect.

In that connection, what do you think about the jobs bills that the Senate and House just passed?

Mr. DEDERICK. Well, I'm not an expert on this legislation, so I don't want to go into detail. But let's recognize the danger that we have always run into—we do too much too late. We get around to attacking a recession when the self-corrective processes have already begun. The cures come late and create problems many years down the road.

Surely, there are forms of spending that were planned and that can be brought forward. If worthwhile projects can be moved up, as the administration has suggested, that would be a favorable development.

But aggressive spending programs aimed at reducing unemployment at the very time when the problem is beginning to correct itself usually bring their fruits far too late. They also raise the question whether we put the people in the right jobs.

Senator JEPSEN. One last question. In your view, are the long-term interest rates low enough to sustain a recovery over the next several years or do you think they need to decline further?

Mr. DEDERICK. I think probably they are, but I would feel more comfortable if they were somewhat lower. If inflation comes down, and stays down, the way it has, long-term interest rates probably will decline further. I think the economy has developed sufficient strength so that we will get a sustainable recovery with the interest rates we have now. But I would feel much more comfortable if they were lower.

Senator JEPSEN. Congresswoman Holt.

Representative HOLT. Thank you, Mr. Chairman. One area that worries me, and you mentioned that you felt we'd see a turn upward in the second half of the year, is business investment in new plant and equipment. We did a lot of things to try to encourage business to make those investments. Why is it so slow in coming? What do you see as the danger there or is it necessary for them to delay as long as they have?

Mr. DEDERICK. I think recession is the problem. Capital spending is very much influenced by how businesses look at their markets. So, desirable incentives can be overwhelmed for a time if market prospects are very unfavorable.

I believe that as businesses begin to look at stronger markets they will begin to take advantage of these increased incentives that have been put into effect. I think it is encouraging that the latest survey taken by the Commerce Department's BEA does point to an upturn in capital spending in the second half, a rather vigorous one at that.

Representative HOLT. Well, I certainly hope so. I think that that's the one thing that seems to be missing, is confidence in the future. I have been very disappointed that our business sector has not developed confidence a little bit earlier because, as the chairman said, it depends on how you look at it whether your cup's half full or half empty. I'd like to see a few more half-full people around this country.

What's the relationship between real GNP growth and the employment rate? I am concerned about the slow reduction in unemployment. How does that relate?

Mr. DEDERICK. At the early stages of a turnaround, for say, 2 or 3 months, there can be a lag between the upturn in the economy and a drop in the unemployment rate. Businesses increase hours worked before they add more workers.

You get a response to rising output within just a few months. A rule of thumb is that a 1-percent rise in the GNP above the economy's potential reduces the unemployment rate by about 0.4 percentage point, and frequently more than that in the early stages of a recovery.

Because the economy is going to recover throughout 1983 the unemployment rate will be trending down. And I look for the unemployment rate to drop well under 10 percent by the fourth quarter of the year.

Representative HOLT. I read in the morning paper some comment that our exports are really pretty good, except for those to Canada and Mexico, that that was the largest portion of our export deficit, that their economies were very dependent on ours, and that our recovery would lead them out.

Would you comment on that? Is that a true statement? Is that a factual evaluation of the export situation?

Mr. DEDERICK. Yes; these two countries have not been as good a customer of ours as they once were. Our exports were badly affected in the last part of the year by Mexico's difficulties. Canada, our major trading partner, also has been in a recession.

In general, we have had two problems. For one, the dollar is a highly valued currency, extremely attractive as an asset. This has pushed up its price, raising the prices of U.S. goods in terms of other currencies. For another, business has been very sluggish in most countries that are our customers. But we look for exports to turn up somewhat this year, but not dramatically.

Representative HOLT. We are all concerned about the deficit, trying to find ways to bring that down. Many analysts foresee a clash between fiscal and monetary policy about a year or two into the recovery, unless we can reduce those budget deficits.

Do you agree with that assessment and what can we do to reduce the deficits?

Mr. DEDERICK. I believe that if the deficit is not brought down there will be a clash eventually if monetary policy continues to be anti-inflationary.

Just when the anti-inflationary monetary policy and the fiscal situation might clash is hard to say because there is so much slack in the economy and because we have made such enormous improvement on the inflation front.

Certainly, I see no problem this year. Next year is iffy. But almost certainly by 1985, we could have a clash as rising private credit demands confront the still enormous public credit demands.

So it's only a matter of time.

When it comes to the best way to reduce the deficit, I'm a great believer in the administration's proposals.

Representative HOLT. Won't it also be important to encourage savings so that there is more private sector money there to meet the credit demands? And what do we do to encourage that?

Mr. DEDERICK. We have done a great deal to encourage private savings. Of course, the tax cut itself has had that impact. There are the IRA's, and a number of technical actions that encourage savings.

Representative HOLT. Should we continue that third-year tax cut?

Mr. DEDERICK. Oh, almost certainly. In fact, I'll take off the "almost" and say certainly. [Laughter.]

Representative HOLT. That's good. Thank you, Mr. Chairman.

Senator JEPSEN. Congressman Hawkins.

Representative HAWKINS. Thank you, Mr. Chairman. Mr. Dederick, I quite appreciate your optimism. However, I don't see exactly what it's based on. You have indicated some doubt as to whether or not the 4-percent growth is valid, that that again is a calculated guess.

But assuming that it is correct, would you compare that type of growth in the first quarter following a recession? Would you compare that type of growth with the historical type of growth in the first quarters preceding recessions?

Mr. DEDERICK. Well, I don't have the numbers exactly at hand, sir. The first quarter is a difficult one because it is hard to pinpoint when a recession ends.

So, the first quarter could rise sharply or sluggishly, depending on the month in which the recession ended. We have had varying increases in first quarter GNP. But, over the first four quarters, we have tended to have increases around 6½ to 7 percent.

Representative HAWKINS. Isn't that exceedingly above the administration's projection of what the growth will be in 1983?

Mr. DEDERICK. Fourth quarter to fourth quarter?

Representative HAWKINS. You indicated that, generally, the quarters following a recession run in the neighborhood of 6 to 7 percent?

Mr. DEDERICK. In the first year, yes.

Representative HAWKINS. Isn't that considerably above—far more optimistic than what the administration is projecting and actually planning for?

Mr. DEDERICK. Well, the administration is currently reappraising its forecast.

Representative HAWKINS. What is the current one? Let's not talk about what they may do. What is the current projection?

Mr. DEDERICK. Well, the forecast was made before it was realized that the recession was ending. Therefore, there was an attempt to make it conservative. It shows an increase of 3 percent over the first four quarters of recovery. Certainly, if one were to go back, as we have in the Commerce Department, and redo the numbers, one would come up with a higher number than 3 percent.

Representative HAWKINS. Well, you haven't done that. The budget is predicated on what has already been done, not what may be done. I appreciate your attempt to shield the projection. However, the current budget and budget discussions are based on the projections in the Economic Report of the President and in his proposed budget, and not on what you may do subsequent to this point in time.

The answer, I assume, is that the projection for 1983 is in the neighborhood of 3.1 percent in growth; is that not true?

Mr. DEDERICK. I can say, sir, that it was at the time that the budget was announced. That is the number that was used. There has been no official change.

Representative HAWKINS. Are you saying that it's going to be adjusted to some 6 or 7 percent, then?

Mr. DEDERICK. No, sir. Let me say, there has been no official change since that time. And so that is still the official number.

Representative HAWKINS. Well, you're not really responding to the question.

Mr. DEDERICK. I'm sorry, sir.

Representative HAWKINS. I asked you what is the current projection of the administration?

Mr. DEDERICK. It still remains——

Representative HAWKINS. It still remains 3.1 percent.

Mr. DEDERICK. Yes. Right. Officially, that is so.

Representative HAWKINS. Now you indicated a few minutes ago that you felt that we generally do too little too late in referring to jobs bills. Would you say that unemployment is projected by the administration to be somewhere in the neighborhood of 7 percent, as late as 1987? We still are talking about high unemployment for another 4 or 5 years. Why aren't we in time to discuss something to employ Americans since unemployment is going to be with us a long, long time?

In other words, we're not too late, at least for the unemployment that may take place next year and the year after the year after that and as late 1987.

Mr. DEDERICK. I think, first of all, we do have to recognize that there have been some changes, even if they are not in the official forecast. And these changes do suggest, certainly to me, that the recovery is going to be faster than the official forecast, as the chairman himself referred to. So I think that is something we have to consider.

The second thing we have to do is ask ourselves what is full employment in the United States? The work that has been done suggests that full employment is around 6½ percent.

The administration's program certainly does not envisage return to full employment in the very short term. The reason is we have gone through one of the great inflations of modern times. We really had a "Great Inflation."

This inflation was fed by periodic attempts to speed up the growth of the economy in an attempt to drive down the unemployment rate rapidly. This administration's view, and my own view, is that one must be more cautious; that inflation, while it has been brought down to an extent that was expected by virtually no one, is still alive. And inflationary expectations, in particular, are still alive.

I believe, if an aggressive attempt were made to drive down the unemployment rate in the short term, we would again be faced with the danger of creating the very problem that we have gone through so much pain to try to resolve.

Representative HAWKINS. It seems again that you are reflecting a strange point of view in that you attribute employment as the cause of inflation. You deal again in the tradeoff theory that in order to avoid inflation, we've got to keep 15 million persons unemployed for a very long time. And you again described full employment, you define full employment in terms of 6½ percent unemployment.

Are you aware of what 6½-percent unemployment really means? Are you aware that it means at least 7 million persons unemployed and that in some groups, women, minorities, and teenagers, that it will be several times 6½-percent unemployment? Do you consider that a worthwhile goal of economic policy, that we are so devoid of any thinking for other human beings that we would keep that many people unemployed in order to achieve what you state is price stability and you're not so sure that that will actually buy any price stability itself?

Mr. DEDERICK. I am aware of what that means.

Representative HAWKINS. Would you describe to us what 7 million unemployed people really mean to our social structure?

Mr. DEDERICK. If we say that that is the high employment rate, what are we talking about? We're saying there are two components of the 6½ percent. First is what economists call frictional unemployment, which reflects such factors as people entering the labor force and leaving the labor force and deciding to change jobs; there is invariably a period of unemployment at that time.

Frictional unemployment in the United States, we used to think was somewhere around 3 percent. That is a normal phenomenon of a mobile economy, particularly one of the geographic size of this one.

The second component is structural unemployment. Here we have the problem of the youth who do not have the skills required to find jobs at the minimum wage, the problem of discrimination—we must face that—and the problem of the skilled worker who has been displaced because of the technological developments.

This administration is not insensitive to structural unemployment. There is a program designed to deal with it. It offers retraining and job subsidies.

I hope that as a result of these actions the 6½ percent rate will drop over the years ahead. Indeed, I expect it.

Representative HAWKINS. Well, my dear Mr. Dederick, I'm fully aware of the discourse that you're now giving us. Some of us heard that in high school. As to the structural unemployment problem, the training bill, which I authored on the House side—so I'm familiar with the training bill—that doesn't create one single job. And you can train every individual in America and still, if you don't have jobs available, they're not going to get them.

The frictional unemployment that you speak of and you're very generous in making it 3 percent to help the case out. But even if you subtract that from the current 10 percent, you still have 7 percent left which is not frictional. Not individuals who are changing from one job to the other. You're not including the lay offs of those who certainly would love to change from one job to the other.

At the current time, there are 5 million persons who have been unemployed for 15 weeks or more than 15 weeks. That certainly isn't frictional. That's 5 million persons unemployed now. And that certainly isn't structural because you're including individuals who are not young people, necessarily. Some of those are middle age people. Some of them are very highly skilled, educated people. They're not minorities, for the most part. They are about 3 to 1 white males.

And so that isn't frictional and it isn't structural. And on top of that, you are now saying that we shouldn't do anything about that problem because we may be doing it too late and we've got to wait for the things to correct themselves.

Mr. DEDERICK. Let me try to respond.

Representative HAWKINS. Well, I wish you would because it seems to me that you are just parroting the old trade-off theory and suggesting that trickle-down is going to work. We're in the eighth postwar recession. The recovery in this recession at the current growth rate is lower than that in any previous recession. And I can give you the full number. For the last two it's been 4.9 and 4.3 percent. But those very weak recoveries led to another recession. And now we are discussing this thing as if we're waiting now before we get out of this recession, we're going into another one with the same type of policy discussion that you're now giving us.

And you have offered no concrete program, or it certainly is not your responsibility to do so. But inasmuch as we did get into the question of inflation and unemployment, you certainly have not indicated anything here today which gives any encouragement that those 15 million unemployed people out there, 5 million of whom have been unemployed for 15 weeks or longer, are going to have anything on which to base any hope.

Mr. DEDERICK. I certainly didn't mean to give that impression, sir.

Representative HAWKINS. May I indicate, Mr. Chairman, what is the time element of the questioning?

Senator JEPSEN. Ten minutes, ordinarily. I didn't set any today, but 10 minutes is normal time.

Representative HAWKINS. Well, I think that we should have the opportunity to do so without people passing these notes around indicating that we have exhausted our time. I have been encouraged today because I think that we're dealing with a rather serious problem. I think that I should have the opportunity to pursue the questioning because I'm not getting any answers.

Senator JEPSEN. You'll have that opportunity.

Representative HAWKINS. If I got an answer, I would be very glad to stop at that point.

Senator JEPSEN. You'll have that opportunity, Congressman. I think we'll just follow normal procedure for this committee—in the absence of any direction by the chairman—it has always been a 10-minute questioning rule. You may, of course, it's your prerogative to ignore that if you so desire. And so you may proceed.

Mr. DEDERICK. May I answer your question, then?

Representative HAWKINS. I think that Mr. Dederick was in the process of answering the question at that time.

Mr. DEDERICK. Let me go back to the fundamental problem we had. This Nation had an inflation of virtually unparalleled proportions. There is no way an inflation of that sort could be followed by anything but recession. The only question was when and how deep the recession was going to be?

And finally, it happened. That is point 1. My point is that inflation is the enemy of employment.

Representative HAWKINS. Why did it happen, Mr. Dederick?

Mr. DEDERICK. Recession happened because inflation existed.

Representative HAWKINS. Are you blaming the unemployed for the recession that has happened? And are you saying that they should bear the brunt of the recession because they were the cause of it?

Now let's get it straight. Why did the recession happen in the first place?

Mr. DEDERICK. To try to answer again, the recession basically happened because of the inflation, not because of the unemployed. The inflation created enormous credit demands. It created enormous distortions in the financial system. It created enormous price-cost distortions, which are the forerunners of recession.

And the only question when inflation develops is, when is recession going to hit? It hit us in 1980, and because we made no progress against the inflation at that time, it hit us again very shortly thereafter.

So, my point is that the enemy of employment is inflation. My second point is that we have had a recession as a result of inflation. That recession has been a prolonged one, a painful one, and a tragic one for many people. But that recession is over. That recession ended sometime in the fourth quarter. We are now on the path to increased employment. I know of no employment program that can do a fraction of what recovery can do. Recovery adds millions of jobs, and this one will do the same.

There will be new people who will be drawn into the labor force. There will be people currently unemployed who will be pulled back into the labor force.

Nobody says that when you go into a recovery that you will instantly return to the full employment that you had before the recovery began. That process takes time.

I suggest that a mad rush back toward full employment can get us right back into the situation we had before. And this administration does not want to see that happen again. We want sustainable increases in employment and that is what we are forecasting. Steps have been taken to help those who are unemployed. And the President does have the job subsidy bill for workers who have been displaced. We do have the retraining efforts. We proposed the summer unemployment minimum wage change.

There is no disregard for the unemployment. I would say that the program is, first, recovery and second, selective measures to help those who are unemployed.

Representative HAWKINS. So will you tell me where the unemployed in my district can be sent to get those jobs that you're talking about? I'd like to know because I have quite a few that would love to get those jobs that you say the recovery is bringing about or will bring about. Just tell me where do they go to get those jobs?

Mr. DEDERICK. Well, I'm obviously in no position to answer specifically.

Representative HAWKINS. I'd be very glad to know that and I think they would, too.

Mr. DEDERICK. And I would, too, sir. But when the job openings arise, I would very much hope that they will not——

Representative HAWKINS. Well, we will be back with you in 6 months and I hope your optimistic predictions will come true and I hope that the rest of us are around in order to see them. But, unfortunately, I don't agree with your position. I don't agree with your definition of full employment as being 6½ percent unemployment. And I don't feel that you've advocated anything here which shows any sensitivity to the problems of persons who have been unemployed for long periods of time, 4 million of whom lost their jobs under this administration since January 1981.

I think that you've offered no consolation to me that we're doing anything any better than what we have done in the past under other administrations.

Senator JEPSEN. Mr. Dederick, let the record show that the unemployment today is approximately 11 million, not the 15 million that was mentioned.

Representative HAWKINS. Mr. Chairman, in order to set it in proper perspective, let me enumerate to you what the actual facts are. Roughly 11——

Senator JEPSEN. Congressman, I have the floor.

Representative HAWKINS. I'll explain the statement that you're trying to explain that I made. I made the statement and I should like to justify it. I said that there are roughly 15 million unemployed people.

Now in addition to those officially counted as unemployed, which you're now dealing with, you have 5 million who are employed only part time. Now you don't count those as being full-time employees. You have 1½ million who are discouraged, who are not counted because they have fallen out of the labor market. They have been unable to locate jobs.

And in addition to that, I could go on giving you the numbers who are unemployed partly because they are earning less than the minimum wage.

Now, surely, you don't ignore these other people.

Representative HOLT. Would the gentleman yield?

Representative HAWKINS. Yes, I'd be glad to.

Representative HOLT. Another factor is that in February, only 6.2 percent of the 10.4 percent unemployed were job losers; 0.8 percent left their jobs; 2.3 percent were reentrants; and 1.1 percent were new entrants. So those factors have to be taken into consideration, too.

Representative HAWKINS. Well, it seems to me that the tendency is to downplay the problems of unemployment.

Representative HOLT. Not at all.

Representative HAWKINS. Well, that seems to be the drift of this particular symposium that we are engaging in.

Representative HOLT. Well, will the gentleman yield further?

Representative HAWKINS. Surely.

Representative HOLT. I think it's not that at all. I think we're trying to figure out where we are and what we can do about it. Mr. Charles Schultze was recently quoted as saying the huge stimulative package which the Carter administration offered was their greatest mistake, because it didn't reduce unemployment and it fired inflation.

Senator JEPSEN. The Chair would advise that this committee in the past has been used as a forum to air opinions, to discuss facts. In fact, it has been used from time to time as a "bully pulpit" to politically exploit a given situation. That has been a matter of record. I feel that we will hold hearings on—as I indicated in our last meeting—how we build on and analyze unemployment figures.

With all due respect to Mr. Dederick and our report here before the Joint Economic Committee today, I think we can at that time deal with some of these things which very appropriately have been raised by Congressman Hawkins and Congresswoman Holt. It leaves a lot to be desired, in my opinion, as to how you arrive at who's unemployed.

I also would want to have the record show that the only ones that I have ever heard of or know that ever make statements alluding to the fact that someone is keeping people unemployed as a measure to control inflation are those extreme liberals whose favorite political technique is to set up their own strawman, building this strawman with all kinds of distorted facts and convenient statistics and once having that strawman established, then they step back and punch it to death.

Thank goodness the American public sees through that for what it is and, therefore, I just do not accept statements that you keep unemployment high to make inflation low.

It's ludicrous.

I would hope that we could try to stick with what is recognized and has been used throughout the years as the standard or the foundation of the measurements to discuss both growth of gross national product or the economic health of our economy.

At this time, Mr. Dederick, what is the track record of the accuracy for the gross national product flash estimates? And isn't that what you called this, sort of a flash estimate?

Mr. DEDERICK. Yes, sir.

Senator JEPSEN. I mean, I know they're based on incomplete data. That was stated at the beginning here. But are they generally in the ball park?

Mr. DEDERICK. Oh, yes, sir, they have been. Over the last 3 years there's been an average deviation between the flash and the preliminary of about 1 percentage point.

Right now, the BEA is getting underway a study, a much more in-depth study of the effectiveness of the flash and its other estimates.

Senator JEPSEN. So is that true year-in and year-out, the flash estimates generally have been historically, precedent-wise, have been reasonably accurate?

Mr. DEDERICK. Yes, sir.

Senator JEPSEN. Have you got any reason to believe that this one is any different?

Mr. DEDERICK. Not in the least. The economy began to rise in the latter part of the fourth quarter and continued to rise in the early part of this quarter. BEA, in making its estimate of the flash, assumed that there would be some further progress, but less rapid progress than there already had been. It was a conservative estimate from that point of view.

So while almost certainly the number will be changed, I think the general tone is not going to be. It's clearly that we are in an upturn now.

Senator JEPSEN. The index of industrial production was up slightly in February. It's continuing a 3-month rise. How significant is this evidence that the recovery is underway?

Mr. DEDERICK. My own view is that the industrial sector is of tremendous importance because this is where recessions concentrate. So the fact that the industrial production index has turned up is of extreme importance. And that, again, is why I referred to the National

Association of Purchasing Managers' survey because that zeroes in on the industrial sector. That has been showing a considerable rebound.

That, to me, is the most encouraging part. In other words, the area where recessions concentrate is the area where we are now seeing the recovery concentrate.

Senator JEPSEN. Congresswoman Holt.

Representative HOLT. Mr. Chairman, thank you. Wasn't core inflation part of the thing that we've had to battle? This has disturbed me. But wasn't the core inflation caused by some of the wage demands and the expectations of the very people who are unemployed today?

For instance, in my district, I have shipbuilders and automobile manufacturers. And we find that both those industries are in very serious trouble and they're beginning to work those problems out. But isn't that part of the hard core inflation that we have had to overcome, that inflation mentality that we constantly had those higher expectations?

Mr. DEDERICK. The core inflation rate is a statistical construct that is heavily based upon unit labor cost trends and incorporates wages and increases in compensation, and allows for productivity changes. It also includes the cost of capital, which is a very important aspect.

There is no question that inflationary expectations became very pronounced as the inflation persisted. It manifested itself not only in wage increases, but also in the behavior of management and business in general.

There was a general feeling that wage increases should be substantial.

In some areas, there was more push than in others. But it was a general phenomenon across the entire spectrum of the economy and there was a general impression that cost increases could be passed on because demand was stimulated.

So I would say, yes, core inflation is heavily dependent upon wages, but it's a broader phenomenon. It's heavily dependent upon attitudes. Wages, after all, are granted by business. And we did have a strong inflation mentality.

We have brought down inflation markedly, but that inflation mentality has not disappeared. And we do continue to have costs on a trend basis appear to be rising at a higher rate than would be consistent with the long term.

Representative HOLT. Are we making any progress in that area?

Mr. DEDERICK. I think we are. There has been a drop, a dramatic drop, in the rate of increase in labor compensation, as there has been a reflection of the changing economic circumstances.

Now, of course, the fortunate thing is that inflation has dropped dramatically as well. So the fact that wage increases have been going up more slowly has not meant that real income has been adversely affected because prices have been going much more slowly as well.

Representative HOLT. Thank you, Mr. Chairman.

Representative HAWKINS. I've used up my 10 minutes. I wouldn't want to disturb you any further, Mr. Chairman.

Senator JEPSEN. All right. Thank you, Mr. Dederick.

The committee stands adjourned.

[Whereupon, at 12:02 p.m., the committee adjourned, subject to the call of the Chair.]

FIRST AND SECOND QUARTER GROSS NATIONAL PRODUCT ESTIMATES

TUESDAY, JUNE 21, 1983

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

The committee met, pursuant to notice, at 11:10 a.m., in room 2247, Rayburn House Office Building, Hon. Roger W. Jepsen (chairman of the committee) presiding.

Present: Senator Jepsen; and Representatives Hamilton, Mitchell, Hawkins, Wylie, Holt, Lungren, and Snowe.

Also present: Charles H. Bradford, assistant director; and Mark R. Policinski and Paul B. Manchester, professional staff members.

OPENING STATEMENT OF SENATOR JEPSEN, CHAIRMAN

Senator JEPSEN. Secretary Baldrige, we welcome you to this Joint Economic Committee hearing. It is an honor to have you with us.

There's good news this morning. The "Flash Estimate" by the Bureau of Economic Analysis, showing that real gross national product is growing by 6.6 percent during the second quarter of 1983, demonstrates that the economy, indeed, is booming. This strong economic growth contradicts earlier pessimistic forecasts that this would be a slow, sluggish economic recovery. A 6.6 percent gross national product rise would rank this recovery with the best of past recoveries.

I am also pleased to note that the final revised data in our press release shows that the real gross national product grew by a respectable 2.6 percent in the first quarter. This strong GNP performance and our low inflation means more of everything—more jobs, more income, more profits, and rising living standards for all Americans.

We realize that the BEA "Flash Estimate" for the second quarter is a tentative estimate, based on about half the data that will become available for later revisions. Because May was stronger than April, it appears that June will be stronger than May. Therefore, we can be confident that when the revised figures are released, they will also show a strong recovery.

Mr. Baldrige, we appreciate your taking time from your very busy schedule to be with us today. I understand that the President has asked you to meet with him and the Prime Minister of Spain at 11:40 a.m., and that you will have to leave promptly at 11:30 a.m. So I guess when the boss calls, you've got to respond.

We appreciate your making your capable Under Secretary Bob Dederick——

Mr. DEDERICK. Deed-rick, sir.

Senator JEPSEN. Deed-rick. I should know. We have shared several meetings together. You testified in March and handled yourself very well.

In the interest of time, I would prefer for Secretary Baldrige to begin first, please; Mr. Secretary, you may proceed.

STATEMENT OF HON. MALCOLM BALDRIGE, SECRETARY OF COMMERCE, ACCOMPANIED BY ROBERT G. DEDERICK, UNDER SECRETARY FOR ECONOMIC AFFAIRS

Mr. BALDRIGE. Thank you, Mr. Chairman. I am pleased to be here this morning to discuss the performance of the economy in the second quarter and give you my assessment of the outlook for the quarters ahead.

Based on the limited statistics currently available, and they are limited—as you mentioned, there are only about somewhere around half actually available. The rest are projections and judgments about the missing data—the Commerce Department has made a projection for the second quarter gross national product, GNP——

Representative MITCHELL. We're having difficulty hearing you, Mr. Secretary, is the mike on?

Mr. BALDRIGE. Can you hear me now if I speak this way?

Senator JEPSEN. Thank you.

Mr. BALDRIGE. The Commerce Department has made a projection of second quarter gross national product, GNP, and our so-called "Flash Estimate" shows real GNP advancing at an annual rate of 6.6 percent this quarter. As this large gain vividly demonstrates, the economy is rebounding strongly from the recession. An alternative measure of output—nonfarm business product, which is GNP less output originating from the rest of the world, households and institutions, farms, and government—shows an even larger gain. Real nonfarm business product appears to be rising at an annual rate of 8.2 percent this quarter, following a healthy 5.9 percent annual rate of growth in the first quarter.

The recovery not only has gained momentum, it has broadened as well. The Labor Department compiles a diffusion index of employment in 186 private nonfarm industries. During the first quarter, on average, about 55 percent of these industries added workers to their payrolls. In April and May, the proportion expanding employment rose to an average of over 69 percent.

The two most significant contributions to the projected rise in real GNP this quarter are, first, a reduced rate of inventory liquidation and, second, accelerated growth in consumer spending. Additional stimulus is coming from residential construction, business investment in new equipment, and defense purchases.

We have only sketchy data on inventories for the second quarter right now. Stocks rose in April. With a judgment that real inventories changed little in May and June, we project a small net liquidation for the second quarter as a whole, following a huge decline in the first quarter. This development alone adds 4 percentage points to the GNP growth rate.

Incoming data also point to the consumer as a star performer during the second quarter. The recovery in employment, accelerated growth in personal income, a rebound in confidence, and a dramatic improvement in wealth positions are bolstering consumer outlays. Spending for durable goods and services are showing large gains, particularly for new automobiles and trucks.

The upturn in residential construction slowed this quarter, but is still strong. Firms are expanding their investment in capital equipment, though weakness persists in a number of major categories. Growth in defense purchases continues to pick up.

Still not all industries or sectors are participating in the recovery. Farm output is declining, and further weakness during the rest of the year is likely, partly due to the payment-in-kind program. Output remains weak in industries that supply the farm sector.

The reduction in farm output has lowered purchases of agricultural products by the Federal Government's Commodity Credit Corporation. Other nondefense Government purchases, including those of State and local governments, are projected to remain unchanged this quarter.

Spending on nonresidential structures has continued to decline this quarter, largely reflecting weakness in commercial and industrial building. No sign of an early turnaround is yet apparent. Net exports are still suffering, too, partly from the effects of a strong dollar and partly because economic activity among our major trading partners remains sluggish.

Among other major economic developments in the second quarter, real disposable personal income appears to be climbing at an annual rate of 2.8 percent. The acceleration from the first quarter's 2.3-percent pace largely reflects stepped-up growth in wage and salary income as employment gains have become larger.

Prices rose a little more in the second quarter than in the first quarter, but I do not view this as the beginning of an acceleration in inflation. The fixed-weighted price index for GNP is projected to rise at an annual rate of 4.7 percent, compared with 3.3 percent rate in the first quarter. Much of this pickup comes from energy prices, which were declining earlier this year, and from larger increases in consumer food prices, which are partly related to the weather.

Looking ahead, I expect further good gains in business activity during the remainder of the year. The economy is well on its way toward the administration's projection of 4.7 percent growth in real GNP over the four quarters of 1983, and that figure may exceed 5 percent.

Economic strength during the second half will come primarily from consumer spending, renewed inventory building, residential construction, and defense purchases. Business fixed investment, net exports, and nondefense Government purchases excluding sales by the Commodity Credit Corporation are likely to show small changes. Farm output probably will decline further.

In my view, the economy will continue to push ahead during 1984. Among the broad expenditure sectors, residential construction and consumer spending probably will grow more slowly. But business fixed investment will gather strength while net exports should improve and State and local outlays should begin to increase.

I expect inflation to remain under control during the second half of this year and in 1984 as well. Wage gains should be moderate at a time when productivity is improving considerably. Also acting as a constraint will be ample productive capacity.

This completes my review of current and prospective economic developments. Data presently available point to strong and widening gains this quarter, even though not all sectors of the economy are participating in the recovery as yet. The administration currently is reviewing its economic forecasts both for 1983 and for later years. Any revisions will be made available when the midsession review of the budget is released in July.

Thank you, Mr. Chairman. I'll be pleased to answer your questions.

[The Department of Commerce press release referred to follows:]

UNITED STATES DEPARTMENT OF
COMMERCE
NEWS
WASHINGTON, D.C. 20230

OFFICE
OF THE
SECRETARY

FOR RELEASE AT 11:00 A.M. EDT, TUESDAY, JUNE 21, 1983

STATEMENT BY MALCOLM BALDRIGE, SECRETARY OF COMMERCE,
ON GNP FOR THE SECOND QUARTER

Initial projections by the Commerce Department's Bureau of Economic Analysis show that real gross national product is rising at an annual rate of 6.6 percent in the current quarter. This follows an upward-revised growth rate of 2.6 percent in the first quarter.

A virtual end to inventory liquidation accounted for a large part of the stepped-up growth in real GNP. In addition, real final sales, paced by accelerated growth in consumer spending, rose more rapidly than in the first quarter.

As measured by the fixed-weighted price index for GNP, the annual rate of inflation during the second quarter is projected at 4.7 percent.

The projections of real GNP and inflation for the second quarter are based on partial and preliminary data, along with estimates of data not yet available. The official preliminary estimate of GNP will be released on July 21.

Senator JEPSEN. Thank you, Mr. Secretary. In the interest of everyone having an opportunity to address the Secretary, the Chair requests that each member confine himself to one question for the Secretary. I'll ask mine very quickly.

Over on my left and your right, Mr. Secretary, we have a chart that indicates real GNP growth for the last 3 quarters, beginning with the fourth quarter of 1982, which showed a 1.1 percent decline in GNP. This is followed by a 2.6 percent increase for the first quarter of 1983 and now we have an estimated 6.6 percent growth for the second quarter.

My question, Mr. Secretary, is while the estimated 6.1 percent jump in GNP is good news and shows a dramatic increase, what will happen in the future? How long do you expect the current momentum of the economy to be sustained?

Mr. BALDRIGE. We'll certainly see it sustained this year, in my opinion, a good part of next year. The only caveat I would have would be toward the latter part of next year. If the budget deficits in the outyears are not reduced, that could cause enough of a rise in interest rates to slow down or abort the recovery.

It's very difficult to judge right now, but without that caveat, we should see a moderate to strong rise this year and next year in the real GNP.

Senator JEPSEN. Congressman Lungren.

Representative LUNGREN. Thank you, Mr. Chairman. Mr. Secretary, you've indicated obviously that these are flash estimates or reports.

Mr. BALDRIGE. Yes.

Representative LUNGREN. That we'll have the full reports when we have all the data for the entire quarter in. You've also indicated that we have some rather significant rises in the major economic indicators in June, particularly talking about housing starts and retail sales.

Would you care to suggest what might be your most optimistic estimate of what we might see with this quarter if that trend continues?

Mr. BALDRIGE. Well, historically, these flash estimates are done early enough with—yes, most of the data, for instance, in this quarter for April in so we can see it. Much of May's data, but little of June's data in.

So you're dealing with some guesses about what's going to happen in June. And June is the last month of this quarter. You can have some surprises either way in what happens to inventories as well as sales.

So if one were to be optimistic, instead of 6.6 percent, we could see a swing of 1 percentage point on the upside, and if one wanted to be pessimistic, we could see a point off on that.

The average of all of the final figures compared to this flash initial projection show an error of 1 percent. And it hasn't really been too much plus or too much minus. It's just been wrong by 1 percent in most cases.

So I would say the optimistic would be 7.6 percent; the pessimistic would be 5.6 percent.

Senator JEPSEN. Congressman Mitchell.

Representative MITCHELL. Thank you. Mr. Secretary, you failed to mention in your testimony anything about the monetary policy, which I think perhaps has had some impact on the change in GNP. My specific question to you is, if you continue the same monetary policies that are now in effect—the last time I checked, the M_1 supply was above 9 percent—if you continue that high level or increase it, is it not inevitable that you would confront another round of inflation?

Mr. BALDRIGE. The Federal Reserve Bank has difficulty always in once a course is set, having the proper tools to reach the exact course. That's still not a science as much as they or we would like to see it.

We have the debate now on whether M_1, the growth in M_1, that is, beyond the target limits, is a temporary phenomenon. We have the case presently where M_2 and M_3 are within the target limits. And incidentally, those limits are set based on a 4½ to 5 percent GNP growth this year, which is our forecast.

So while M_1 is outside the target limits, M_2 and M_3 are in it.

Now if M_1 were to continue outside the limits for another few months, I think there would be concern at the Fed about that, even though M_2 and M_3 were within the limits. My guess would be that we would see some tightening.

I think the Fed itself is very much aware that while their primary job is to control the runaway inflation that we had been having, their second priority, and a very strong second priority, is not to abort this recovery. There's a very fine line that they have to walk. In my opinion, they've been doing a good job at it, but it takes very close watching from now on to understand what their actions—how their actions will be governed with the kind of monetary growth rates we're seeing between the 3 M's. It's difficult to foresee how M_1 is going to turn out. Some think it will start to slow down, the growth will start to slow down very quickly. Others don't.

So that's the unknown *x* factor that we are dealing with.

Senator JEPSEN. Congresswoman Holt.

Representative HOLT. Thank you, Mr. Chairman. Thank you, Mr. Secretary. Capital spending remains weak. I know that corporate management is really tightening its belt and practicing a lot better management procedures. But why aren't we able, why aren't the administration's incentives able to get capital investment moving again? It seems to me that is the answer to unemployment, but what's wrong?

Mr. BALDRIGE. I think they have. You know, it depends on how you read the figures. The incentives that the administration put in, in my opinion, had this effect. During this last recession, capital goods investment spending dropped only about half as much as it had during the average of the last four or five recessions.

So while that's a negative, you're looking at this from a negative point of view. It is a plus or a positive in the sense that capital spending did not fall off as much as had been true in the past.

We are already seeing capital spending and, again, I think because of the incentives that are there picking up. While this year, as a whole, will not be a good year overall for capital investment, it's already turned around. We're beginning to see plus figures now on capital investment.

I think, if my memory serves me correctly, capital investment was off 3 percent in the fourth quarter of last year. We would expect it to be up 3 percent in the fourth quarter of 1983. And the change has already taken place. I mean, we're beginning to see some plus in that.

So while the year as a whole won't be strong, the trend is heading in the right direction.

I might also add one other point. Capital spending is not the first part of the GNP to pick up in any recovery. It's almost usually the last part. First you have to see consumer spending pick up due to some kind of after-tax income increases. That picks up capacity utilization. Capacity utilization starts to get a little tight and that's when capital spending plans usually begin to come in.

So it's usually at the tail end of the business cycle and that's what's happening this time. We believe it will come along normally as it has in the past.

Senator JEPSEN. Congressman Hawkins.

Representative HAWKINS. Mr. Secretary, you speak in your statement of the recovery in employment. However, since December 1982, while the number of unemployed has dropped from 10.8 to 10 percent, the total number of civilians in the labor forces also dropped from 111,129,000 to 110,749,000. Therefore, the drop in unemployment, while it has occurred, has not resulted in more people finding jobs. Yet, you speak of the recovery in employment.

Would you explain what seems to be a contradiction?

Mr. BALDRIGE. In December, unemployment hit a high of 10.7 percent, if you use the new figures to count the military as employed, and I certainly feel that they are employed. That 10.7 percent is now down to 10 percent. That's a drop of seven-tenths of 1 percent in 5 months. That is the largest drop coming out of a recession into a recovery in 30 years, the largest drop since 1949, if you count all the recessions since then.

So that part shows that, actually, unemployment figures are dropping better than they have in coming out of the last recessions.

Since December, we have added 800,000 people—800,000 jobs to payroll employment. That's another indication that that problem is being addressed. The duration of unemployment, the average duration, has not dropped, but it never does drop until 1½ or 2 years after the recovery begins because the people who are last laid off are usually the people that are first brought back on. So that the people who do not share in the initial surge of reemployment are the ones with the longest record of unemployment. That's just one of the tough facts about the way this works.

So I would say that this recovery so far is doing better than any other recovery in the last 30 years in bringing the unemployment rate down. It's still too high, but the amount of movement has been satisfactory in the last 5 months.

Senator JEPSEN. Mr. Secretary, I know that you have to leave promptly at 11:30 a.m. It's now 11:33 and Congresswoman Snowe has not had a chance to ask a question.

Mr. BALDRIGE. Thank you very much, Mr. Chairman. I apologize again for having to go.

I will be late if Congresswoman Snowe has a question that she would like to ask.

Senator JEPSEN. Congresswoman Snowe.

Representative SNOWE. Simple and quick. Thank you. Mr. Secretary, we have heard a great deal lately about real interest rates. In fact, Walter Mondale charged in a Sunday news program that this administration has doubled real interest rates.

Could you respond to that and what are the causes?

Mr. BALDRIGE. Yes. The reason that real interest rates have doubled has been because of what has happened in the last 10–15 years, on government policies and inflation. And a good part of that was due to the last 4 years before this administration came in. This isn't something that you just flip over like that. That's why they have been so stubborn and have held in there so long and contributed to the high level of unemployment.

We will not get, in my opinion, real interest rates down as far as they should go unless Congress addresses the budget deficits. You can argue about how to address them, but unless those out-year budget deficits come down, people are going to worry about their effect on long-term interest rates and the economic theory, I've heard that that doesn't make any difference—I don't agree with. I think that 9 out of 10 business people think that high budget deficits do affect long-term interest rates and 9 out of 10 people in the financial markets think they do. We had better act as if they do and not worry about the economic theory being proved one way or the other. We don't want to be the ones to prove it.

Senator JEPSEN. Thank you, Mr. Secretary.

Mr. Dederick, how would you describe the economic recovery to date? Is it average, below average, relative to comparable post-war recovery periods? Is this average or below average or above average?

Mr. DEDERICK. Can you hear me, Senator?

Senator JEPSEN. I can, but be sure to speak directly into them. They are not very receptive microphones.

Mr. DEDERICK. I would describe it thus far as a typical recovery. It depends, actually, upon which particular measure you use. Some are a little stronger than others. But, taken together, I would say that this is very much an average recovery following an average recession.

[The following statement was subsequently supplied for the record by Representative Hawkins. See page 100 of the hearing.]

Mr. Dederick, I must disagree with your statement, and I quote, that "this is very much an average recovery following an average recession." Unfortunately for the nation, you are incorrect on both counts. By almost any measure one wishes to use, the recent recession was extraordinary in its severity. Unemployment hit record highs as did the average duration of unemployment. Capacity utilization hit record lows. Farm income was only half that of just a few years ago. Corporate profits dropped sharply. New investment in plant and equipment fell for two consecutive years. Real average hourly earnings fell steadily as did average real weekly earnings. Home and house mortgage foreclosures climbed to record numbers and auto and home construction fell sharply. The trade deficit and budget deficit both climbed to unheard of levels. Mr. Speaker, no one who studies the facts can deny that the Reagan Recession was not the most severe economic downturn since the Great Depression. To state otherwise is clearly fallacious.

Similarly, to claim that we are now enjoying an "average recovery" is a similar misstatement of fact. The average increase in real Gross National Product for the two quarters following the end of all post war recoveries has been 8.1 percent. With the end of the recession now being pegged as December 1982, we have seen sluggish growth at best. The first quarter of 1983 saw GNP rising at a 2.6 percent rate and the second quarter improved at a 6.6 percent rate. These figures are clearly far below the "average recovery." The Administration has heralded the 0.7 percent drop in the unemployment rate as being extraordinarily strong. However, even with this much needed improvement, the unemployment rate is still higher than under any post-war President. The number of people out of work today is higher right now than it has been under any other President since the Hoover recession. The number of business bankruptcies and home mortgage foreclosures is higher under this President than it has been under any other. No, Mr. Dederick, this is not an average recovery. The weak economic growth of today is significant only in comparison to the severity of the downturn. With no hope of reaching pre-recession levels of unemployment until many years down the road under this Administration's policies, it is a cruel hoax on the millions of innocent victims of the Reagan Recession to proclaim this a strong recovery.

Senator JEPSEN. Well, now that the economic recovery is in full swing, two important questions arise: how strong is the recovery and will it reignite inflation? I think that those are the two questions that are posed most often.

Now that we finally have uncovered the country's best kept secret, which is this economic recovery, I've noticed that the people who were refusing to acknowledge its existence are now saying that it won't last very long. Are economic conditions and policies such that the economy could grow or continue to grow, say, at a 5-percent clip and without a breakout of inflationary fires?

Mr. DEDERICK. Probably not indefinitely, but certainly for the next 2 or 3 years I think it could. There is a great deal of excess capacity in the economy at present as measured by the high unemployment rate and the low operating rate in manufacturing. Typically, when there is a great deal of excess capacity, you can grow relatively rapidly without reigniting inflation.

So I would say that in the foreseeable future, the answer is yes. The problem would come farther down the road when we began to use up these resources, these excess resources, and we began to have tighter markets as we continued to grow at 5 percent. This might be faster than would be sustainable without reigniting inflation. But I don't see that any time over the next several years.

Senator JEPSEN. Ever since February, all of the basic economic indicators that measure the health of an economy have been pointing in the right direction, and there has been some positive action taking place. Among them, of course, is the increase in savings. We noted that for the 30 days between the middle of March and the middle of April, that there was a very dramatic increase in the dollars that were put into savings in this country.

Are not the improved savings habits of the people of this country a good sign, and an indication that we can hold down inflation as this economy continues to recover?

Mr. DEDERICK. A comfortable level of savings will enable us to finance the investment which is needed for noninflationary growth.

When we come to savings, though, there are various measures, Some are stronger than others. The inflows into some institutions have been very strong of late, but by our measures, if you take aggregate savings, all of the instruments together, there hasn't been any unusual surge.

But the basic thing is that savings, particularly in an environment when you have very large government deficits, are really a necessity if you are to have any chance at all of achieving noninflationary growth because you must have the means of financing investment to increase your capacity and improve your productivity.

Senator JEPSEN. Do you know what the percent of savings is now as recorded last month?

Mr. DEDERICK. The savings rate is based upon the very rough preliminary estimate for May of the Commerce Department. It was somewhere around 5.3 percent or 5.4 percent, I believe.

Senator JEPSEN. Congressman Lungren.

Representative LUNGREN. Thank you, Mr. Chairman. Mr. Dederick, going at the same point that the chairman did, but a little different direction, whenever we have good economic news a number of analysts say that it's bad economic news. And in one specific way, whenever we start the economy going, a number of economic observers say, well, if the economy is going, obviously, we are going to run into inflation. Almost whenever you're getting out of the doldrums, the payment for growth is inflation.

How do you respond to that and how would you suggest that we can have, as both you and the chairman have mentioned just previously, a recovery that is noninflationary driven or is not inflationary as a result?

What combination of things must we do as far as the Government is concerned to allow that type of recovery or is such a recovery possible?

Mr. DEDERICK. To go back to the very beginning of your question, it depends upon the environment in which the recovery begins. Those people who equate a recovery with a prompt re-ignition of inflation fail to take that into consideration.

If you begin a recovery at a time when there is a large amount of excess capacity in your labor and product markets, there is very little chance of re-igniting inflation for some time. If you begin it at a time when inflationary expectations have been brought down significantly, there is very little chance that you will re-ignite it.

Both of these factors have to be taken into consideration. And, of course, we begin the current one with both of these situations. We do have the excess capacity and to a considerable degree the inflationary psychology has been broken. And that permits one to have a sustainable recovery for a much longer time than would otherwise be the case.

How long can you continue to have a good, solid recovery without reigniting inflation once you begin to have less unemployed and a higher capacity utilization rate in manufacturing? The answer is it becomes more difficult. But if you have a moderate recovery, if you do not try to go all out so that you continue to grow more or less in line with your capabilities, your productivity gains and your labor force gains, there is nothing really to suggest that inflation should explode.

At the same time, if you are pursuing actions designed to improve productivity, which, of course, is what the administration's program has been all about, and improve savings, which is another portion of it, then you have a better chance of being able to have a good, solid, growth rate for a long time without reigniting inflation.

So it's a combination of where you start and the policies that you follow once the recovery is underway. I refuse to think that recoveries are anything but good if they are managed properly.

Representative LUNGREN. What role does labor cost play in that? In other words, I read some works done by some economic observers who suggest that one manifestation of the breaking of the inflationary psychology is the labor contract results that we have seen over the past year, 1½ years. Is that important and where does that stand right now? Do we see any change in that as the economy starts to come off?

Mr. DEDERICK. Clearly, what we want is that wage increases not vastly outrun increases in man-hour productivity because that merely means that the wage increases have to be financed by inflation. Nobody gains.

This was a serious problem in the latter part of the 1970's and the very early part of this decade; wage gains outraced productivity.

Under current circumstances, this is not happening. The wage increases have become much more moderate while productivity gains have improved. We have a much more noninflationary, sustainable situation.

The latest evidence which would carry us through early May suggests that there has been no bad news on this score. The wage increases continue to be noninflationary and from what we can see, productivity has continued to show a very good gain in the current quarter.

Senator JEPSEN. Congressman Hawkins.

Representative HAWKINS. Mr. Dederick, I have a little trouble with the definition of recovery. It tends to imply that you are getting back to a certain point or a certain level. Since January of 1981, more than 3 million persons have lost their jobs. And now without a great reduction in that number, we are talking about recovery.

Just what do you construe to be a real recovery? Would it be getting back to January of 1981, which would mean a reduction of unemployment from 10 to 7 percent? Is it more than just negative economic growth? We know how a recession is defined, but how would you define recovery?

Mr. DEDERICK. Well, sir, I define recovery as the period during which the economy is returning to the level of activity that it had prior to the recession. So right now, we are in a recovery. We have been in a recovery since December. But we have not completed the recovery. We still have farther to go before the recovery is over.

And then there is the fact that even when you return to the level where you previously were, you have had increases in your labor force and you have had increases in productivity, if you have been fortunate. And therefore, you must really push ahead beyond that level if you are to have a satisfactory reduction in unemployment.

So recovery is even not adequate. You have to go into an expansion beyond the recovery stage so that you can take up these unutilized resources and bring yourself to full prosperity. We certainly are in a recovery now, but it is an incomplete recovery because it has only gone on 6 months to date and we have not yet returned to our previous level of economic activity.

Representative HAWKINS. How long do you think it will take, then, to complete this recovery that we are talking about today in vague terms? In other words, when do you foresee unemployment returning to the prerecession level or to the January 1981 level?

How long will it take? Have you any prediction?

Mr. DEDERICK. I think that GNP, which is the total sum of economic activity, has a very good chance, indeed, a probability, of returning to that level within the summer quarter. But, in the meantime, going back to my earlier point, we have had improvements in productivity. We have had increases in the labor force.

So as far as returning to the level of unemployment that we had at the prior peak, that is likely to take us another 2 or 3 years.

Representative HAWKINS. So that you don't see any substantial drop in the unemployment or getting back to the prerecession unemployment level for several years; is that your statement?

Mr. DEDERICK. As far as the unemployment rate is concerned, I think we are talking about a matter of several years. As far as employment is concerned, we are talking of a much shorter period. But, in the meantime, we will have had new individuals entering the labor force.

Representative HAWKINS. Well, then, we don't have very much cause to be cheering so great about good news today, do we, if you happen to be among the 16 to 18 million unemployed people?

Mr. DEDERICK. If you happen to be among the unemployed people at any time, I feel you have no cause for cheer.

Representative HAWKINS. So you have even less, then, currently than you did at any time between 1940 and 1982, because the drop in unemployment still leaves us at the highest level that we had between 1940 and 1982.

Mr. DEDERICK. There's no question that we will have, based upon the current economic outlook, a relatively high unemployment rate over the next several years as we bring down the rate from the high levels which were generated as a result of the inflationary excesses of the late 1970's. And this is not a rapid process because if one does attempt to make it a rapid process, he finds that rather than adding sustainable jobs and having a sustainable improvement in productivity, that he regenerates the situation that caused the trouble in the first place.

So what we want is jobs that stay. Our experience has shown that if we try to race back too rapidly, we will re-ignite the situation that got us here in the first place.

Senator JEPSEN. Congresswoman Holt.

Representative HOLT. After the record trade deficits of $42 billion last year, what are our expectation for 1983 and what are we doing about it? How will the proposed trade reorganization help and what will be the impact of the Japanese Diet action?

What do we anticipate for the future?

Mr. DEDERICK. I think the odds strongly favor that we will have another increase in the trade deficit this year. At the moment, the figure for last year is around $43 billion. We think at the Commerce Department that the trade deficit may well run in the $50 to $60 billion range this year.

Now the current account deficit, which also includes receipts on services and the like, is likely to be much smaller; it was around $11 billion in 1982. We think that it will be at least $20 billion in 1983.

This is not surprising because the American economy is leading the way to world recovery. The very strong dollar, brought about by the high real interest rates and the fact that the United States is viewed

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around the world as a safe haven for funds, puts American exporters at a disadvantage. As we recover more rapidly in the initial stages than other nations, of course, we will draw in imports.

However, as we find that the rest of the world begins to respond to the American recovery and make their own recoveries, we should begin to see some improvement on the trade account. We should see the dollar begin to lose some of its strength as these current account deficits begin to be reflected in the marketplace, but the timing of this is beyond any mortal to predict.

The key is to try to hold down our real interest rate so that we don't give artificial strength to the dollar and to try to encourage other nations to pursue policies similarly noninflationary as ours so that we will not be such an island of attraction. And, of course, if I might toss it in, to reorganize the Commerce Department to make it a trade department, so that it is more effective with the WSTR; the two combined can more effectively address the trade problem.

Representative HOLT. Well, then, you're saying that, or you're not saying that it's entirely dependent on the economies of our country and other countries. There are other things that need to be done. It's trade policy throughout the world that has some impact on it.

Mr. DEDERICK. Our view on trade policy is that we must take steps to encourage other nations to remove the barriers to fair trade which they might have imposed. We must avoid putting up barriers of our own which would only trigger further imposition of barriers of others.

I'm thinking of such things as local content legislation. Here we feel that the best way of having a trade system which would be to the benefit of this Nation and all nations is to have one where barriers are pulled down rather than put up.

Representative HOLT. Well, are we making any progress? We keep saying that we have got to encourage other nations to view it that way, but I don't see any real progress being made in moving to convince them. How are we going to convince them. Everybody wants to look out for his own employment—his own labor force.

Mr. DEDERICK. The fundamental thing is to have a world-wide recovery. At a time when unemployment is high and economies are weak, protectionism seems to be a very easy answer and it's something that people are likely to seize.

The way to avoid that is to encourage a sustainable, noninflationary recovery of the sort which this Nation has entered. Over and above that, of course, there are negotations, and the WSTR and the Commerce Department have been actively involved in these. I do not participate in these myself, but my impression is that we are seeing a response on the part of our trading partners, including Japan. It may not be to the degree that we all would like to see, but I think that this constant effort on our part has produced some results and will produce further results.

Representative LUNGREN [presiding]. Congresswoman Snowe.

Representative SNOWE. Thank you, Congressman. There has been some skepticism, of course, about this economic recovery—it is not strong enough. It's not a quick-fix recovery. I was wondering if you could tell this committee how different is this recovery from previous recoveries? Isn't part of the problem the fact that many structural problems exist within our economy which did not prevail previously when we were recovering from a recession or a high period of inflation?

Mr. DEDERICK. That is an issue which is extremely complex and it's one that will be not really satisfactorily answered until after we have proceeded much farther in the recovery.

We have had in this Nation since the late 1970's, as a result of the inflationary boom, 4 years of stagnation, and we have had the same phenomenon elsewhere in the world.

When you have such episodes culminating in a recession, the notion always emerges that our problems are structural rather than cyclical, that some fundamental change has taken place. I heard this in the late 1950's, for instance. We were told that there had been major structural readjustments and that manufacturing in this country would never return to its previous highs.

It did in the 1960's when we had a sustained, long-term recovery. Clearly, though, over time, while we were going through these cyclical episodes, we also had secular changes. Some industries have become more subject to foreign competition and that was the case when we entered this period of stagnation, for instance.

So there have been some changes, without question.

This, though, is a very normal part of a dynamic domestic economy and a dynamic world economy. I think if we were to want to go back to where we started from, with everybody in the same relative position, that we better not have a free enterprise economy; a planned economy can give us that and it can also give us all the rigidities and lack of progress as a result.

What I'm trying to say is that in a dynamic, free economy, some industries will grow faster than others. But I am not convinced that there have been major structural changes in this Nation that have weakened us relative to where we were a few years ago.

Representative SNOWE. If that is the case, then why can't we get this unemployment rate down faster than we are at this point? It seems to me that the problem has been in our economy; in the fact that we had major industries which have sustained high levels of employment in this country, such as the auto industry and the steel industry, but have suffered significant setbacks and perhaps will not come back to their previous high levels of employment.

So it seems to me that contributes to the fact that we are having a slower growth rate in employment. So I am just wondering to what degree is that a significant factor, that we are having a slow recovery?

Mr. DEDERICK. We have to go back and look at the evidence to date. To refer back to the Secretary's testimony, it has not been a slow recovery. It's been a fairly normal recovery. We have added 800,000 jobs in a mere 5 months. That is about the norm for the first 5 months of recovery. We brought the unemployment rate down by more than the norm during the early stages of a recovery. We don't have any evidence that suggests that we are having a slow recovery. We have to distinguish between the expectations of a great many people and what is in fact happening.

In a normal recovery, some industries do not go back to where they started. I would point out, though, that the automobile industry has added over 100,000 jobs since this recovery began. They have had a significant recovery, and we are seeing improvement in their supplier industries.

But, if we want to restore all industries to their pre-recession peaks, it would mean that the dynamic industries would not be able to grow to their full potential. We would find that we have a nondynamic, stultified economy because, ultimately, we are constrained by resources.

Representative SNOWE. In the past recoveries, the gross national product has grown an average of 7.6 percent in the first year and an average of 6.1 percent in the first 2 years. Do we have any hope of achieving those levels that we did in the past?

Mr. DEDERICK. Conventional forecasts usually predict, that recoveries will be below normal. I go back in this business for about 25 years and I have never known my fellow practitioners, including myself, to predict anything other than that a recovery would be less than normal and yet, again and again, it has exceeded expectations.

At the moment, we are saying that the economy is not going to have an average increase. But if you exclude some real boom periods, this recovery will not fall too short. Basically, this somewhat below average recovery is part of public policy because of the great desire not to reignite inflation.

We know how to grow very rapidly, but we haven't learned how to grow very rapidly without reigniting inflation. It is our belief that a somewhat more tempered recovery will be longer and more sustainable.

When we predict that it may fall a bit short of the norm, that should not be taken as bad news. In my view, that should be taken as increasing the likelihood that the recovery won't burn out promptly or be forced to burn out by a Federal Reserve that is compelled once again to rein in inflation.

Representative SNOWE. My time has expired. Thank you.

Representative LUNGREN. Mr. Secretary, we heard from some that suggest that we haven't done a whole lot in terms of employment. You mentioned the figure 800,000. I just, for the record, would like it to be clear. That is seasonally adjusted. The testimony that we had the last couple of weeks ago from Janet Norwood was nonseasonally adjusted, 1.7 million since December, which when I asked her, she meant that that 1.7 million bodies—real people actually working now that were not working in December. That's pretty good news.

I'm not an economist. We're politicians. We probably are unduly optimistic. I find that economists at times seem to be unduly pessimistic. The Commerce Department has been, let's say, cautious in terms of their estimates of where we're going to be.

But given the fact that these second quarter "flash figures" are significantly better than was suggested in the administration's initial projections, ought we not to expect an adjustment upward in July of the administration's forecast for this year?

Mr. DEDERICK. We are, at present, in the midst of reviewing the forecast. I am going to leave here for a meeting on that very subject. So, at the moment, I am not really prepared to answer that.

Representative LUNGREN. We'd like to leave you in an optimistic mood when you go over there. [Laughter.]

Mr. DEDERICK. I think we can say, based upon the record to date, that if we are wrong in the present forecast, and economists have a record of being wrong more than occasionally, that the chances are that the official recovery forecast will prove to be on the low side. Any revisions which are likely, based upon the evidence to date, certainly would have to push it higher.

Representative LUNGREN. It sure would help us up here when those of us who are fighting tax increases, to see those adjustments coming sooner than later. But I appreciate the position you're in.

Congresswoman Snowe.

Representative SNOWE. Yes, just one final question. Concerning consumer spending, Secretary Baldrige mentioned in his testimony that consumer spending could be a star performer in the second quarter. The first quarter consumer spending was below our original projections. What do we expect? Will it be higher than the first quarter? And what could happen if we were to cap the tax cut, for example? Would that affect consumer spending and ultimately, the recovery?

Mr. DEDERICK. Consumer spending, at least as we're able to measure it, tends to rise somewhat erratically. It has a sort of ratchet-type behavior, as do many series. It moved up very strongly in the fourth quarter of last year, which is what laid the groundwork for the recovery, the strong performance of it in the fourth quarter.

It tended to mark time in the first quarter, a normal phenomenon. It does appear that consumer spending began to gather strength in the second quarter, again a normal behavior pattern.

The evidence suggests that it is going to have a very solid rise, in part because of the tax cuts which are going into effect in July, in part because of the rebates as a result of last year's tax cuts, and in part because of the tremendous improvement which has occurred in people's balance sheets as a result of the rise in prices of stocks, bonds, and homes.

A number of factors suggest that consumer spending is likely to be, as the Secretary says, a star performer.

Now if one were to take steps to remove some of the stimuli which are in effect, including weakening the tax cut, I think we could expect that the increase would be less than it otherwise would be. Some of the tax cut will go into increased consumer spending, strengthening markets, and some will go into increased saving, as Senator Jepsen said, thereby providing the wherewithal to finance increased investment spending on the part of business to meet these markets.

Representative SNOWE. Thank you.

Representative LUNGREN. Mr. Secretary, I want to thank you for being here and thank Secretary Baldrige for being here. As you go back to that meeting to perhaps readjust the figures, I might just try and put you in a good mood by reminding you that when several of us on this committee joined you in Europe for meetings with people from France and London, both businessmen and those in government, you were one of the most bullish on the ability of the United States economy to bring the world recovery about. There were a lot of skeptics there and I think you convinced some of them. Perhaps you can do the same thing at the present time.

I would also just like to announce the continuation of this hearing at 2 p.m. in this room with a distinguished panel of economists including Alan Greenspan, Allen Sinai, and William Shipman.

Again, we thank you for your testimony.
Mr. DEDERICK. Thank you, sir.
Representative LUNGREN. The committee will be in recess.
[Whereupon, at 12:10 p.m., the committee recessed, to reconvene at 2 p.m. the same day.]

AFTERNOON SESSION

OPENING STATEMENT OF SENATOR JEPSEN, CHAIRMAN

Senator JEPSEN. This morning we heard from Commerce Secretary Baldrige. We heard that the real gross national product grew 2.6 percent in the first quarter of 1983. This is an upward revision of an estimate last month of 2.5 percent. The Secretary also released the Bureau of Economic Analysis "Flash Estimate" for the second quarter and it showed that the economy is currently growing at a 6.6 percent clip.

This, indeed, is good news. This is a robust recovery, well in line with the strong recoveries of the past, as was testified to this morning. Obviously, the pessimists who were saying last January that this recovery would be slow and sluggish were dead wrong.

The basic question for this hearing is how sustainable is the recovery? Will it be a short spurt or can we look for a long ride? What factors will affect the recovery's strength and durability? What dangers do you see on the horizon and how can we avoid them?

We have an outstanding panel of distinguished economists with us this afternoon to discuss these and other questions. Alan Greenspan is president of the Townsend-Greenspan, Co., and former chairman of the President's Council of Economic Advisers. Welcome, Mr. Greenspan.

Allen Sinai is a senior vice president of Data Resources, Inc. Welcome. Mr. Sinai.

And Mr. William Shipman is a partner of H. C. Wainwright & Co., Economics.

Gentlemen, we look forward to your analysis and your comments. A sound assessment of the direction of the economy is important to Congress because it sets the tone for much of our legislative action. I, for one, hope we can assure the Congress that the new Government programs, the fine tuning, and doses of Keynesian public spending are not needed and that the best role for government is to step back and give the private sector its head, let it do its thing.

Gentlemen, we look forward to your testimony. I would now ask the distinguished vice chairman of the Joint Economic Committee, Congressman Lee Hamilton, if he has anything to say.

Representative HAMILTON. No comments, Mr. Chairman. I would just like to welcome the panelists.

Senator JEPSEN. Is there any other member of the panel desiring to say anything?

[No response.]

Senator JEPSEN. Gentlemen, we look forward to your testimony and Mr. Greenspan, will you lead off, please?

STATEMENT OF ALAN GREENSPAN, PRESIDENT, TOWNSEND-GREENSPAN & CO., WASHINGTON, D.C.

Mr. GREENSPAN. Thank you, Mr. Chairman.

Senator JEPSEN. Excuse me. I would announce that these microphones need to be placed very close for speaking because they are not very sensitive.

Mr. GREENSPAN. Thank you, Mr. Chairman. I, too, was quite encouraged by the "Flash Report" on the second quarter. I think it clearly indicates what we have known from other pieces of information; namely, that the economy is, indeed, in a fairly pronounced upswing.

Late in 1982, a secondary wave of pessimism drove business to a final stage of inventory liquidation. That set the stage for a rapid snapback. The inventory reversal has now moved from liquidation into the early phases of accumulation in the month of June. The shift which began early this year has accelerated. As production rose from levels well below consumption last winter, as inventories were being sharply reduced, to somewhat above consumption now, employment and income have grown. The consequent increase in real disposable personal income is beginning to impact consumer markets, carrying the economy forward in a manner quite typical of the early stages of past business cycle recoveries.

The high level of real short-term interest rates is not a significant inhibitor of economic recovery at this stage of the business cycle. Even modest rises in rates from current levels is unlikely to abort the currently unfolding expansion.

Inventory liquidation ended when stocks finally were driven so low that many companies had difficulty operating efficiently. This triggered a classic inventory cycle response. As liquidation came to a halt and production moved to the level of consumption, new orders for materials rebounded. The ability of the materials producers to supply shipments on minimal lead times then began to weaken and in response, purchasing agents became concerned that inventories would now be inadequate to support the now high level of desired production, leading to a possible loss, obviously, of market shares. To protect their companies, they began to order more heavily and will continue to do so for awhile. The very pickup in orders which they are generating in turn is further extending delivery lead times, including still greater concern about inadequate stocks. This process normally proceeds until the catchup phase is complete and inventories are perceived as adequate to support production plans.

During the inventory expansion phase, most companies would opt for protection against potentially costly production curtailments and consequent loss of market share even if this entailed considerably higher interest costs. When the adjustment is complete, high real short-term interest rates would then affect decisionmaking at the margin, although cancellations of bookings already made are unlikely. Under these circumstances, continued accumulation would occur as the unfilled orders in the hands of suppliers are converted into the inventories of their customers.

Moreover, high interest rates will not immediately suppress those areas of capital investment which are now improving. A couple of years ago in the early stages of the recession, authorizations for cost-saving capital investment continued at the usual recession pace; that is, moderately strong. Even when a company's overall level of operations is well below capacity, so long as a particular facility is likely to remain in operation, any cost-cutting project for that facility has a high probability of yielding an acceptable rate of return.

Many such projects were committed last year, even when interest rates and capital costs were far higher than at present. While the rate of return was only modestly in excess of capital costs, it was as assured as engineering estimates could make them. However, as the second and largely unanticipated downward phase of the recession took hold in late 1982, many of these projects were temporarily shelved. As demand weakened markedly, the risks increased that facilities scheduled for replacement might not remain operative. With production expanding again and continuous operation of facilities to be replaced more certain, a number of the delayed projects have been reinstituted. Since they were largely initiated in the context of higher interest rates and lower stock prices than those currently prevailing, even a modest raise in interest rates should not inhibit going forward with these projects in the near future.

Housing has rebounded from its severely depressed levels of 1982 and in this sector as well, a very modest increase in rates would not cut off recovery. There is basically an ongoing amount of construction activity which will proceed from starts already in place. Hence, even if the impact in the housing markets were more severe, substantial short-term gains in output are nonetheless possible, even in the face of modestly rising interest rates.

In general, interest rates will become a more important influence on economic growth during the later stages of the current recovery as a larger share of the growth in GNP entails durable items which, by definition, are added to the Nation's balance sheets, thereby requiring financing; that is, offsetting increases in liabilities or equity.

When short-lived items such as nondurable goods and services are involved, financing is not a critical factor in determining production levels. Hence, these are not likely to be significantly affected by modest rises in interest rates should they occur.

In the second phase of the business cycle, when there is a shift in production toward longer-lived assets, such as newly initiated capital goods projects, when surplus additions to inventories begin to emerge and when commercial real estate investment growth becomes important, the economic expansion may well be impeded by the currently high, or worse, rising costs of capital, either through climbing interest rates or falling stock prices.

Thus, for the next 6 to 9 months, perhaps longer, the economy is likely to do well, even in the face of historically high interest rates. However, as we get beyond the first phase of the business cycle recovery and into the types of economic activity which implies significant expansion in the asset side of company balance sheets, currently partially dormant financial constraints come into play. The first reflects the necessary shift from the unsustainable emphasis on short-term debt instruments of recent decades. Economic activity has been financed since the 1960's by an inordinate amount of debt generally, and short-term debt in particular. This meant that the ratio of short-term to total debt on company balance sheets rose inexorably, as did the ratio of aggregate debt to book equity. We have finally reached the point where balance sheets have run out of running room.

Further expansion of the asset side of balance sheets must now be financed significantly more with equity either through higher retained earnings or new stock issues and less with debt. What debt is extended must be increasingly long term. Company balance sheets must be restructured and further financing is going to have to reflect large amounts of equity if economic growth is to be maintained at desired levels.

The effect is to raise the perceived cost of capital. Had more long-term debt and equity been judged as lower cost financing than short-term debt, companies would have already moved in that direction. A rise in the cost of capital implies a lowering of capital investment plans from what would otherwise have been contemplated.

The key to current balance sheet problems is obviously lower long-term interest rates. That would lead to still higher stock prices. The joint effect would create a large funding of short-term liabilities and hence, a fall in short-term interest rates, more equity financing, and reduced pressure on the banking system.

Lower long-term interest rates would have a similar impact on the composition of the recovery. It would facilitate the shift to more emphasis on investment in long-term assets. But a significant decline in long-term interest rates almost surely requires a marked lowering of long-term inflation expectations and that, in turn, presupposes a cridible reduction in the so-called outyear budget deficits.

Fortunately, the huge budget deficits that confront us and the administration, as well as the Congress, is increasing the pressure to find a solution. The Congress and past administrations have clearly exhibited a well-honed capacity to expand benefit programs and reduce taxes for lower- and middle-income constituents. Reversing this process is essential and is going to require abilities which will be new to the ways of Washington. It is obvious that the job ahead for the President and the Congress to come up with the package is going to be politically formidable. Some broad political compromise clearly will be required, probably struck during the domestic summit of our political leaders.

Some elements of such a compromise readily suggest themselves. Medicare, for example, could become means-tested and not available to all elderly, irrespective of income. Cost-of-living escalators for all Government programs could be adjusted to the Consumer Price Index, less a fixed 2 or 3 percentage points yearly for several years. Some slowing in the rate of increase in the defense budget authority and finally, some increase in revenues, probably from a value-added tax, are the chips we conservatives are likely to have to throw into the compromise pot.

It is hard to imagine, however, such a compromise deficit-reducing package emerging prior to the elections of November 1984. In fact, short of a crisis, the political atmosphere probably will get increasingly less conducive to any solution between now and then. But since the budget deficit will surely be a major issue during the 1984 campaign, a resolution of the problem in early 1984 seems likely. Should that occur, a broad expansion in the latter half of the 1980's would fall into place.

Thank you.

[The prepared statement of Mr. Greenspan follows:]

Prepared Statement of Alan Greenspan*

Late in 1982 a secondary wave of pessimism drove business to a final stage of inventory liquidation. That set the stage for a rapid snapback. The inventory reversal has now moved from liquidation into the early phases of accumulation. The shift which began early this year has accelerated. As production rose from levels well below consumption last winter, when inventories were being sharply reduced, to somewhat above consumption now, employment and income have grown. The consequent increase in real disposable personal income is beginning to impact consumer markets, carrying the economy forward in a manner quite typical of the early stages of past business cycle recoveries.

The high level of real short-term interest rates is not a significant inhibitor of economic recovery at this stage of the business cycle. Even a modest rise in rates from current levels is unlikely to abort the currently unfolding expansion.

Inventory liquidation ended when stocks finally were driven so low that many companies had difficulty operating efficiently. This triggered a classic inventory cycle response. As liquidation abruptly came to a halt and production began to move up toward the level of consumption, new orders for materials rebounded. The ability of the materials producers to supply shipments on minimal lead time then began to weaken. In response, purchasing agents became concerned that inventories would now be inadequate to support the now higher desired production levels, leading to a possible loss of market shares. To protect their companies, they began to order more heavily and will continue to do so for awhile. The very pickup in orders which they are generating, in turn, is further extending delivery lead times, inducing still greater concern about inadequate stocks. This process normally proceeds until the catch-up phase is complete and inventories are perceived as adequate to support production plans. During the inventory expansion phase, most companies would opt for protection against potentially costly production curtailments and consequent loss of market share even if this entailed considerably higher interest costs. When the adjustment is complete, high real short-term interest rates would then affect decision making at the margin, although cancellations of bookings already made are unlikely. Under these circumstances, continued accumulation would occur as the unfilled orders in the hands of suppliers are converted into the inventories of their customers.

Moreover, high interest rates will not immediately suppress those areas of capital investment which are now improving. A couple of years ago, in the early stages of the recession, authorizations for cost saving capital investment continued at the usual recession pace, i.e., moderately strong. Even when a company's overall level of operations is well below capacity, so long as a particular facility is likely to remain in operation, any cost cutting project for that facility has a high probability of yielding an acceptable rate of return. Many such projects were committed last year even when interest rates and capital costs were far higher than at present. While the rate of return was only modestly in excess of capital costs, it was as assured as engineering estimates could make them. However, as the second, and largely unanticipated, downward phase of the recession took hold late in 1982, many of these

*Dr. Alan Greenspan is Chairman and President of Townsend-Greenspan & Co., Inc.

projects were temporarily shelved. As demand weakened markedly, the risks increased that facilities scheduled for replacement might not remain operative. With production expanding again, and continuous operation of the facilities to be replaced more certain, a number of the delayed projects have been reinstituted. Since they were largely initiated in the context of higher interest rates and lower stock prices than those currently prevailing, even a modest rise in interest rates should not inhibit going forward with these projects in the near future.

Housing has rebounded from its severely depressed levels of 1982. In this sector as well, a very modest increase in rates would not cut off the recovery. Ongoing construction is likely to be maintained for some time even if interest rates should rise. Once a unit has been started, it is financially less costly to move to completion and obtain a return on the investment than to halt work or stretch it out. Multifamily projects take longer than single-family homes to complete and the number of units already started, for which financing terms have already been arranged, suggests that residential investment is not likely to slacken in response to an initial rise in rates. A sharp or protracted increase in mortgage interest rates would, of course, hobble home building. Steeply higher mortgage rates would also suppress the turnover of existing homes and the resulting realized capital gains. These capital gains tend to generate net new mortgage debt, which has been a major factor in the financing of big ticket consumer items.

Hence, even if the impact in the housing market were more severe, substantial short-run gains in output are nonetheless possible even in the face of modestly rising interest rates.

In general, interest rates will become a more important influence on economic growth during the later stages of the current recovery as a larger share of the growth in GNP entails durable items which by definition are added to the nation's balance sheets, thereby requiring financing, i.e., offsetting increases in liabilities or equity. When short-lived items such as nondurable goods and services are involved, financing is not a critical factor in determining production levels. Hence, these are not likely to be significantly affected by modest rises in interest rates.

In the second phase of the business cycle, when there is a shift in production towards longer lived assets, such as newly initiated capital goods projects; when surplus additions to inventories begin to emerge; and when commercial real estate investment growth becomes important, the economic expansion may well be impeded by the currently high or worse, rising costs of capital, either through climbing interest rates or falling stock prices.

Thus, for the next six to nine months the economy is likely to do well even in the face of historically high interest rates.

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Further expansion of the asset side of balance sheets must now be financed significantly more with equity, either through higher retained earnings or new stock issues, and less with debt. What debt is extended must be increasingly long-term. Company balance sheets must be restructured and further financing is going to have to reflect large amounts of equity, if economic growth is to be maintained at desired levels. The effect is to raise the perceived cost of capital. Had more long-term debt and equity been judged as lower cost financing than short-term debt, companies would have already moved in that direction. A rise in the cost of capital implies a lowering of capital investment plans from what would otherwise have been contemplated.

The key to current balance sheet problems is obviously lower long-term interest rates. That would lead to still higher stock prices. The joint effect would create a large funding of short-term liabilities and hence a fall in short-term interest rates, more equity financing, and reduced pressure on the banking system.

Lower long-term interest rates would have a similar impact on the composition of the recovery. They would facilitate the shift to more emphasis on investment in long-term assets. But a significant decline in long-term interest rates almost surely requires a marked lowering of long-term inflation expectations and that in turn presupposes a credible reduction in the so-called "out year" deficits.

Fortunately, the huge budget deficit that confronts the administration and the Congress is increasing the pressure to find a solution. The Congress and past administrations have clearly exhibited a well honed capacity to expand benefit programs and reduce taxes for lower and middle income constituents. Reversing this process is essential and is going to require abilities which will be new to the ways of Washington.

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Senator JEPSEN. Thank you.

Now William Shipman, partner, H. C. Wainwright & Co., Economics. Mr. Shipman, please proceed as you wish.

STATEMENT OF WILLIAM G. SHIPMAN, PARTNER, H. C. WAINWRIGHT & CO., ECONOMICS, BOSTON, MASS.

Mr. SHIPMAN. Thank you, Mr. Chairman. I am, too, excited about the report, the second quarter flash report, and it looks like we're on our way to a strong recovery. The question is, how long will it last and how strong will it be?

As you well know, it's terribly difficult to forecast the economy accurately. Last year, which was the worst calendar year recession since 1946, took most of us by surprise. I might add that the marketplace, and I'm not talking necessarily about the stock market, but markets in general saw this and in mid-1981 expected that 1982, indeed, would be a bad year and the market forecast of GNP in 1982 would be down 1.4 percent. It actually fell 1.7.

Now using the same methodology that we have used in the past to forecast real GNP, it's our best guess that we are entering 2 years which are the best years since the Korean war period. Real GNP this year is up about 6 percent and next year up more than 8 percent. And that is year over year, not fourth quarter over fourth quarter.

Obviously, while parts of the economy do not participate in this in the same way, durables lead. Residential investment follows. Housing should be strong this year and next. Autos should be strong this year and next.

By almost any calculation that we have made, it looks like 2 great years. I caution to add that there is no way that we know of to give you a credible forecast beyond that period.

There are many concerns that have been voiced and we have seen in the media that the recovery could be aborted. Those concerns include interest rates—high real interest rates—budget deficit, tax policy, and many other items.

I would like to touch upon just a few of them. First of all, the market expects, if you look at the Treasury bill futures market, which we think is the best guess, that interest rates next year will be higher than this year and that they will rise by about 1¼ percentage point. The second item is that it is stated that the real rate of interest now is higher than it has been in a long time. And although as that is measured conventionally, it's true, we don't think it's terribly important.

To arrive at the real rate of interest, you should take the market rate of interest and adjust it for taxes. That interest income is taxed. And the market clears on an aftertax expected return, not pretax.

The second thing is to look at the expetced rate of inflation over the term of the credit instrument and not what inflation just recently was reported to be. If you make those two adjustments, the real rate of interest is probably about 1½ percent. There are problems in the computation, but if we look at other markets, such as the United Kingdom, where they issue indexed bonds, Government issues index bonds, they get paid back in constant purchasing power, that is a pretax yield on what is called the index link gilts of 2½ percent. The aftertax yield, of course, is something less than that.

The real rate of interest, in our view, conventionally measured, is high, but not relevant, and adjusted for expected tax rates and expected inflation is low and relatively stable, and really is not a concern.

The second item is budget deficits. We have been told a great deal that unless the budget deficit comes down, interest rates will not fall. So we have got to get the budget deficit down using fiscal responsibility, and that generally means tax increases. If you look at annual data, there is a relationship between interest rates and the budget deficit on a contemporaneous basis. And that relationship is, that if the budget deficit rises, interest rates in that same year tend to fall.

The budget deficit does not lead interest rates as an empirical matter. Interest rates lead the budget deficit. If you were to tell me that next year the budget deficit was going to rise by some amount, it would give me no information as to what would happen to interest rates next year and the years beyond that.

The last item I would like to touch upon is tax policy and the budget deficit. If you look at the relationship between tax revenues and the change in the budget deficit, we find that in the year that tax revenues rise as a percentage of GNP, indeed, the budget deficit falls. That happens for that year alone. After that, the budget deficit rises.

The experience over a long time is that we have increased tax revenues as a percent of GNP and at the same time we have increased the budget deficit as a percent of GNP.

I would argue strongly that if you want to bring the budget deficit down, for whatever reason, don't expect that you are going to do it in a circular sense by raising taxes.

To sum up, it looks to us like we've got, as I mentioned, two of the best years since the Korean war period. I can't help you at all looking at 1985. We are just unable to forecast with any accuracy out that far. If we want the recovery to continue in a long secular sense, from a policy standpoint, it would be our view to move toward a price policy for monetary policy where the dollar buys tomorrow as much as it buys today and to move toward a fair tax system where tax rates are substantially lower than where they are now.

Thank you.

Senator JEPSEN. Very interesting; thank you, Mr. Shipman.

[The prepared statement of Mr. Shipman follows:]

Prepared Statement of William G. Shipman*

The 1983 and 1984 Recovery: Two of the Best Years Since the Korean War Period

Mr. Chairman, I thank you for this opportunity to testify before the Joint Economic Committee on the current state of the economy and the economic outlook. In your invitation you asked that I touch upon the strength and sustainability of the recovery. I am pleased to say that as of this time, the outlook, at least through 1984, is very bright indeed.

Thankfully 1982, the worst calendar year recession since 1946, is behind us. Now the debate is focused on the recovery's magnitude and longevity. Related concerns are the budget deficit and high real interest rates.

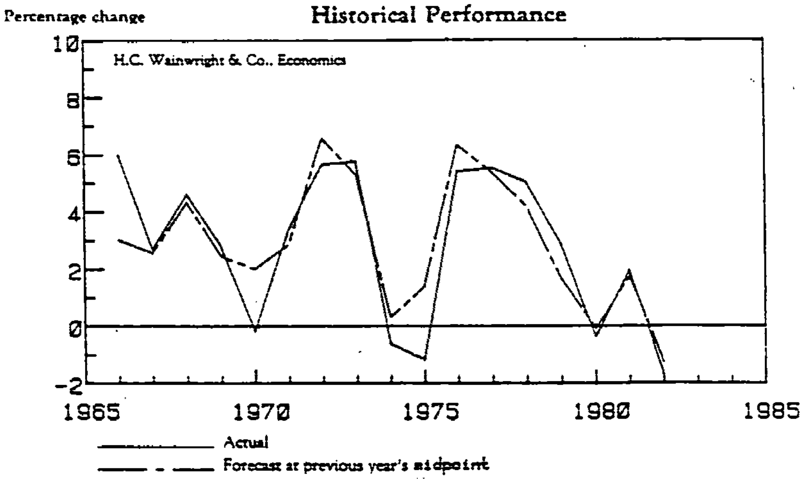
For most forecasters, last year's economic disaster came as a surprise. In mid-1981 the consensus forecast anticipated that 1982's real GNP would rise 3.4[1] percent over 1981. The official administration forecast was also for a 3.4 percent gain. But capital markets saw it differently. Using the information reflected in unbiased market prices as of June 30, 1981, a decline of 1.4 percent[2] was anticipated.[3] Although this estimate was labelled as extreme at the time, it proved close to the mark. Real GNP declined 1.7 percent.

*This testimony draws upon research conducted by H.C. Wainwright & Co., Economics. The author is indebted to Charles E. Babin, R. David Ranson and Tania Zouikin for their assistance.

1. See *Blue Chip Economic Indicators*, Eggert Economic Enterprises, Inc., Sedona, AZ, June 10, 1981.
2. The historical forecasting record cited in these pages uses a "naive" extrapolation of market prices from the latest spot quotation of interest rates. An alternative method, the "market" forecast, is based on futures quotations.
3. See *Current Forecast Tables*, H. C . Wainwright & Co., Economics, Boston, MA, August, 1981.

The accurancy of this forecast was not a fluke (Figure One). The solid line in the chart indicates the actual change in real GNP, year-over-year, for the last sixteen years. The accompanying broken line depicts the forecast, made six quarters in advance, as derived from market prices. In 1981, for example, real GNP registered 1.9 percent growth. The published forecast as of June 30, 1980 was 2.3 percent. Similarly, the forecast for 1982, minus 1.4 percent, was made June 30, 1981.

Figure One
Real Gross National Product



So much for the past. What's ahead? According to market prices, a lot. For at least a year now, contrary to the Administration's slow recovery scenario, this year's real GNP has been expected to rebound rather dramatically, followed by an additional significant gain in 1984. As of May 31, 1983, markets expect real GNP to rise 6.0 percent this year, and 8.4 percent next. Should this be at all close to what materializes, we are facing two of the best years since the Korean War period. These numbers may seem extreme. They certainly remain at odds with present consensus estimates of 2.9 percent and 4.8 percent.[4] But if history is any guide, they will not appear as extreme as time progresses.

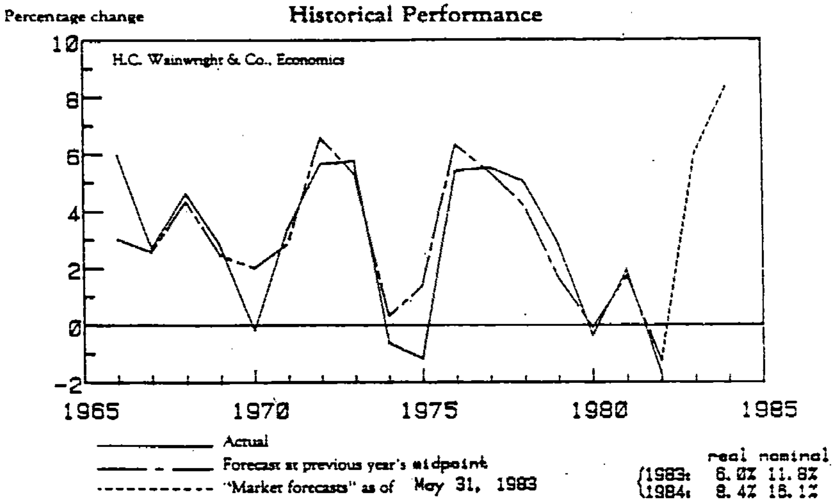
Importantly, major components of the economy are expected to behave differently. The accompanying charts show the historical forecasting record and current "market" forecasts for a number of them. As indicated, durable goods are forecast to lead the way. Investment in nonresidential structures, which tends to lag the economy, is not expected to rebound until next year.

In the light of these widely divergent forecasts, a brief discussion of *Wainwright*'s methodology is in order.

4. See *Blue Chip Economic Indicators*, *ibid* June 10, 1983.

Real Gross National Product

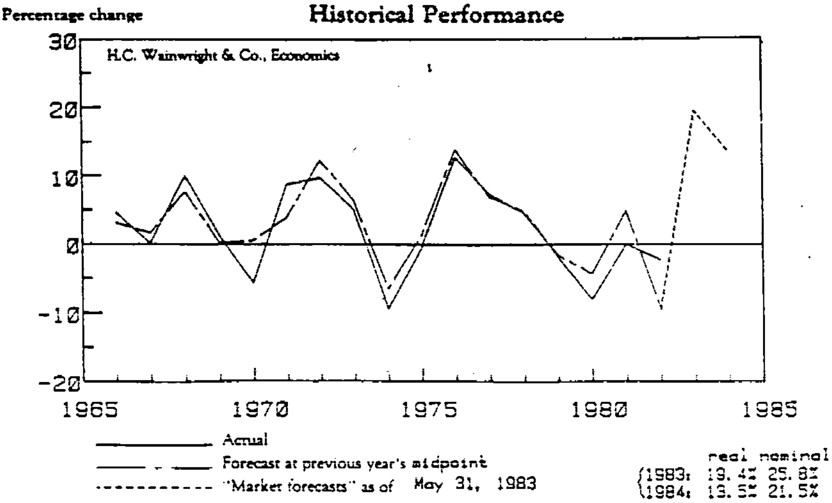
Historical Performance



Real Personal Consumption Expenditures

Durable Goods

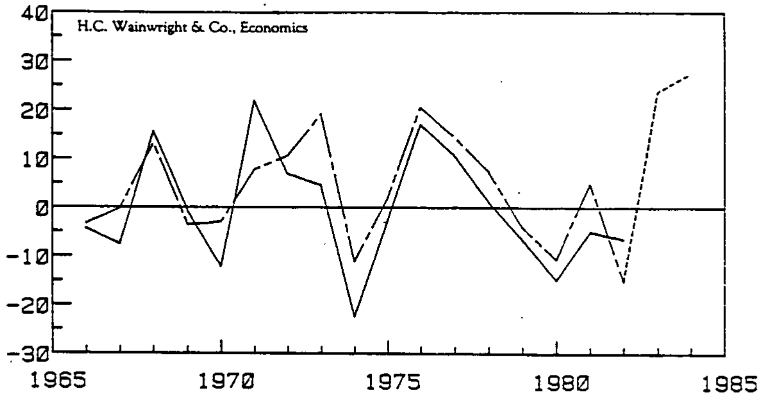
Historical Performance



Retail Sales (units)
Total New Passenger Cars

Historical Performance

Percentage change

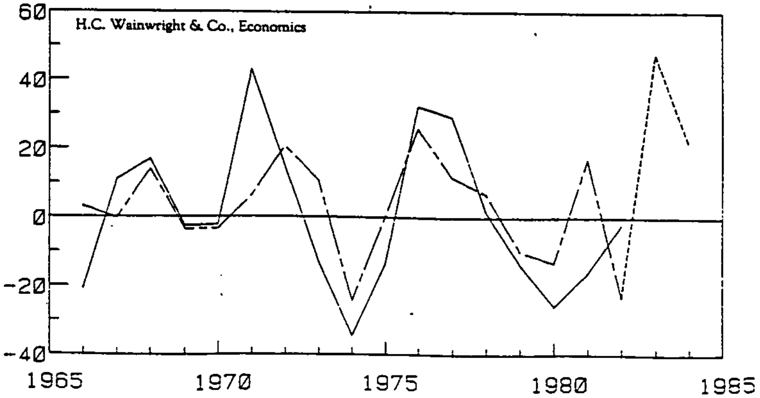


Actual
Forecast at previous year's midpoint
"Market forecasts" as of May 31, 1983 {1983: 24% 1984: 27%

New Housing Units Started
Total

Historical Performance

Percentage change

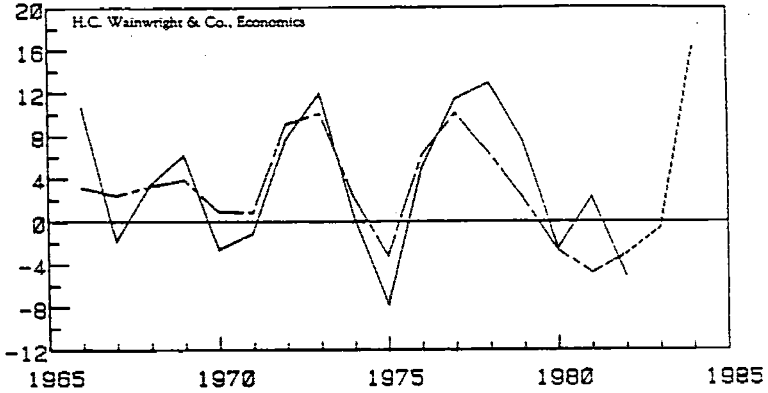


Actual
Forecast at previous year's midpoint
"Market forecasts" as of May 31, 1983 {1983: 48% 1984: 22%

Real Private Domestic Fixed Investment
Nonresidential

Percentage change

Historical Performance



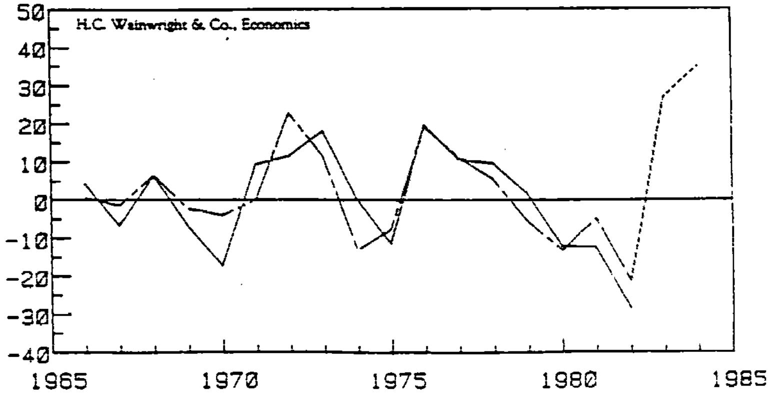
———— Actual
—— – —— Forecast at previous year's midpoint
- - - - - - - - "Market forecasts" as of May 31, 1983

	real	nominal
1983:	-1%	5%
1984:	16%	24%

Real Pre-Tax Corporate Profits
as reported

Percentage change

Historical Performance



———— Actual
—— – —— Forecast at previous year's midpoint
- - - - - - - - "Market forecasts" as of May 31, 1983

	real	nominal
1983:	27%	34%
1984:	35%	44%

THE CONDITIONAL FORECASTER™

The advent of computer technology gave rise to a number of complex forecasting models — which seek to estimate the economic impact of public policy initiatives. Most of these models are firmly rooted in conventional economic theory. They assume that the government manages the economy almost exclusively by stimulating or restraining "demand," and that inflation and unemployment arise from disequilibria between "demand" and "supply." But the unexpectedly turbulent economy of the past decade has brought into question both the theory and its application to forecasting.

The *Wainwright* **Conditional Forecaster™** technique represents a new development. The chances that subjective estimates of the unfolding business cycle can be both timely and accurate are low. *Wainwright*'s approach overcomes this problem by relying only on objective market price information which signals changes in economic behavior. This technique is a practical application of the idea that market prices reflect known information fully and without bias. Its forecasts are the forecasts of the market itself.

Statistical testing has confirmed the power of market prices to anticipate economic turning points. Since 1952, the technique captures more than 70 percent of the inter-year variation in U.S. economic growth. Indeed, it appears to provide the earliest possible warning of business cycle turns. And, in recent years, the method has proved its value in circumstances that have frustrated conventional methods.

Incentives and tax borders. The *Wainwright* approach is founded on two premises. The first is incentive economics — the proposition that economic behavior is governed in part by the anticipated returns to effort and sacrifice. The second is efficient markets — the idea that market prices contain the most complete and objective information available about the economy.

The classic kernel of incentive economics is the trade-off between "work" and "leisure." When the trade-off is shifted, behavior is altered accordingly. These terms are symbolic. "Work" includes all activities which are taxed, and "leisure" those which are not.

Although it is the starting point, this trade-off is only a specific case of a more general phenomenon. A decision maker can choose among many kinds of "work." Different tax rates apply to different types of economic activity, or even to the same economic activity under different circumstances. Tax differentials change the allocation of resources from one kind of "work" toward another.

An example occurs at the border between two states. Take the case of Massachusetts and New Hampshire. Massachusetts built an expensive social welfare system and financed it with tax rates that were high by national standards. New Hampshire, in sharp contrast, had no personal income or sales tax, and much lower property taxes.

The results of this difference in policy are clearly visible. Driving to New Hampshire, we observe that Massachusetts is marked by many symptoms of industrial decline. At the New Hampshire border there is a noticeable change, with much recently completed construction in evidence — shopping malls, office buildings, housing developments, and other signs of economic vitality. The discontinuity takes place right at the border. It is the result of a confrontation between two structures of tax rates, and reflects a kind of arbitrage. The general principle is simple: "work," when free to do so, will move from high tax to low tax jurisdictions.

In more recent years, however, Massachusetts has increased incentives, and its economy has recovered noticeably.

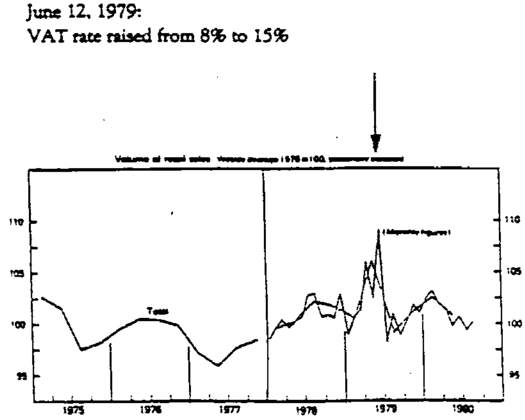
Tax arbitrage in the time domain. At the national level, tax differentials also have drastic effects. But many of the relevant tax borders exist in time rather than space.

A celebrated example occurred a few years ago in Great Britain. Soon after Margaret Thatcher became prime minister she decided to raise tax rates on spending. The value added tax (VAT) rate was increased from 8 to 15 percent. The minimum warning that the British government could give was a few weeks. Apparently, it takes that much time to reprogram the computers and reprint the tax forms. Not surprisingly, for those few weeks people went on a spending spree (see Figure Two). They bought all the things they could, while inventories lasted, literally pre-empting the tax rate increase. And for a long time thereafter retail business was depressed.

The response was prompt, and there was no mystery about it. The government gave the minimum amount of warning because it knew what would happen. It wasn't the first time that this pattern had occurred. The same response had taken place when Edward Heath announced his intention to introduce the VAT in 1973.

It is convenient to refer to these disturbances as "flip-flops." The flip side is the boom that took place as consumers scrambled to arbitrage the anticipated tax hike: the paradoxical result of *bad* news about the future. And the flop is the lull in purchases which followed.

Figure Two
The British Economy and the VAT



Source: "Economic Trends," Central Statistical Office, London.

"Flip-flops" in the U.S. economy. Many ups and downs in the U.S. economy can be traced to the same mechanism. And they are as predictable as in the Thatcher case, although the circumstances and timing are quite different. Incentives arising from tax rate differences can and do alter behavior in various ways. However, the complexity of our tax structure, and the frequency with which it changes, make it far more difficult to see what is going on than in the isolated example of a VAT tax hike. In the U.K. example, even the government fully understood what happened. But in our environment, few claim to understand why turning points occur when they do; most of us are too busy trying to recognize a turn once it has already happened.

The change from year to year in U.S. tax rates is not always easy to predict. Tax decisions by Congress are difficult to anticipate, and some of them, cliffhangers till the last moment, are retroactive. Tax rate changes also emanate from bracket "creep," to an extent that depends on the inflation rate, which is volatile. Nevertheless, we do have expectations about what will happen to tax rates from one year to the next. Indeed, the tax-shelter industry exists chiefly to take advantage of these expectations.

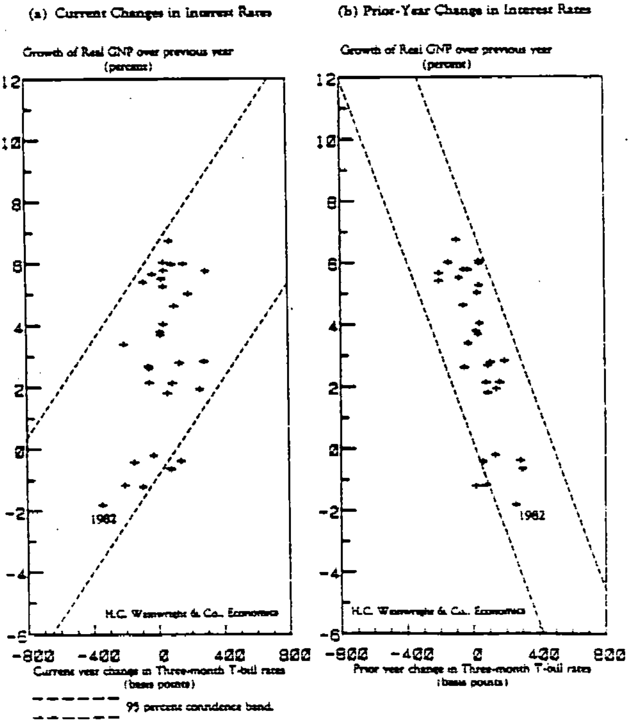
The relevant tax border is the line between one calendar year and the next. It is on January 1 that nearly all changes in income, corporate, or Social Security tax rates take place. (The notion that the Reagan-Kemp-Roth tax cuts take effect on July 1 forgets that income earned during each year's first half is taxed exactly like income earned in the second half.) For this reason, the **Conditional Forecaster™** identifies turning points between, rather than within, calendar years.

As in the VAT example, a change in tax rate expectations will set off a flip-flop in the economy as producers and spenders try to pre-empt the expected change. In effect, we get a year's warning of these turns in the economy — if we know how to read the relevant signals.

The task of monitoring expected tax changes, and using them to predict turning points in the economy, seems formidable. Fortunately, the financial markets do a lot of the work for us. Short-term interest rates reflect, among other things, expectations about two factors that borrowers will readily concede lenders ought to be compensated for: inflation and taxation. Increase the expected rate of inflation, and interest rates will rise. Keep expected inflation constant while raising next year's tax bite, and again interest rates will rise. Thus, by monitoring short-term interest rates, we can keep track of two of the chief sources of news about next year's taxation: bracket "creep," and legislative changes.

Figure Three depicts two historical relationships which confirm a bidirectional link between interest rates and the economy. The link is positive on a contemporaneous basis, and negative on a lagged basis. Both patterns are statistically significant.

Figure Three
Interest Rates and Economic Growth
1952-82
using calendar year average data



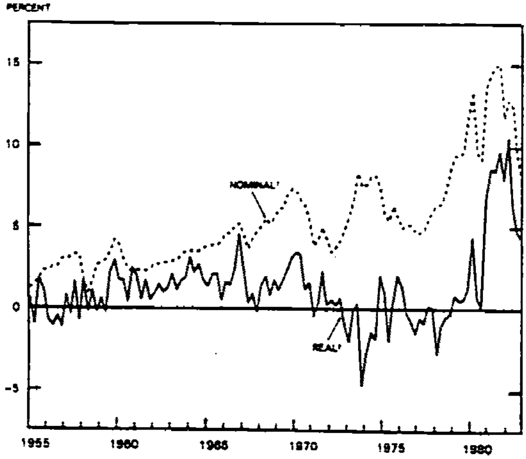
Our work at *Wainwright* confirms that interest rates do help to signal year-to-year flip-flops in the economy. Indeed, it is possible to anticipate turning points more than a year in advance. Despite the number of extraneous factors affecting the economy at all times, the market-price approach has accurately called the direction, timing, and magnitude of recent turns. Hence, market prices do contain valuable information about the economy.

Although the "market's" forecasting record has been surprisingly accurate, vindication of the present outlook must wait until 1985. In the interim, however, it is useful to analyze these forecasts, and the underlying logic which supports them, in the light of the concerns cited in my opening remarks such as the high real rate of interest and the large budget deficits.

Policy Implications: ***The Real Rate of Interest.*** Consider the current debate over today's high *real* rate of interest. Forecasting interest rates is a humbling business. Accurately forecasting interest rates is near to, if not impossible. But there is still a need to make a "best guess." For this purpose *Wainwright*'s technique harnesses the Treasury bills futures market. As of the end of May, the market expected the average 3-month bill rate to average 8.65 percent in 1983 and 9.69 percent in 1984. In our view, that's as good an estimate as any. After all, individuals who create this interest rate figure do so with much capital risk.

With inflation abating recently, many argue that today's real rate of interest, the market rate of interest minus the inflation rate, is unprecedented (Figure Four). Many argue further that if the real rate does not fall, the recovery will be aborted, and we will be riding the economic cycle again all too soon.

Figure Four
Nominal and Real 3-Month Treasury Bill Yield



[1]CONVERTED TO EFFECTIVE ANNUAL YIELD FROM DISCOUNT BASIS.

[2]EQUALS NOMINAL YIELD LESS ACTUAL RATE OF INFLATION, DEFINED BY PERSONAL CONSUMPTION DEFLATOR, OVER THE PERIOD TO MATURITY. DEFLATOR FOR FIRST QUARTER 1983 FORECAST BY COUNCIL OF ECONOMIC ADVISERS.

SOURCES: DEPARTMENT OF COMMERCE, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, AND COUNCIL OF ECONOMIC ADVISERS.

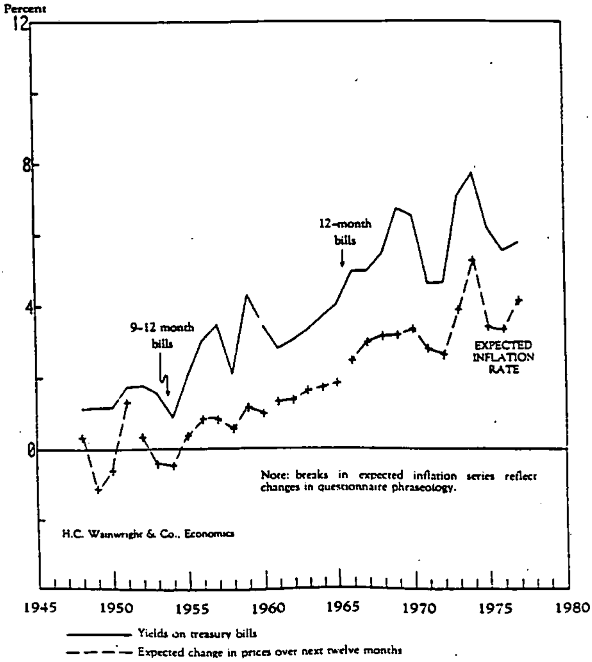
Reprinted from: *Economic Report of the President* 1983, p.138.

There is an alternative view — one which suggests that today's market pricing of credit is efficient and that real rates are not high. First, interest income is taxable. And, credit markets clear on the anticipation of an after-tax return. While there are multiple problems in gauging the marginal tax rate that clears the market, one thing is certain: ceteris paribus, higher tax rates spell higher interest rates.

For the purpose of illustration I'll use a 35 percent tax rate. Assume a market interest rate of 10 percent. The after-tax rate would be 6.5 percent before any allowance for inflation. The inflation rate that should be deducted is not the most recently published rate, as is conventionally done, for this reflects past price experience. Since credit instruments are only concerned with future inflation over their term, the *expected* inflation rate is the relevant factor. Figure Five illustrates the sensitivity of interest rates to the expected inflation rate. Should market participants expect inflation to be 5 percent through the maturity of the credit instrument, then the remaining return is 1.5 percent.

Figure Five
ANTICIPATED INFLATION
Treasury Bill Yields vs. Consumer Survey

current method of computation



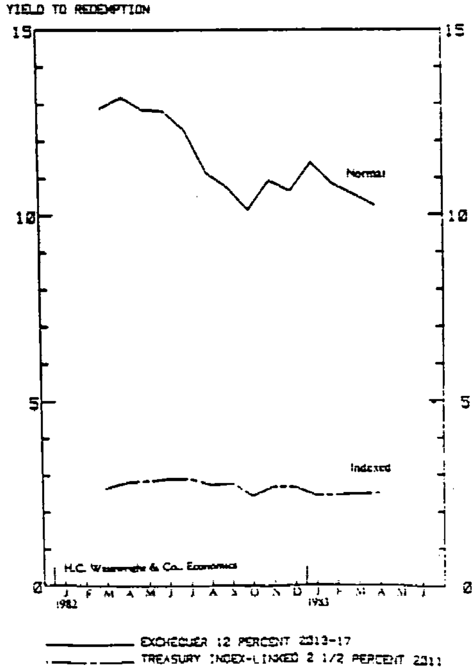
Source: *The Real Rate of Interest*, H.C. Wainwright & Co., Economics, March 3, 1981.

This return, which is adjusted for *expected* inflation and tax rates, is the after-tax, ex-ante real rate of interest.

Measuring this interest rate is, of course, problematical. But imagine what the yield might be on treasury debt if the U.S. government promised to pay interest and principal in constant purchasing power dollars. That is, bonds whose return would be indexed to the price level. No inflation premium for these bonds would exist since the indenture would guarantee that they would be inflation proof. Such bonds would be expected to trade at a much lower yield than conventional debt.

This concept is not hypothetical. In 1981, the United Kingdom started issuing index-linked gilts. Principal and interest are indexed to the UK retail price index with an eight month lag. Outstanding issues currently total 6.4 billion pounds or approximately $10 billion. Tax treatment is comparable to conventional government debt. The yield of the indexed gilts is substantially lower than the non-indexed, as shown in Figure Six. The after-tax yield, of course, is even less.

Figure Six
Yields on Normal and Index-Linded Bonds Compared
British Government Securities



Source: Financial Times. End of month data.

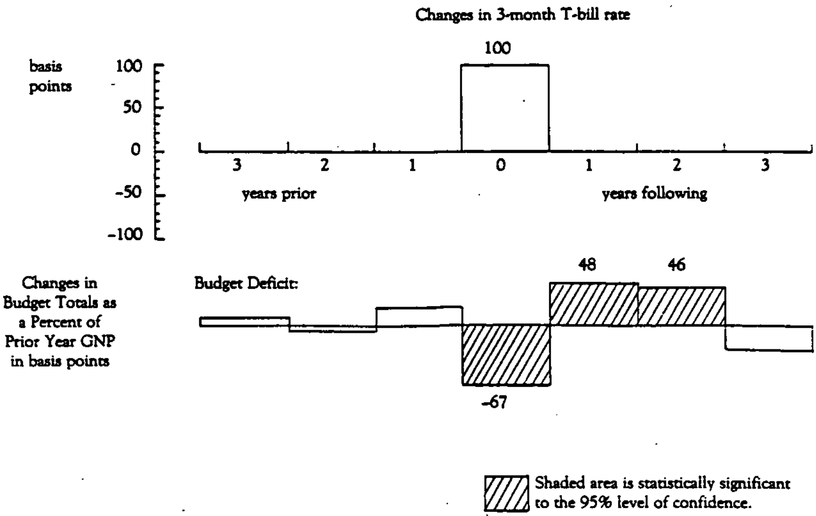
From this and other evidence, we conclude that the after-tax, ex-ante real rate of interest is not high, and is rather stable. And any discrepancy between the "ex ante" and "ex post" real interest rates implies an expectation that future tax rates and/or inflation will differ from past rates.

Policy Implications: ***The Budget Deficit and Interest Rates.*** It is argued that in order to bring down interest rates, let alone the real rate, we must get our horrific budget deficits under control. The emerging solution suggests that a healthy recovery demands "fiscal responsibility," that is, a tax increase.

Many congressmen have offered their prescription. Alternative tax proposals are sure to follow, including rescinding indexation and the July 1 tax cut. These proposals follow the Tax Equity and Fiscal Responsibility Act of 1982, a $98.3 billion tax increase, a 5¢ a gallon gasoline tax, and an increase in the Social Security tax.

But what is the history of budget deficits and interest rates? Figure Seven presents the relationship between the budget deficit as a percent of GNP, and the average annual 3-month treasury bill rate.

Figure Seven
The Budget Deficit and the Interest Rate:
The Timing of the Relationship
year-to-year changes



We find that there is a relationship between the budget deficit and interest rates but not quite the same one which is used to argue for a tax increase. Using annual data, a budget deficit this year does not lead to any expected interest rate next year or the year after. This year, however, if the deficit were to rise, it would be consistent with a *fall* in interest rates this year. Additionally, a rise in interest rates this year would be consistent with a fall in the deficit this year, but a rise in the next two years. Interest rates lead the deficit, the budget deficit does not lead interest rates, even though there is a contemporaneous relationship between the two.

There is, however, a larger question: Would our budget deficit woes be solved by another round of tax increases?

Official projections, which take into account all recently enacted tax programs, show in stark terms why there is such a concern about budget deficits and, therefore, the possibility of raising taxes further.

THE BUDGET DEFICIT CRISIS
Official Projections[1]
($ Billions)

Fiscal Year	Total Federal Receipts	Federal Budget Deficit
1982 (actual)	617.8	-110.4
1983	598.3	-210.2
1984	653.7	-190.2
1985	732.4	-184.6
1986	843.8	-144.6
1987	921.3	-136.6
1988	1022.9	-102.4

1. Budget of the United States Government, as amended April 1983.

In part, the deficit problem is linked to the economy's recovery. On the magnitude of the recovery, there is a wide difference of opinion. The Administration currently projects cumulative real GNP growth through 1984 at half the rate implied by the "market" forecasts.

The experiment of attacking deficits through increased taxation has, in fact, been the traditional prescription. It is easy to understand the convention that the road to a balanced budget is higher taxation. Looking at year-by-year changes, increases in government receipts are coincident with improvements in the budget accounts (Figure Eight). But, from a wider perspective, the trends run in the opposite direction (Figure Nine). Over the full period, increases in taxes have been accompanied with an ever deteriorating budget picture. Does it seem reasonable that by raising taxes still further we will bring the deficit under control?

Figure Eight
Taxes and the Budget Deficit
1952-1982

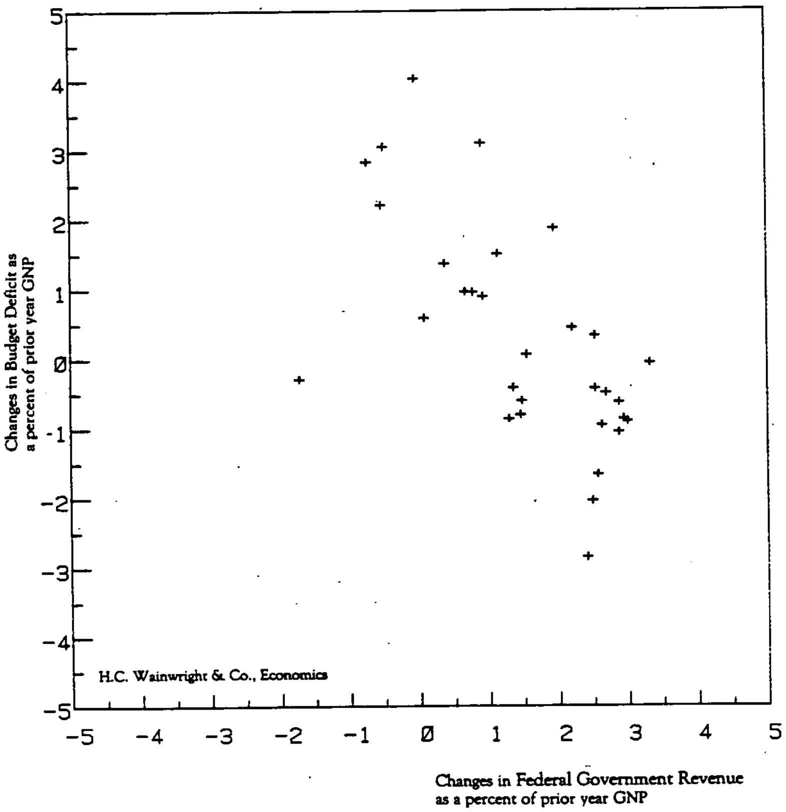
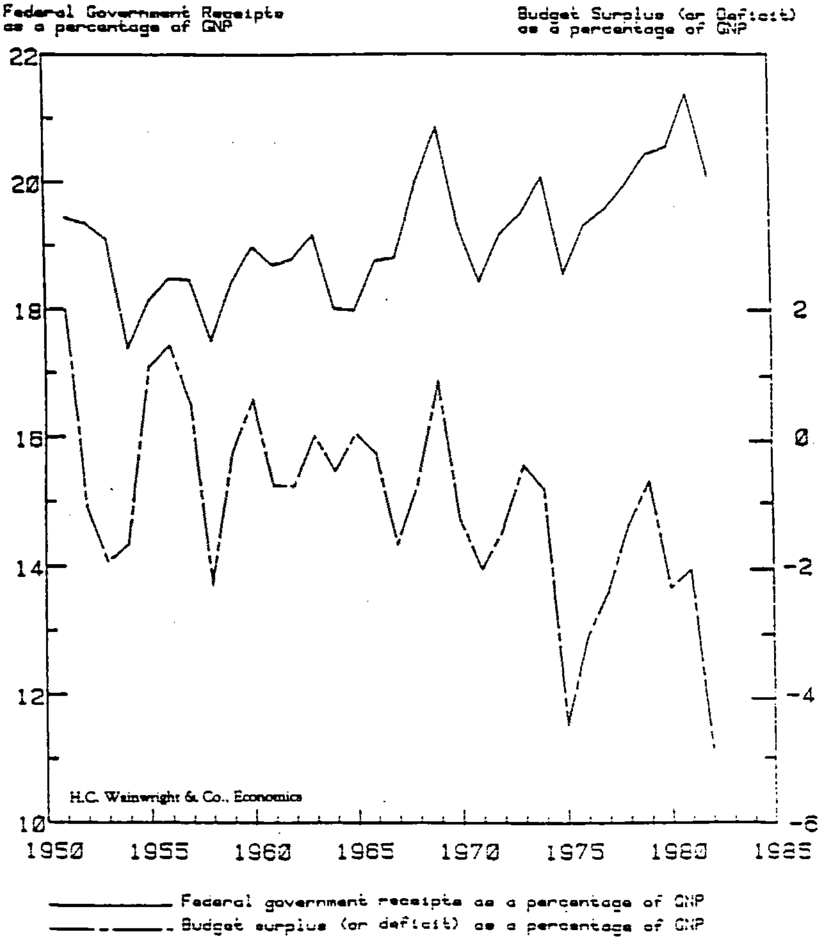


Figure Nine
FEDERAL RECEIPTS AND THE BUDGET



An anemic recovery, such as that envisioned by the Administration, is damning to the deficit picture. As Budget Director David Stockman, Martin Feldstein and others see it, the Administration must rely on spending cuts and more tax boosts rather than the hope of a strong recovery.

Ironically, it is just such transmissions which push in favor of a boom scenario. According to the logic behind *Wainwright*'s **Conditional Forecaster™** outlined earlier, anticipations of higher tax burdens in the future cause the marketplace to expedite economic activity. The more politicians clamor for new taxes, the more likely the system is to place discretionary activity into the earlier and lower tax period. Whether or not such tax increases actually are legislated is unimportant. What is important is that they are *expected* to come true.

Conclusions

- The likely path for 1983 and 1984 is a strong economic recovery, perhaps the best two consecutive calendar years since the Korean war period.
- The real rate of interest, adjusted for *expected* inflation and tax rates, is not high, and not a concern.
- Market rates of interest are expected to rise next year.
- The budget deficit, although significant for some reasons, should not cause alarm concerning interest rates or the economic recovery.
- There is precious little reason to believe that the budget deficit will shrink as a result of continued increases in taxation.

Thank You

William G. Shipman

Partner

H.C. Wainwright & Co., Economics

Senator JEPSEN. Mr. Sinai, please proceed, as you wish.

STATEMENT OF ALLEN SINAI, SENIOR VICE PRESIDENT AND ECONOMIST, DATA RESOURCES, INC., LEXINGTON, MASS.

Mr. SINAI. Thank you very much, Mr. Chairman. I want to ask and deal with four questions in the testimony. First, what is the current state of the economy and the financial markets? Second, what is the near-term and longer run outlook for economic recovery, the profile of the expansion, interest rates, and economic policy? Third, what are the major risks to sustained expansion and is there much chance that the recovery will be aborted? And last, what policy choices might promote sustained expansion and declining unemployment without a major reacceleration of inflation in the coming years?

And so let me try and deal with each of those.

First, the current state of the economy and financial markets. The economic recovery is now clearly in a powerful growth phase. It's only 6 months old. But it is rebounding very strongly from the most severe downturn since the thirties.

The recovery, which began rather weakly in January, gained considerable momentum in the second quarter, especially in consumer spending, and through a shift to inventory accumulation rather than decumulation. The real economic growth rate estimated by the Department of Commerce of 6.6 percent may actually turn out to be conservative in terms of what the final numbers provide. There is upwards of $29 to $30 billion of real GNP coming out of both the swing in inventories and the increase in consumer spending so far in the second quarter. The rises in sales, orders, production, employment, and income, which are now regularly occurring, are very much characteristic of the early stages of expansion and once in place, promote a kind of self-sustaining process which is very hard to interrupt.

Once in place, I think it's very safe to say that the economy is decisively launched into expansion and it is very difficult to do anything to ruin that short of egregious policy errors or some external shocks, especially when you are starting from the low position that began this recovery.

Indeed, the demand side pressures are so strong in the second quarter that a good part of the money growth that we are seeing and the extra growth in M_1 is coming out of increased demand for money in the economy, and the ½ to 1 percentage point rises of interest rates in recent weeks are further evidence that we have a very strong upturn occurring.

Now in subsequent quarters, the growth of real GNP is unlikely to surpass that of the second quarter. There are areas of weakness in the economy which will persist and which actually are in evidence in the second quarter. Foreign trade, for example, net exports will continue to be weak. There is likely to be some fading of residential construction in terms of its contribution to real GNP. We will see only flat or small rises in business fixed investment and consumer spending will likely not be so strong as in the second quarter.

From the fourth quarter of 1982 to the fourth quarter of 1983, we are now projecting about a 5-percent rise in real GNP. The Consumer

Price Index will be up about 3 percent. The unemployment rate will still be around 9.3 percent in the fourth quarter and interest rates should be near current or at somewhat higher levels.

The year 1984 promises to be an even better year for the U.S. economy. Actually, this year is more of a transition year to a solid, broad-based expansion across the board in 1984. Next year, the business sector should really begin to come on stream into the recovery, both in terms of inventory accumulation and a much stronger pace of spending on plant and equipment.

Net exports—foreign trade—should begin to improve by the second half of 1984. For all of next year, we are projecting 4.7 percent growth rate for real GNP, with the unemployment rate down to 8½ percent by election time.

Now the profile of the recovery so far has really been very typical of most upturns. And as a matter of forecasting, it is quite likely that the rest of the expansion will unfold in a way that is very familiar, with a couple of exceptions.

The recovery began in the interest-rate sensitive areas of housing and auto sales. Then it moved into consumption and now we see a very strong swing in inventories. At the same time, broad-based strength in consumption is emerging and that is the key to propelling the expansion for many more months. Once the process gets going, and it will be buttressed by the tax cuts of July 1, the expansion really does have a life of its own.

In the second half, we expect to see some increases in business-fixed investment, but not anything of great strength until 1984–85.

For the business sector, low-capacity utilization rates, still high nominal and real interest rates, still slow rises in final sales, despite the good GNP number, and weak balance sheets will continue to prevent any capital goods boom.

The behavior of net exports is one unusual element in this recovery, the result, really, of a very strong dollar, weak economies abroad and enforced austerity in many of the third world countries.

The other unusual facet of the recovery is that growth is likely to be subpar, on average, over the string of years, as the string of the next few years. Very fundamentally, so long as we have such high nominal and real interest rates, the interest rate sensitive sectors in the economy—autos, housing, business, capital formation, and net exports—we will not be able to sustain the kind of rises that typically go on in a recovery. This will prevent the average growth rates in the U.S. economy from matching the 5 to 6 percent per annum that we often see after a recession for 2 or 3 years.

Those high interest rates, both long and short, are very much the result of the string of deficits in the out-years and their effects on long-term rates through expectations and the effect on short-term rates through the volume of Treasury financing that occurs. And, there does not seem to be any prospect of a major break in the deficits to anything other than a range of $175 billion to $225 billion for the next 3 or 4 years. So long as that is true, interest rates will remain high. They may not rise sharply until there is a clash, until private sector credit demands really begin to surge and push against the Treasury financing to create problems for the Federal Reserve. But they will remain at these high levels both in nominal and real terms, and that is going to be a deterrent once the initial surge of growth in the interest rate sensitive areas ends.

Now with regard to the sustainability or how long the expansion will last, on that I am very optimistic. I believe we have seen some very fundamental changes in the U.S. economy, very much the result and the aftermath of the severe downturn that we had over 1979 to 1982. And some of these changes, not all of them, but these are the major ones, include permanently lower rates of inflation, both for prices and wages. The deceleration of inflation since 1980, both in prices and wages, has been extraordinary, certainly not without immense costs, but probably something that could not be avoided in terms of getting inflation rates down.

Really, by anybody's theory, the 15-year acceleration of inflation from 1965 to 1980 was a very serious matter and the cost of not dealing with it would undoubtedly have been much greater than the costs, as bad as they have been, of recession and unemployment—bringing those inflation rates down.

Now that really was the fundamental change for the economy, the reduction of inflation. And it is unlikely that we are going to get a quick re-acceleration of inflation to decidedly higher levels. There are a number of reasons for that. The economy, though growing, is very much below its potential. There is a gap between potential and actual real GNP of over 12 percent. That's a record for the post-war period. There is tremendous pressure in the labor market, downward pressure on wages. Wage costs are rising much more slowly. We are likely to see a very strong increase in productivity growth, one that may prove to be quite surprising. Those two factors, low increases in wage costs and the strong productivity growth, will combine to promote small rises in unit labor costs. In the year or two after the recession ends, unit labor costs really call the tune on pricing. If they are low, business can recapture profits without raising prices simply through increases in sales volume.

So I think the outlook for inflation is quite bright and the way to discuss it or phrase it or describe it for the next 2 or 3 years would be low single-digit rates of increases and, at most, 4 to 5 percent as we move into 1984 and 1985. That's very fundamental because that changes the underpinnings for interest rates. So long as inflation rates are in the range that I have described, it will be difficult for there to be any sustained upward surge of interest rates that, at least for the next year or two, and maybe even three, would cause the economy to move into so severe a downturn as we had in the last few years.

So a second fundamental is permanently lower interest rates. Although they are still high by historical standards, they have moved low enough to provide a stimulus to growth in the economy.

A third fundamental change is the change in the purchasing power of households and businesses. That grows not only out of the lower inflation, but also out of the increased incomes that are being generated by tax cuts and for businesses what has been called the leaning of corporate America.

Purchasing power is much greater now for households. They may not realize it because of downward pressure on wages up to 3, 4, or 5 percent, but the fact is that in real terms, real wages are rising now. They certainly were not 3 or 4 years ago. And, real disposable income is on the upswing as well.

In addition, there is a little kicker of over a 55-percent increase in the stock market in the last year. The increase in wealth that comes out of that, not for a lot of people, but for some who do spend on big ticket items, the effect on consumer confidence, and also the effects of lowering business financing costs, is one of those factors that has been propelling consumer spending so much higher in the second quarter. And, it may continue to provide somewhat of a surprise for the rest of the year.

The fourth fundamental change is the different attitude toward productivity in the U.S. economy and business. We have had for about 10 years very low productivity growth, I think as all of us know, which has been one of the major problems in terms of growth of potential output. There really is a different attitude in business; indeed, those workers who are still working really are supposedly the most productive. Their job tasks are being doubled and tripled. The productivity numbers have been quite good in the last three quarters. We may be surprised by the growth in productivity over the next year or two, both as an outgrowth of the deep recession we had and also from some technological change that will enhance productivity growth. But whatever the reason, it's going to help potential output and be a weapon against inflation.

The last reason for a long expansion beyond 3 years is very simply that when you start from so low a position in the economy as we are starting from, it is a lot easier to sustain growth for many years. The last long growth period that we had was in the early 1960's, when, indeed, we had quite a bit of slack coming out of a long period of recession.

Well, I think it's clear that I don't think the risks to aborting the recovery are all that great at this moment of time. At the same time, they cannot be ignored or diminished. And primary among them is the problem of high deficits and high interest rates and whether or not the Federal Reserve has to tighten monetary policy either because of the deficits, because of too rapid monetary growth, or because the growth of the economy gets going too fast.

I don't think that 1 or 1½ percentage points of rises in interest rates, nominal or real, will really do much except slow down the pace of the expansion over the next year or two. But anything that would raise interest rates 2 or 3 percentage points would definitely threaten to not only abort the U.S. economic recovery, but to create even more difficult problems for the debtor nations, the Third World countries and LDC's who are having trouble now and for the banks who are trying to help them over their difficult times.

The deficit is clearly the culprit and, as has been argued many times, it would be of great help to the economy and to minimizing the risks of aborting the recovery if we were to see a tightening of the deficit and some further easing of monetary policy at the same time.

As for policy, really, the question for policy is how, now that we're starting so far in advance, can we encourage sustained expansion without a regeneration of inflation so that we can avoid going through the same difficulties as in 1980, 1981, and 1982. I think that's the $64—I guess these days it's $64 now, not $64,000, because this is, after all, an era of disinflation. The $64 question is how to do that without—how to grow the economy, reduce unemployment, and not have sharp increases in inflation as a result.

I think there are a lot of policy choices to do that. It would be wise for Congress and the administration policymakers to consider that early. One way would be to tilt the mix of policy toward a tighter fiscal, easier money stance, which would bring lower interest rates, but not create too much stimulus in the economy, that would create an environment of lower interest rates that would raise and enhance business capital spending and increase potential output.

The current budget impasse, I would say, is worth about half a percentage point so far in long-term bond yields and is really a major danger if it keeps going on. Second, a better coordination of monetary and fiscal policy is necessary to achieve common goals. In fact, I think it's a necessity. We have had too many periods of clashing monetary and fiscal policy in recent years, with very counterproductive results.

I don't have any brilliant ideas on this, except to increase the communication between the major arms of policy. It may be time to establish a policy board to coordinate policy where goals are jointly set for growth, employment and inflation, and discussion and setting of parameters of both monetary and fiscal policy are made in a coordinated way. Such a board could include the Chairman of the Federal Reserve Board, the Secretary of the Treasury, the Chairman of the Council of Economic Advisers, the chairman of the key congressional committees, and the Director of OMB. Getting the communication going about what policymaking ought to be, what the goals are for the economy and how to achieve them, would be a major step in minimizing the lack of coordination of policy we have seen in some recent years.

Another policy choice is to encourage only slow growth for the economy in the early stages of expansion. I think that's actually a plus. If growth is slower at the start, that will ease demand-side pressures on inflation and buy time before we run into some more inflation which ultimately has to happen once you get close to full employment.

And finally, it would be worth some study of income policies well in advance of inflation problems in case a need arises later. Tax-based incomes policies operating on wages might be implemented as we move along in the business expansion. I have thought that such policies could offer a means to sustain lower costs to business and lower inflation without the painful side effects of a severe recession. But that's a very difficult subject and a lot of early planning would be necessary.

In conclusion, I would say that there is little that can disturb the prospects for sustained expansion now. Only egregious policy errors or unforeseen external shocks can really upset the momentum for expansion that has been established. Most likely, we will have a string of years of good growth—not boom or runaway prosperity, but steady expansions on average, each year.

Simultaneous good news is going to occur on all fronts for most of this year, both in economic growth, employment, inflation, interest rates, and for most investors, quite a change from recent years. It's hard to see any major trouble in prospect—perhaps late this year or early 1984, but more likely not until 1985.

There is really too much slack in the economy now and unit labor costs will be too low for the kind of inflation that would necessitate a major restraint in policy. Only the continuing huge Federal budget deficits, the high interest rates that are associated with them, and potential problems of countries with severe debt problems loom as threats to sustained recovery both in the United States and the rest of the world.

Thank you.

[The prepared statement of Mr. Sinai, together with an attached appendix, follows:]

Prepared Statement of Allen Sinai

Can the Recovery be Sustained?

This testimony is concerned with four questions--

1) What is the current state of the U.S. economy and financial markets?

2) What is the near-term and longer-run outlook for economic recovery, the profile of the business expansion, interest rates, and economic policy?

3) What are the major risks to sustained expansion and is there much chance that the recovery will be aborted?

4) What policy choices might promote sustained expansion and declining unemployment without a major reacceleration of inflation in coming years?

In brief:

-the economic recovery, now six months old, is currently in a powerful growth phase, rebounding strongly from the most severe downturn since the 1930s. The recovery, which began rather weakly in January, has gained considerable momentum; especially in consumer spending and through a shift to inventory accumulation rather than decumulation. Real economic growth in the second quarter is estimated at an annual rate of 6½ to perhaps over 8%, with increases concentrated in inventories, consumption, residential construction and military spending. With rises in sales, orders, production, employment, and income now regularly occurring, the economy appears to be decisively launched into expansion. Indeed, pressures have developed on M1 and interest rates from the demand-side strength. The 16.4% surge in M1 growth, at an annual rate, over the past two months and 50 to 75 basis point rises of interest rates in recent weeks provides further evidence that a solid upturn is occurring.

-in subsequent quarters, real economic growth is unlikely to surpass that of the current quarter, with continuing weakness in net exports, some fading of residential construction, only flat or small rises in business fixed investment, and a slower pace of rises for consumption. From 1982:4 to 1983:4, a 5% rise in real GNP is now projected, with the CPI-U up 3% or so, the unemployment rate still at 9.3% in the fourth quarter, and interest rates near current or at somewhat higher levels. 1984 promises to be an even better year for the U. S. economy, with business spending to pick up and a turnaround finally emerging in foreign trade. A 4.6% growth rate in real GNP is projected for the year, with strength well distributed across the economy and the unemployment rate down to 8.5% by election time.

-the profile of recovery has been generally typical of most upturns, with housing and auto sales having led the way, then consumption and a positive swing for inventories. A broad-based strength in consumption is emerging, which should propel the expansion for many more months. During the second half, business fixed investment should begin rising, but a much greater pace of capital outlays will not occur until 1984 and 1985. Low capacity utilization rates, still high nominal and real interest rates, only slow rises in final sales, and weak business balance sheets will continue to depress capital outlays. The behavior of net exports has been unusual, however, reflecting the strong dollar, the weak economies abroad, and enforced austerity for many of the debtor nations. The typical recovery profile is forecast to continue, except for subpar growth over the next few years.. Growth of 5 to 6% for real GNP during the first few years after a recession is not unusual. An interim DRI forecast shows 3.1%, 4.5%, and 3.5% growth rates for 1983, 1984, and 1985, respectively.

-the expansion will be sustained for at least several years as a result of fundamental changes in the U.S. economy and financial markets. These changes include 1) permanently lower rates of inflation, both for prices and wages; 2) a lower profile of interest rates than in recent years, although still high by historical comparisons; 3) increased real purchasing power for households and business; 4) much higher growth in productivity; and 5) the room for expansion that exists simply because the economy is so far below its potential. The long deterioration in the performance of the U. S. economy is over, principally because the severe inflation problem has been ended. Lower inflation is critical for lower interest rates, which combine to stimulate growth in output, production, employment, and income. Greater purchasing power for households despite depressed wages will enhance the affordability of all items, sustaining increased consumption for many quarters. Business, too, is experiencing improved purchasing power, as cash flow rises well above capital outlays and costs remain low. A new productivity ethic, fostered by the deep downturn and "leaning" of corporate America promises to hold unit labor costs extremely low and to bring a greater increase in potential output. Finally, a "gap" between actual and potential real GNP of over 12% will permit considerable growth before demand-pull inflation becomes a problem again.

What is unusual for this expansion is the prospects for subpar growth, almost solely the result of the $175 billion to $200+ billion federal budget deficits in prospect over FY1983 to FY1988. These deficits are responsible for two to three percentage points of nominal and real long-term interest rates, and will prevent the interest rate sensitive areas of the economy from rebounding fully. Weak net exports and a permanently smaller share of total economic activity for the interest rate sensitive sectors will be a characteristic of the economy in coming years as a result.

-Numerous risks to sustained expansion remain, however, although more likely to cause less robust growth rather than an aborting of the upturn. These include 1) the crowding-out that is now occurring from the effects on interest rates of actual and prospective federal budget deficits; 2) the risks of default or collapse abroad; and 3) the ongoing failure fallout from the 1979-82 downturn. Our estimates for the effects from crowding-out are one to two percentage points of real economic growth per annum, as expectations of large deficits raise bond yields two or three percentage points and short-term interest rates by a percentage point or two.

-Policy choices have been the key to economic performance in recent years and will remain critical to the patterns that emerge for the U. S. economy and financial markets in coming years. The downturn of 1979 to 1982 was almost solely a policy induced recession, arising from the tight fiscal and tight monetary policies in 1980 to 1982. But now, fiscal stimulus is propelling the economy higher and so is the monetary stimulus that began last summer. Although, the coordination of fiscal and monetary policies often has been a problem, both currently are operating in favor of sustained economic growth.

The critical policy issue for the future is how to sustain economic growth and declining unemployment witout a major reacceleration of inflation. Several policy choices could enhance this prospect. First, tilting the mix of stabilization policy to a "tighter fiscal-easier money" stance remains essential, creating an environment of lower interest rates that would raise business capital spending and potential output. The current budget impasse between Congress and the President is a major problem, clearly responsible for 30 to 50 basis points of higher bond yields recently. Second, a better coordination of monetary and fiscal policy to achieve common goals is now a necessity. The costs of policy clashes have been too great in recent years. It is time to establish a policy board to coordinate policy, jointly setting goals for growth, employment and inflation and setting the parameters of both monetary and fiscal policy in a coordinated matter. Such a board might include the Chairman of the Federal Reserve Board, Secretary of the

Treasury, Chairman of the Councel of Economic Advisers, and the Chairman of the key Congressional Committees, and Director of OMB. Third, slow growth for the economy in the early stages of expansion could be a plus, easing demand-side pressures on inflation. Last, income policies should now be planned and studied, in case a need arises later, ready to be implemented. Tax-based wage policies offer a means to sustain lower unit labor costs without the painful side effect of a severe recession.

There is little that can disturb the prospects for sustained expansion now. Only egregious policy errors or unforeseen external shocks could upset the momentum for expansion that has been established. Most likely, there will be a string of years of good growth, not boom or runaway prosperity, but steady expansion, on average, each year. Simultaneous good news will occur on all fronts for most of this year, in economic growth, employment, inflation, interest rates, and for investments, quite a change from recent years. No major trouble is in prospect before late this year and perhaps not even until 1985. Too much slack exists in the economy now and unit labor costs will be too low for the kind of inflation that would necessitate restraint in policy. Only the continuing huge federal budget deficits associated high interest rates, and potential collapse of countries with severe debt problems loom as serious threats to sustained recovery, both domestic and worldwide.

APPENDIX
Tables and Charts

Table 1
Recent Evidence

	1983					1982						1982	
	May	Apr.	Mar.	Feb.	Jan.	Dec.	Nov.	Oct.	Sep.	Aug.	Jul.	IV	III
Demands:													
Retail Sales - Total													
(Bils. of $, SA)	96.9	94.9	93.3	91.2	92.3	92.5	92.5	90.9	89.9	89.1	89.5	92.0	89.5
%	2.1	1.7	2.3	-1.2	-0.2	0.0	1.7	1.1	0.9	-0.4	1.0	2.8	0.2
%CH	28.5	22.7	31.4	-13.9	-1.9	-0.4	23.1	14.3	11.7	-5.2	12.4	11.5	0.8
%CHYA	6.7	7.2	6.3	3.5	6.7	5.8	5.9	4.2	1.5	0.3	1.9	5.3	1.3
Auto Sales - Total													
(Mils. of Units, SAAR)	8.9	8.4	8.2	8.3	8.7	8.7	9.4	7.9	8.3	7.6	7.4	8.7	7.8
%CH	100.1	33.5	-13.5	-43.2	0.0	-60.5	705.4	-43.0	179.2	37.7	94.8	55.6	14.5
%CHYA	8.5	15.1	6.5	-1.2	10.1	20.8	22.1	6.8	-5.9	-24.0	-9.8	16.6	-13.8
Housing Starts - Total													
(Mils. of Units, SAAR)	1.791	1.490	1.627	1.784	1.694	1.280	1.361	1.142	1.134	1.046	1.185	1.261	1.122
%CH	809.7	-65.2	-66.9	86.1	2787.0	-52.1	720.9	8.8	163.6	-77.6	2277.5	59.7	94.6
%CHYA	74.2	63.6	76.8	95.8	93.2	41.3	62.2	31.9	26.0	10.2	14.5	44.9	16.7
New Orders for Durable Goods													
(Bils. of $, SAAR)													
%		3.8	3.2	-6.0	8.1	7.2	0.5	-2.2	-0.8	-3.4	-0.8	-1.3	-3.7
%CH		56.2	46.5	-52.1	154.8	130.2	5.8	-23.7	-9.7	-34.3	-9.0	-5.1	-13.8
%CHYA		8.1	2.3	0.1	7.4	0.1	-10.1	-9.9	-13.2	-15.0	-13.1	-6.7	-13.8
Personal Consumption Expenditures													
(Bils. of $, SA)		2085.2	2064.0	2048.2	2050.3	2041.1	2035.9	2015.5	2003.2	1981.5	1974.1	2030.8	1986.3
%CH		13.0	9.6	-1.2	5.5	3.2	12.8	7.6	13.9	4.6	12.5	9.3	8.1
%CHYA		7.8	7.4	6.2	7.5	7.6	8.0	7.7	6.5	5.6	6.7	7.8	6.3
Production and Inventories:													
Industrial Production - Total													
%	1.1	2.0	1.3	0.5	1.6	0.2	-0.6	-1.2	-0.8	-0.3	0.1	-2.1	-0.9
%CH	14.3	26.8	16.8	6.3	21.4	2.7	-6.8	-13.1	-9.1	-3.4	0.9	-8.1	-3.4
%CHYA	3.7	1.8	-1.3	-3.4	-2.3	-5.7	-7.8	-9.0	-9.4	-9.9	-9.8	-7.5	-9.7
Inventory-to-Sales Ratios -													
Manufacturing and Trade (*1)													
Nominal		1.442	1.446	1.487	1.470	1.513	1.517	1.543	1.519	1.518	1.499	1.524	1.532
%CH		-3.1	-28.3	14.7	-29.3	-3.3	-18.3	20.1	1.3	16.2	7.6	3.3	5.4
%CHYA		-4.9	-3.6	-1.4	-4.4	-0.5	0.6	3.6	4.0	5.5	5.0	1.2	4.6
Real				1.684	1.671	1.734	1.746	1.790	1.755	1.750	1.729	1.766	1.744
%CH				9.4	-35.6	-8.1	-26.0	27.1	3.2	15.9	4.0	2.8	5.0
%CHYA				-3.1	-6.3	-1.5	-0.2	2.8	3.7	4.5	4.3	0.4	4.2
Incomes:													
Personal Disposable Income													
%		1.0	0.6	-0.1	0.5	0.2	0.8	0.4	0.3	0.1	1.8	1.2	2.2
%CH		12.2	7.5	-0.9	6.4	2.0	9.5	5.1	3.3	1.0	24.1	4.9	8.9
%CHYA		6.1	6.2	5.9	6.4	6.1	5.9	5.5	6.0	6.6	7.5	5.9	6.7
NIA Saving Rate													
(Percent)			5.8	5.9	5.9	5.9	6.0	6.2	6.5	6.9	7.0	6.0	6.8
%CHYA			-13.4	-10.6	-11.9	-18.1	-21.1	-16.2	-5.8	6.2	11.1	-18.5	3.6
Prices:													
FHLBB Sales Price for													
Existing Single-Family													
Homes ($1,000, NSA)		78.8	74.7	79.3	79.1	71.6	70.8	70.5	71.4	69.2	71.1	71.0	70.6
%CH		89.9	-51.2	3.1	230.5	14.4	5.2	-14.1	45.6	-27.7	-1.7	2.3	4.1
%CHYA		14.0	5.1	9.1	13.0	2.3	1.0	-1.9	2.9	-1.6	-1.8	0.4	-0.2
Consumer Price Index -													
All Urban Consumers													
%		0.6	0.1	-0.2	0.2	-0.3	0.0	0.4	0.1	0.3	0.6	0.5	1.9
%CH		7.2	1.6	-2.4	2.1	-3.2	0.0	5.0	1.2	3.8	7.3	2.0	7.8
%CHYA		4.0	3.6	3.5	3.7	3.9	4.6	5.0	5.0	5.9	6.5	4.5	5.3
Producer Price Index -													
Finished Goods													
%	0.3	-0.1	-0.1	0.0	-1.1	0.3	0.6	0.4	0.1	0.5	0.5	1.1	1.5
%CH	3.9	-0.9	-1.7	0.4	-12.2	3.8	7.4	4.3	1.3	5.7	5.7	4.4	6.1
%CHYA	2.4	2.1	2.2	2.1	2.2	3.7	3.8	3.5	3.6	4.0	3.6	3.7	3.7

Table I (continued)

	Latest (*2)	1983 May	1983 Apr.	1983 Mar.	1983 Feb.	1983 Jan.	1982 Dec.	1982 Nov.	1982 Oct.	1982 Sep.	1982 Aug.	1982 Jul.	1982 IV	1982 III
Employment and Utilization:														
Employment - Household Survey (Mils. of Persons, SA)		99.6	99.5	99.1	99.1	99.1	99.1	99.1	99.2	99.5	99.7	99.6	99.1	99.6
%CH		1.2	4.4	0.5	-0.5	0.1	-0.5	-0.5	-4.3	-1.7	1.2	-1.1	-1.9	-0.5
%CHYA		-0.4	0.0	-0.5	-0.6	-0.6	-0.6	-1.1	-1.2	-0.6	-1.0	-1.2	-1.0	-0.9
Unemployment Rate (Percent)		10.1	10.2	10.3	10.4	10.4	10.8	10.7	10.5	10.2	9.9	9.8	10.7	10.[illegible]
Capacity Utilization - Manufacturing - Total (Percent)		72.0	71.1	69.8	68.9	68.5	67.5	67.4	68.0	69.2	69.8	70.0	67.6	69.7
%CHYA		2.6	0.4	-2.5	-4.6	-3.7	-7.7	-9.9	-11.2	-11.6	-12.3	-12.3	-9.6	-12.1
Money And Finance:														
Commercial and Industrial Loans at Large Weekly Reporting Commercial Banks (Bils. of $, SA)			218.2	220.3	219.8	219.3	215.9	268.9	274.2	274.0	272.1	271.7	253.0	272.6
%CH			-10.8	2.7	2.8	20.3	-92.8	-20.9	1.0	8.4	1.7	3.0	-25.8	7.0
%CHYA			-17.5	-15.1	-14.6	-13.0	-12.5	10.2	14.0	14.9	16.6	18.8	3.8	16.8
Money (M1) (Bils. of $, SA)	514.1	507.4	496.5	497.6	491.1	482.1	478.2	474.0	468.7	463.2	458.3	454.4	473.6	459.6
%CH	77.1	29.8	-2.6	17.1	24.9	10.2	11.2	14.4	15.2	13.6	10.8	2.7	13.7	6.3
%CHYA	12.8	12.2	10.5	10.9	9.6	7.7	8.5	8.7	8.2	6.9	5.6	5.2	8.5	5.9
Three-Month Treasury Bill Rate (Percent)	8.74	8.19	8.21	8.35	8.11	7.86	7.94	8.07	7.71	7.92	8.68	11.35	7.91	9.32
Average Yield on New Issues of High-Grade Corporate Bonds (Percent)	10.45	.42	10.44	10.99	11.30	11.37	11.35	10.79	11.08	12.78	13.82	15.66	11.07	14.09
Standard & Poor's Stock Price Index - Composite 500	169.13	54.10	157.71	151.88	146.80	144.27	139.37	138.10	132.66	122.43	109.65	109.38	136.71	113.92
%CH	43.7	61.0	57.1	50.4	23.2	51.4	11.6	62.0	162.0	275.4	3.0	-3.4	105.1	-1.0
%CHYA	54.2	41.0	35.6	37.0	28.2	23.0	12.6	12.3	10.7	3.5	-15.4	-15.3	11.9	-9.4
Sentiment and Expectations:														
Consumer Sentiment Index - U. of Michigan Survey		0.933	0.891	0.808	0.746	0.704	0.719	0.721	0.734	0.693	0.654	0.654	0.725	0.667
%CH		73.8	223.3	160.7	100.4	-22.4	-3.3	-19.3	99.3	100.4	0.0	-5.3	39.3	2.8
%CHYA		38.2	36.0	30.3	12.2	-0.6	11.8	15.4	4.4	-5.2	-15.3	-11.7	10.3	-10.8
Vendor Performance - Companies Reporting Slower Deliveries (Percent)			52.0	50.0	42.0	41.0	38.0	40.0	44.0	40.0	40.0	37.0	40.7	39.0
%CHYA			67.7	42.9	16.7	28.1	26.7	25.0	15.8	-7.0	-16.7	-19.6	22.0	-14.6
Leading Indicators:														
Leading Indicators Composite Index %			1.1	2.2	1.4	3.0	1.0	0.5	0.7	1.1	0.1	0.6	2.2	0.5
%CH			14.4	30.4	18.8	42.2	12.7	6.2	9.1	14.0	0.9	7.3	8.9	3.1
%CHYA			12.1	11.9	8.6	7.5	3.6	2.0	1.5	-0.9	-4.1	-4.5	2.4	-3.2

(*1) The quarterly inventory-to-sales ratios are averages of the monthly data.

(*2) Money (M1) as of June 1, 1983 average yield on new issues of high grade corporate bonds as of June 15, 1983; Three-month Treasury bill rate and Standard & Poors Price Index as of June 17, 1983.

Table 2
DRI Summary: Interim Forecast
June 18, 1983

	1983				1984				Years				
	I	II	III	IV	I	II	III	IV	1981	1982	1983	1984	1985
GNP and Its Components Billions of Dollars - SAAR													
Total Consumption	2054.2	2104.0	2149.0	2196.7	2242.8	2287.0	2330.8	2375.0	1843.2	1971.1	2126.0	2308.9	2493.2
Nonres. Fixed Investment	338.1	337.8	341.1	350.8	356.9	364.4	372.5	381.0	346.1	348.0	342.0	365.7	404.5
Res. Fixed Investment	120.5	133.8	143.5	143.9	147.2	151.1	155.9	162.0	105.0	96.2	135.4	154.0	172.7
Inventory Investment	-37.3	7.4	6.8	11.5	19.3	23.9	30.6	33.0	20.4	-23.9	-2.9	26.7	36.6
Net Exports	19.0	7.0	3.7	-0.5	0.8	0.6	1.6	2.0	26.1	20.6	7.3	1.3	0.7
Federal Purchases	274.0	272.6	286.5	296.9	303.6	313.1	320.9	333.6	228.9	257.9	282.5	317.8	355.0
State and Local Govt. Purchases	402.5	406.0	411.4	417.3	422.5	429.5	437.9	446.4	368.0	389.4	409.3	434.1	467.0
Gross National Product	3170.9	3268.6	3342.1	3416.6	3493.3	3569.6	3650.2	3732.9	2937.7	3059.3	3299.6	3611.5	3930.0
Real GNP (1972 Dollars)	1486.2	1515.4	1535.9	1552.2	1568.2	1584.1	1600.8	1615.8	1502.6	1476.8	1522.4	1592.2	1643.4
Prices and Wages - Annual Rates of Change													
Implicit Price Deflator	5.7	4.5	3.6	4.7	4.9	4.7	4.9	5.4	9.4	5.9	4.6	4.7	5.1
CPI - All Urban Consumers	-0.4	4.4	4.9	4.8	5.0	4.9	4.7	4.9	10.3	6.2	3.3	4.9	5.1
Producer Price Index - Finished Goods	-2.9	1.6	4.7	4.9	4.6	4.7	4.7	5.4	9.3	4.0	2.1	4.6	5.6
Compensation per Hour	6.0	4.4	4.9	5.2	6.7	5.7	5.7	5.5	9.7	7.3	5.5	5.7	5.8
Core Inflation	7.5	6.7	5.9	5.2	4.7	4.4	4.3	4.2	9.7	8.6	6.3	4.4	4.2
Production and Other Key Measures													
Industrial Production (1967=1.000)	1.384	1.442	1.469	1.492	1.512	1.534	1.554	1.578	1.509	1.386	1.447	1.544	1.624
Annual Rate of Change	9.5	18.1	7.5	6.4	5.4	5.9	5.5	6.1	2.6	-8.1	4.4	6.6	5.1
Housing Starts (Mil. Units)	1.702	1.672	1.646	1.644	1.644	1.682	1.720	1.753	1.100	1.059	1.666	1.700	1.767
Retail Unit Car Sales (Mil. Units)	8.4	8.8	9.1	9.7	9.9	10.1	10.3	10.5	8.5	8.0	9.0	10.2	10.8
National Unemployment Rate (%)	10.2	9.8	9.5	9.3	9.0	8.9	8.7	8.6	7.5	9.6	9.7	8.8	8.4
Federal Budget Surplus (NIA)	-173.9	-166.1	-199.0	-202.3	-201.4	-201.5	-199.3	-201.8	-60.0	-149.6	-185.3	-201.0	-210.6
Money and Interest Rates													
Money Supply (M-2)	2040.9	2090.3	2141.8	2187.9	2231.3	2286.3	2334.3	2391.1	1779.8	1944.7	2187.9	2391.1	2611.4
% Change, 4th-Qtr. to 4th-Qtr.	12.2	13.0	12.7	12.5	9.3	9.4	9.0	9.3	9.4	9.3	12.5	9.3	9.2
New AA Corp. Utility Rate (%)	12.23	11.85	11.95	11.23	10.98	11.05	11.33	11.37	16.25	15.13	11.82	11.18	11.55
New High-Grade Corp. Bond Rate (%)	11.22	10.68	10.80	10.58	10.53	10.60	10.64	10.70	15.01	13.89	10.82	10.62	10.88
Federal Funds Rate (%)	8.65	8.77	9.03	8.72	9.07	8.93	8.58	8.36	16.38	12.26	8.79	8.73	9.34
Prime Rate (%)	10.88	10.50	10.50	10.75	11.57	11.37	11.20	10.81	18.87	14.86	10.66	11.24	11.45
Incomes - Billions of Dollars													
Personal Income	2648.3	2714.3	2770.2	2829.9	2897.8	2958.0	3022.6	3088.1	2415.8	2569.8	2740.7	2991.6	3260.6
Real Disposable Income (%Ch)	2.1	6.4	7.0	4.4	5.3	3.1	3.6	3.5	2.5	1.1	3.3	4.7	3.7
Saving Rate (%)	5.9	6.1	6.7	6.7	7.0	6.9	7.0	7.0	6.4	6.5	6.4	7.0	7.6
Profits Before Tax	178.3	195.1	208.3	216.8	227.6	236.3	245.5	259.1	232.1	174.9	199.6	242.1	282.5
Profits After Tax	112.5	123.8	137.4	143.0	150.6	158.4	163.3	171.1	150.9	117.2	129.2	160.8	187.4
Company Profits	88.0	101.6	114.1	118.0	119.8	123.9	128.0	132.7	107.3	91.4	105.4	126.1	140.7
Four-Qtr. Percent Change	-0.7	10.3	21.4	29.5	36.1	22.0	12.2	12.5	2.9	-14.8	15.3	19.6	11.6
Composition of Real GNP - Annual Rates of Change													
Gross National Product	2.5	8.1	5.5	4.3	4.2	4.1	4.3	3.8	1.9	-1.7	3.1	4.6	3.5
Final Sales	1.3	2.7	5.6	3.8	3.4	3.7	3.6	3.7	1.0	-0.5	2.5	3.8	3.4
Total Consumption	2.6	5.3	4.3	4.6	3.8	3.4	3.2	3.0	1.8	1.0	3.5	3.9	3.0
Nonres. Fixed Investment	5.6	-1.0	2.3	7.5	2.9	4.2	4.4	4.7	3.5	-3.6	-1.0	4.0	4.9
Equipment	10.1	0.8	6.3	4.9	2.7	5.0	5.3	5.9	2.4	-6.4	0.0	4.4	6.1
Nonres. Construction	-3.3	-4.6	-5.9	13.5	3.3	2.6	2.3	2.0	6.3	2.9	-3.1	3.1	2.3
Res. Fixed Investment	80.1	41.2	25.7	-3.9	3.7	4.9	7.6	10.4	-4.9	-10.2	35.1	7.7	6.2
Exports	-0.9	-8.8	12.8	4.4	7.0	5.5	5.4	5.2	-0.5	-6.5	-6.4	5.6	5.4
Imports	12.8	4.0	9.4	9.1	5.8	5.3	5.1	4.7	7.2	-0.2	1.3	6.5	4.9
Federal Government	-19.0	-6.5	16.7	4.8	4.0	7.8	5.1	5.7	3.7	5.4	2.6	5.9	4.7
State and Local Governments	-0.5	-1.2	0.3	0.6	-0.2	1.2	2.3	2.1	-0.8	-1.0	-0.3	0.7	1.5

Chart 1
Auto Sales:
History and Forecast
(Mils. of units)

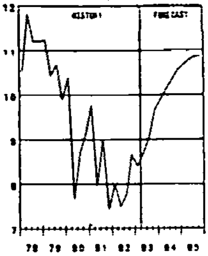


Chart 2
Housing Starts
History and Forecast
(Mils. of units)

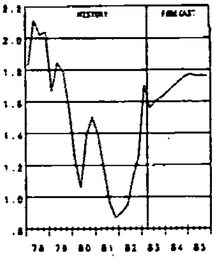


Chart 3
Inventories: History and Forecast
(1972 $'s)

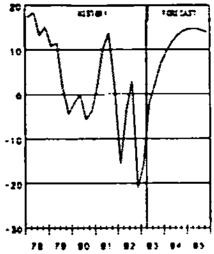


Chart 4
Business Fixed Investment
History and Forecast
(Percent change, real terms)

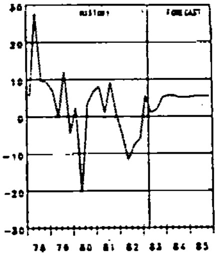


Chart 5
Industrial Production:
History and Forecast

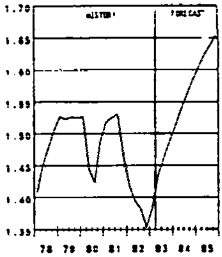


Chart 6
Real GNP: Recent History and Forecast
(Percent change)

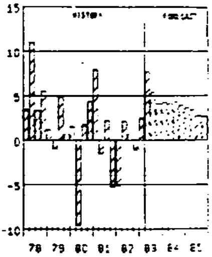


Table 3
Federal Budget Projections: Reagan, House, Senate
(Billions of dollars)

	FISCAL 1983			FISCAL 1984			FISCAL 1985		
	Revised Reagan Administration Proposals	First House Budget Resolution	First Senate Budget Resolution	Revised Reagan Administration Proposals	First House Budget Resolution	First Senate Budget Resolution	Revised Reagan Administration Proposals	First House Budget Resolution	First Senate Budget Resolution
Receipts*									
Total..............	598.3	606.2	603.3	652.7	689.1	671.1	732.4	765.9	743.1
Outlays									
Defense............	214.8	214.3	214.3	245.4	235.4	241.6	285.2	256.3	269.7
Income Security....	278.9	278.1	277.8	276.5	284.7	280.4	282.9	296.8	297.7
Health.............	82.8	83.4	82.9	90.6	96.0	93.0	100.4	108.8	103.5
Veterans' Benefits	24.5	24.6	24.5	25.6	25.6	25.6	26.2	26.0	26.3
Education, et. al.	27.4	32.0	26.8	25.3	32.7	27.3	25.0	32.2	28.6
Transportation.....	21.9	22.0	22.1	25.9	26.2	25.9	26.6	27.1	26.9
Interest...........	88.0	87.8	87.6	102.3	96.2	95.9	114.0	103.4	104.2
Other..............	70.5	72.7	71.3	52.2	64.9	60.0	50.3	65.5	59.1
Total..............	808.5	814.7	807.3	843.9	863.6	849.7	917.0	912.6	910.8
Deficit............	210.2	208.5	204.0	190.2	174.5	178.6	184.6	146.7	167.7

*Breakdown in receipts not available for the First House Budget Resolution or for the First Senate Budget Resolution.

Table 4
Federal Spending Assumptions: History and Forecast
(Real annual growth rates, May DRI Forecast)

	1961-1970	1971-1980	1981-1985
Total	4.5	3.7	3.8
Defense Purchases	1.3	-1.9	6.4
Nondefense Expenditures	7.0	6.0	3.1
Nondefense Purchases	5.1	3.6	0.3
Transfers	7.7	7.4	3.7
Grants-in-Aid	9.1	5.3	-5.1
Net Interest Paid	4.6	6.8	12.0
Net Subsidies	6.4	-0.8	5.5

Table 5
ERTA, TEFRA, and the FY1984 Federal Budget:
Net Effects of Tax Proposals

	1984	1985	1986	1987	1988	Total
Pre-1981 Tax Law Receipts	737.3	825.5	927.2	1,028.2	1,137.4	4,655.3
Tax Policy Changes						
ERTA	-130.3	-158.2	-202.3	-246.7	-282.2	-1,019.8
TEFRA	38.3	42.2	52.1	63.6	67.6	263.7
Highway Revenue Act	3.8	3.9	3.8	4.0	4.0	19.5
Contingency Tax	---	---	46.0	49.0	51.0	146.0
Total	11.2	11.3	15.3	18.0	33.0	88.8
Net Change	-77.0	-100.8	-85.0	-112.1	-126.6	-501.8
Percent Offset	40.9	36.3	58.0	54.6	55.1	50.8

*Source - Office of Management and Budget, Budget of the U. S. Government Fiscal Year 1984, p. 3-20 and The United States Budget in Brief, Fiscal Year 1984.
1/ Structural reforms - primarily from bipartisan social security plan and taxation of health premiums.

Table 6
Money and Credit Target Ranges for 1983 (1983:4 relative to 1982:4, except for M2 which is 1983:4 relative to February-March, 1983)

	1983	1982	
	Targeted (%)	Targeted (%)	Actual (after benchmark revision) (%)
M1	4 to 8	2-1/2 to 5-1/2	8.5
M2	7 to 10	6 to 9	9.2
M3	6-1/2 to 9-1/2	6-1/2 to 9-1/2	10.1
Total Credit (1)(2)	8-1/2 to 11-1/2	6 to 9	7.1

(1) Domestic nonfinancial debt-defined as borrowing by private domestic nonfinancial sectors, state and local government, and the federal government. Source: Federal Reserve Flow-of-Funds. (2) Base for 1982 range was the average for 12/81 and 1/82.

Table 7
M1 and M2 (Monthly forecast and targetted levels for 1983)
(Billions of dollars, SA)

	Lower Target	Forecast M-1	Upper Target	Lower Target	Forecast M-2	Upper Target.
1983:1	476.79	482.10	479.95	NA	2,010.00	NA
1983:2	478.37	491.10	483.11	NA	2,050.80	NA
1983:3	479.95	497.60	486.26	2,066.41	2,070.00	2,068.98
1983:4	481.53	496.50	489.42	2,078.43	2,075.10	2,086.16
1983:5	483.11	507.40	492.58	2,090.45	2,097.20	2,103.33
1983:6	484.68	511.59	495.74	2,102.47	2,114.71	2,120.50
1983:7	486.26	519.49	498.89	2,114.49	2,135.45	2,137.67
1983:8	487.84	522.39	502.05	2,126.50	2,153.11	2,154.84
1983:9	489.42	524.29	505.21	2,138.52	2,170.71	2,172.01
1983:10	491.00	527.50	508.37	2,150.54	2,191.76	2,189.18
1983:11	492.58	529.50	511.52	2,162.56	2,207.25	2,206.35
1983:12	494.16	531.50	514.68	2,174.58	2,222.76	2,223.52

Table 8
Federal Reserve, Administration, and DRI Projections for 1983

	Federal Reserve Range	Central Tendency	Admin.	DRI
Changes, fourth quarter to quarter, percent:				
Nominal GNP	7-1/4 to 11-1/4	8.0 to 9.0	9.2	9.7
Real GNP	3 to 5-1/2	3.5 to 4.5	4.7	4.9
GNP Deflator	3-1/2 to 5-1/2	4.0 to 5.0	4.5	4.6
Average level in the fourth quarter, percent:				
Unemployment rate*	9-1/2 to 10-1/2	9.9 to 10.4	9.4	9.5

*Percent of total labor force, including persons in the Armed Forces stationed in the United States.

Table 9
Velocity of the Monetary Aggregates
(Annual Rate of Change in Velocity)

	M1	M2	M3
1950 to 1982	3.2	0.2	-0.2
1950s	4.2	1.5*	1.5*
1960s	3.0	-0.2	-0.5
1970s	3.3	0.3	-0.9
1980	2.1	0.4	-0.3
1981	4.3	0.2	-1.9
1982	-4.6**	-5.3	-6.0
1983F	-0.7	-2.6	1.3
1984F	3.5	0.1	-0.7
1985F	3.4	-0.6	-1.3
1986F	3.7	-0.9	-1.1

F-DRI Forecast

Note: Annual changes based on years measured from QIV to QIV.

*Represents growth rates for the velocity of a money series measured as the sum of currency, M1 deposits, and all savings and time deposits at banks and thrift institutions. Data are not available to break time deposits by size before 1959, so that there is not a basis for distinguishing between M2 and M3 in the early period.

**For the five quarters ended with QIV '82, the velocity of M1 declined by almost 4 percent at an annual rate. One has to go back nearly 30 years, to 1954, to find a year with a significant 5-quarter decline; the five quarters ending in mid-1954 showed a 2 percent annual rate of decrease in M1 velocity. Other 5-quarter M1 velocity declines in the period since 1950 were extremely small--only .3 of a percent in the five quarters ending in the QII'58 and just .1 of a percent in the period ending with QIV '70.

Table 10
History and Forecasts of Key Interest Rates

	1982	1983				1984		Years				
	IV	I	II	III	IV	I	II	1981	1982	1983	1984	1985
Short-Term:												
Federal Funds............	9.29	8.65	8.71	8.90	8.72	8.87	8.93	16.38	12.26	8.75	8.68	9.34
3-Month Treasury Bills..	7.91	8.11	8.31	8.74	8.48	8.65	8.83	14.03	10.61	8.41	8.48	8.89
3 Month Commercial Paper	8.80	8.34	8.46	8.91	8.63	9.21	9.52	15.33	11.89	8.59	9.18	9.84
3-Month CD's............	9.04	8.53	8.56	8.89	8.78	9.04	9.63	15.92	12.28	8.69	9.28	10.11
Prime Bank Loans.........	11.96	10.88	10.50	10.94	10.85	11.42	11.47	18.87	14.86	10.79	11.22	11.45
Intermediate-Term:												
3-5 Year U.S. Government Bonds......	10.31	9.96	9.98	10.01	9.70	9.74	9.79	14.34	12.96	9.91	9.64	9.93
Long-Term:												
AA-Utility..............	12.54	12.23	12.23	11.79	11.29	11.11	11.12	16.25	15.13	11.89	11.13	11.35
Bond Buyer Index of 20 Municipal Bonds....	9.90	9.43	9.32	9.43	9.33	9.19	9.22	11.33	11.65	9.38	9.14	9.18
U.S. Government Bonds (Constant Maturity)												
10-Year.............	10.67	10.56	10.53	10.35	10.26	9.91	9.81	13.91	13.00	10.43	9.75	9.82
20-Year.............	10.72	10.87	10.81	10.65	10.43	10.32	10.14	13.72	12.92	10.69	10.05	9.87
Mortgage Commitment Rate Conventional Loans....	14.82	13.61	13.10	12.96	12.88	12.72	12.63	16.71	16.59	13.13	12.66	13.33

Table 11
Critical Factors in the Interest Rate Forecast

	1982		1983				1984		Years				
	III	IV	I	II	III	IV	I	II	1981	1982	1983	1984	1985
Factor													
Fed Policy													
Free Reserves (Bils. of dollars)	-0.05	-0.18	-0.40	-0.20	-0.08	-0.20	-0.11	-0.22	-1.05	-0.53	-0.22	-0.25	-0.80
Federal Funds Rate (%)	11.01	9.29	8.65	8.77	9.03	8.72	9.07	8.93	16.38	12.26	8.79	8.73	9.34
Nonborrowed Reserves %CH	12.0	13.3	0.6	3.5	2.5	6.5	6.5	6.0	6.7	6.4	5.8	5.6	5.6
Inflation - (%CH - Implicit GNP Deflator)	5.0	3.7	5.7	4.5	3.6	4.7	4.9	4.7	9.4	5.9	4.6	4.7	5.1
The Economy													
Real Growth %CH	0.7	-1.0	2.5	8.1	5.5	4.3	4.2	4.1	1.9	-1.7	3.1	4.6	3.5
Unemployment Rate (%)	10.0	10.7	10.4	10.0	9.6	9.4	9.2	9.0	7.6	9.7	9.8	8.9	8.5
The Dollar													
Morgan Guaranty Trade Weighted Exchange Rate %CH	15.1	2.8	-8.2	2.8	-6.2	-2.6	-0.3	-2.8	8.9	9.4	0.5	-2.2	-2.5
Credit Demands (*1) %CH	364.0	-16.6	118.1	-57.5	-4.4	57.0	34.3	-22.6	2.5	19.2	20.8	6.1	7.2
Monetary Growth													
M1 (%CH, SAAR)	6.3	13.7	14.8	12.9	7.6	7.0	4.0	5.2	5.1	8.5	10.5	6.1	4.6
M2 (%CH, SAAR)	11.4	9.6	21.3	10.0	10.2	8.9	8.2	10.2	9.4	9.3	12.5	9.3	9.2
Banking System Liquidity Tension Index (*2)	68.7	94.9	96.9	76.5	133.3	87.3	144.8	122.1	144.4	102.0	98.5	115.3	120.4
Federal Deficit (NIA, Bils. of dollars)	-156.0	-204.2	-173.9	-166.1	-199.0	-202.3	-201.4	-201.5	-60.0	-149.6	-185.3	-201.0	-210.6

(*1) Credit Demands are defined as the domestic credit demands of the household, nonfinancial corporate, and Federal and State and local government sectors.
(*2) The Liquidity Tension Index is based on the changes in bank loans, including C&I loans, plus real estate and individual loans and the flow of total reserves less changes in demand and savings and small-denomination time deposits - index number, 1977:2 = 100.

Chart 7
Standard and Poor 500 Common Stock Index History and Forecast

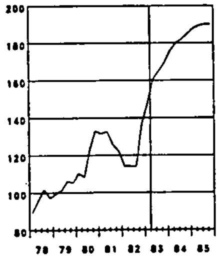


Table 12
Profits: Economy, Sector, Industry
(Percent change)*

	1981	1982	1983	1984	1985
Economy:					
Corporate Profits Before-Tax	-4.3	-24.6	13.5	20.9	17.0
Corporate Profits After-Tax	-4.4	-27.4	9.7	24.3	16.8
Company Profits	2.3	-15.8	14.8	16.7	9.3
Sector:					
Auto Related	NM	3,330.8	117.3	21.1	9.7
Construction Related	-26.9	-54.6	69.3	24.7	22.1
Primary Processing Manufacturing	8.6	-56.0	42.7	33.9	12.1
Specialty Machinery	18.8	-35.8	33.0	33.1	14.5
Financial	-8.1	11.6	15.0	6.1	5.8
Miscellaneous Services	10.6	-3.9	15.0	14.4	9.1
Miscellaneous Manufacturers	6.6	-15.2	12.0	15.1	8.2
Food and Beverages	15.5	-1.8	9.6	8.5	6.7
Retail Stores	9.2	-6.2	9.0	13.0	7.9
Consumer-Household Related	5.5	-0.4	7.7	14.2	8.0
Technology Related	-2.2	-3.9	6.7	19.5	11.3
Oil Related	-9.9	-26.1	6.4	16.0	7.8
Utilities and Communications	17.5	8.2	5.7	10.1	8.2
Metals and Mining	-49.3	NM	NM	53.4	19.7
Transportation	NM	-134.1	NM	35.1	18.8
Industry:					
Auto Related					
Automobiles	68.2	NM	557.9	22.3	9.8
Auto Accessories	16.6	-24.6	17.8	23.7	11.9
Tire and Rubber	200.1	-11.6	7.3	13.3	5.8
Construction Related					
Real Estate & Homebuilding	-45.3	-95.8	746.3	71.5	38.2
Roofing & Wallboard	-45.3	-58.6	74.6	34.1	24.7
Forest Products	-31.6	-50.1	81.2	18.3	23.7
Cement	-9.6	-63.4	54.4	42.6	17.6
Heating, AC, Plumbing	-2.8	-48.9	37.8	24.4	16.9
Primary Processing Manufacturing					
Chemicals	-4.5	-30.4	8.6	28.3	12.7
Paper	5.1	-38.2	11.1	26.2	10.6
Steel	87.3	NM	NM	73.8	13.5
Specialty Machinery					
Construction and Material Handling Machinery	0.5	-80.8	135.0	48.6	75.9
Agricultural Machinery	-300.4	-172.3	66.6	NM	54.3
Machine Tools	-3.4	-43.6	31.5	19.2	18.4
Diversified Machinery	50.6	-23.5	11.9	18.3	10.6
Industrial Machinery	6.1	-31.6	8.6	31.3	13.6
Financial					
Small Loans	-38.5	6.1	30.2	14.3	13.6
Banks	3.4	3.3	1.9	5.7	5.0
Savings & Loans	NM	-36.0	NM	14.1	21.7

Table 13
Wages, Productivity Growth and Unit Labor Costs
May 1983 Forecast

	Growth in Compensation Per Hour Index (%CH)	Growth in Productivity (%CH)	Growth in Unit Labor Costs (%CH)
1960	4.3	0.8	3.4
1961	3.2	3.0	0.3
1962	3.9	3.5	0.3
1963	3.5	3.3	0.3
1964	4.5	3.9	0.6
1965	3.4	3.1	0.3
1966	6.0	2.5	3.4
1967	5.5	1.9	3.5
1968	7.5	3.2	4.1
1969	6.6	-0.2	6.8
1970	6.9	0.3	6.7
1971	6.6	3.3	3.1
1972	6.7	3.7	2.9
1973	7.6	2.4	5.1
1974	9.4	-2.5	12.2
1975	9.6	2.0	7.4
1976	8.1	3.2	4.8
1977	7.6	2.3	5.1
1978	8.5	0.6	8.0
1979	9.4	-1.3	10.8
1980	10.3	-0.9	11.2
1981	9.7	1.4	8.1
1982	7.3	0.0	7.2
1983	5.4	2.9	2.5
1984	5.6	2.3	3.2
1985	5.8	1.8	3.9

Chart 8
Consumer Prices:
Recent History and Forecast
1978:1 to 1985:4
(Percent change)

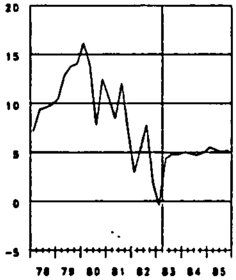


Chart 9
Wages:
Recent History and Forecast
1978:1 to 1985:4
(Percent change)

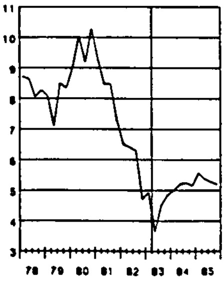


Table 14
Interest Rates, the Stock Market, and the Affordability of Housing Since Midsummer 1982

	7/2/82	8/13/82	10/29/82	6/10/83	Change 7/2/82-6/10/83
Short-Term:					
3-Month Treasury Bills	12.52	8.77	7.89	8.69	-3.83
Federal Funds	14.00	10.00	9.38	8.63	-5.37
90-Day CD's	15.20	11.05	9.15	9.30	-5.90
90-Day Eurodollars	15.81	12.06	9.94	9.69	-6.12
90-Day Commercial Paper	14.50	9.25	8.50	8.88	-5.62
Bank's Avg. Cost of Funds	15.50	11.28	9.69	9.51	-5.99
Prime	16.50	15.00	12.00	10.50	-6.00
Long-Term:					
AA-Utility	16.37	16.30	13.10	12.30	-4.07
10-yr. U.S. Govt.	14.39	13.06	11.05	10.80	-3.59
20-yr. U.S. Govt.	13.96	12.75	10.97	10.89	-3.07
Bond Buyer Index	12.50	11.86	10.06	9.69	-2.81
Stock Market:					
Standard & Poors 500 Common Stocks	107.65	103.85	133.71	162.68	+55.03
%CH					51.1
New York Stock Exchange	61.99	59.54	76.95	94.45	+32.46
%CH					52.3
Affordability:					
New Mortgage Commitment Rate	17.00	16.00	13.50	12.75	-4.25
Monthly Payment on 30-year $60,000 Mortgage (Principal & Interest)	$855.48	$806.95	$ 687.39	$652.17	$203.31

Chart 10
90-Day Treasury Bill Rate: Recent History and Forecast 1980:1 to 1985:4
(Percent)

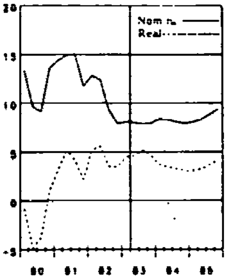


Chart 11
New Issue Rate on AAA-Equivalent Corporate Bonds: Recent History and Forecast
1980:1 to 1985:4
(Percent)

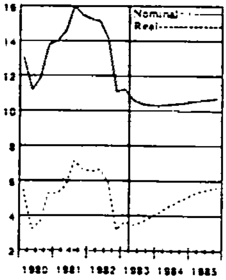


Chart 12
Real Wages: Recent
History and Forecast
(Percent change)

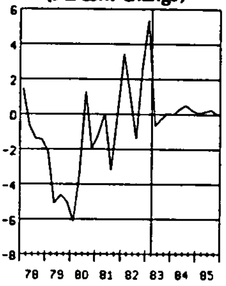


Chart 13
Real Personal Disposable Income:
Recent History and Forecast
(Percent change)

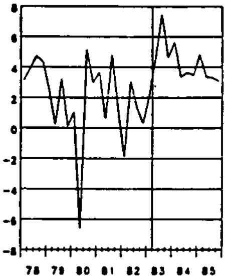


Chart 14
Growth in Productivity:
History and Forecast
1960 to 1985
(Percent change)

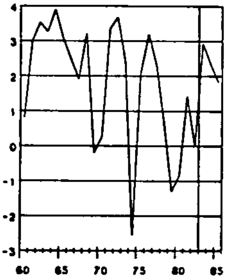


Chart 15
Actual Real GNP vs. Potential
(Bils. of $s)

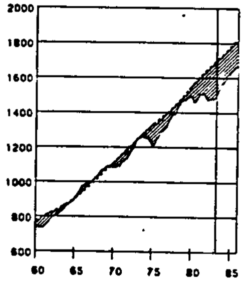


Table 15
Deficits and Interest Rates: History and Forecast (calendar years)

	($ Bils.) NIA Deficit	(%) Deficit Relative to GNP	(%) Treasury Bill Rate	New Issue Corporate Bond Rate (%)	U.S. Govt. Bond Rate (%) 20 Year Constant Maturity
1950	9.3	3.7	1.20	NA	NA
1951	6.5	2.0	1.52	3.04	NA
1952	-3.7	-1.1	1.72	3.10	NA
1953	-7.1	-1.9	1.89	3.42	NA
1954	-6.1	-1.7	0.94	2.90	2.64
1955	4.5	1.1	1.73	3.17	2.90
1956	6.0	1.4	2.63	3.68	3.14
1957	2.2	0.5	3.22	4.45	3.54
1958	-10.4	-2.3	1.77	4.02	3.48
1959	-1.1	-0.2	3.39	4.77	4.13
1960	3.0	0.6	2.88	4.68	4.06
1961	-3.9	-0.7	2.35	4.42	3.92
1962	-4.2	-0.7	2.77	4.23	3.99
1963	0.3	0.0	3.16	4.25	4.05
1964	-3.3	-0.5	3.55	4.40	4.19
1965	0.5	0.1	3.95	4.54	4.27
1966	-1.8	-0.2	4.85	5.44	4.77
1967	-13.2	-1.6	4.30	5.77	5.01
1968	-6.1	-0.7	5.33	6.48	5.45
1969	8.4	0.9	6.66	7.68	6.33
1970	-12.4	-1.3	6.39	8.50	6.96
1971	-22.0	-2.0	4.33	7.36	6.12
1972	-16.8	-1.4	4.07	7.16	6.01
1973	-5.6	-0.4	7.03	7.65	7.12
1974	-11.5	-0.8	7.83	8.96	8.05
1975	-69.3	-4.5	5.77	9.01	8.19
1976	-53.1	-3.1	4.97	8.33	7.86
1977	-45.9	-2.4	5.27	8.06	7.67
1978	-29.5	-1.4	7.19	8.88	8.48
1979	-16.1	-0.7	10.07	9.86	9.33
1980	-61.4	-2.3	11.43	12.47	11.39
1981	-60.0	-2.0	14.03	15.01	13.72
1982	-149.6	-4.9	10.61	13.89	12.92
1983F	-189.7	-5.8	8.41	10.82	10.69
1984F	-204.6	-5.7	8.48	10.62	10.05
1985F	-214.4	-5.5	8.88	10.88	9.87
1986F	-222.4	-5.2	8.74	10.65	9.72
1987F	-212.2	-4.6	8.15	10.44	9.57
1988F	-188.5	-3.7	7.88	10.09	9.37

Table 16
DRI Full Employment Budget Projections (Billions of current dollars, fiscal years)

	1981	1982	1983	1984	1985	1986	1987	1988
Receipts	651.2	686.6	716.8	755.3	828.6	899.3	990.3	1,104.9
Expenditures	663.5	733.5	806.8	875.8	960.3	1,046.9	1,131.7	1,226.1
Surplus or Deficit (-)	-12.3	-46.9	-90.0	-120.5	-131.7	-147.6	-141.3	-121.2
Change in Surplus or Deficit (-)	19.6	-34.6	-43.1	-27.2	-11.2	-15.9	6.3	20.1

*DRI full employment budget model.

Table 17
International: Major European Economies
(Seasonally Adjusted at Annual Rates)

	1982	1983				1984			Years				
	IV	I	II	III	IV	I	II	III	1981	1982	1983	1984	1985
REAL GDP GROWTH *													
West Germany...	-0.6	0.0	6.7	1.3	-2.5	5.4	6.0	-1.7	-0.2	-1.1	0.7	2.5	3.1
France.........	2.8	-0.2	-5.5	1.4	3.0	2.3	-0.1	1.1	0.4	1.9	-0.2	1.2	2.4
United Kingdom.	8.3	1.7	0.4	-0.1	0.6	3.6	4.7	2.7	-2.1	1.4	2.3	2.3	1.4
Product Basis.	1.9	3.0	2.6	1.1	1.0	2.3	6.8	2.5	-2.1	0.9	2.1	2.5	1.2
Italy..........	-0.6	10.7	-2.4	2.4	0.1	9.2	2.7	2.0	0.1	-0.3	0.7	3.5	3.5
GROWTH IN INDUSTRIAL OUTPUT													
West Germany...	-7.6	3.7	7.2	5.1	-3.0	9.9	2.2	-1.9	-2.0	-3.1	-0.6	3.0	2.3
France.........	1.2	-3.3	-0.4	-11.6	2.3	1.4	2.1	0.5	-1.5	-3.0	-3.4	-0.2	2.6
United Kingdom.	-0.4	6.6	2.1	2.3	1.4	3.0	3.3	2.3	-5.1	0.8	2.7	2.5	1.1
Italy..........	14.5	5.1	2.5	1.1	9.4	-3.3	0.9	5.8	-2.3	-2.2	-0.1	2.5	3.5
The Netherlands	-2.4	1.5	2.6	6.6	2.7	1.9	1.9	3.7	-1.6	-3.3	-0.1	2.9	2.0
Belgium........	0.4	-2.3	4.1	5.6	9.2	4.0	-1.3	2.5	-5.9	-0.5	0.5	3.9	1.5
CONSUMER PRICE INFLATION													
West Germany...	4.3	-0.1	1.4	6.8	-0.1	4.7	3.8	7.4	6.0	5.3	2.9	3.7	4.2
France.........	8.8	9.0	11.2	10.3	10.5	10.4	9.4	8.6	13.3	12.0	9.3	9.9	8.3
United Kingdom.	5.0	1.2	6.9	10.1	10.1	8.9	7.2	6.6	11.9	8.6	5.5	8.6	7.5
Italy..........	18.8	14.8	9.3	11.8	9.9	15.0	10.4	9.9	19.5	16.5	14.0	11.5	14.1
The Netherlands	3.2	0.9	2.7	3.1	3.4	4.3	3.9	4.0	6.7	5.9	2.7	3.7	4.9
Belgium........	7.5	5.5	6.3	5.1	4.8	5.2	5.6	5.7	7.6	8.7	6.8	5.4	6.3
UNEMPLOYMENT (000)													
West Germany...	2051	2183	2196	2216	2317	2335	2327	2348	1277	1839	2228	2332	2394
France.........	2038	2142	2196	2287	2351	2332	2343	2342	1769	2007	2244	2350	2462
United Kingdom.	2913	3002	3065	3126	3203	3288	3305	3333	2413	2793	3099	3313	3337
Italy..........	2096	2223	2312	2300	2350	2367	2408	2448	1912	2068	2296	2431	2465
The Netherlands	602	640	670	698	712	731	737	745	386	543	680	741	774
Belgium........	458	492	515	530	524	533	537	551	392	457	515	544	579

* Real GNP Growth in West Germany

Table 18
Country Risk Threatens the International Financial System

Country	Debt owed	Due in 1 Year or Less **	Exports	Short-term Debt % Exports
Argentina	38	13 (38%)	9	144%
Brazil	83	19 (23%)	21	90%
Chile	17	5 (29%)	5	100%
East Germany	12	4 (33%)	8	50%
Mexican	81	32 (39%)	17	188%
Peru	10	3 (30%)	4	75%
Poland	17	5 (29%)	4	125%
Phillipines	18	7 (40%)	8	85%
Romania	5	2 (40%)	5	40%
South Korea	34	12 (35%)	30	40%
Venezuela	32	16 (50%)	17	94%
Yugoslavia	16	3 (19%)	11	27%

**Percent of owed
Source: Data Resources, Inc., IMF, Bank for International Settlements.

Table 19
"Casualty" List of Sectors, Industries States, and Countries

Industries

Agriculture
Agriculture Machinery
Air Transport
Aluminum
Autos
Building Materials
Copper
Forest Products
Lead and Zinc
Miscellaneous Metals and Mining
Oil Drilling
Real Estate and Homebuilding
Retailers
Steel
Trucking

Sectors

Small Business
Mortgage Finance - Thrifts
State and Local Government

States and Latest Unemployment Rate, (%)

State	Rate	State	Rate
Midwest		Mid-Atlantic	
Michigan	14.7**	West Virginia	20.1
Ohio	12.9**	Pennsylvania	12.1**
Arkansas	12.1		
Illinois	11.8**		
Indiana	11.2*		
Wisconsin	10.8*		
West		South	
Nevada	11.3	Alabama	13.5*
Wyoming	11.2	Tennessee	12.3
Oregon	11.2*	Louisiana	11.9*
Arizona	11.1	Kentucky	11.6
New Mexico	10.0*	Mississippi	11.4*
		Missouri	10.6
		South Carolina	10.2*
North East		North West	
Rhode Island	11.1	Idaho	12.7
Maine	10.7	Washington	12.4
		Montana	10.2

Countries

Argentina
Brazil
Chile
Mexico
Poland
Phillipines
Romania
South Korea
Yugoslavia

Unemployment rates are for March, 1983, otherwise:
*April, 1983
**May, 1983

Table 20
Business Failures

Year	Number of Failures	Failure Rate Per 10,000 Listed Concerns
1925	21,214	100
1926	21,773	101
1927	23,146	106
1928	23,842	109
1929	22,500	104
1930	26,355	122
1931	28,285	133
1932	31,822	154
1933	19,859	100
1934	12,091	61
1935	12,244	62
1936	9,607	48
1937	9,490	46
1938	12,836	61
1939	14,768	70
1940	13,619	63
1941	11,848	55
1942	9,405	45
1943	3,221	16
1944	1,222	7
1945	809	4
1946	1,129	5
1947	3,474	14
1948	5,250	20
1949	9,246	34
1950	9,162	34
1951	8,058	31
1952	7,611	29
1953	8,862	33
1954	11,086	42
1955	10,969	42
1956	12,686	48
1957	13,739	52
1958	14,964	56
1959	14,053	52
1960	15,445	57
1961	17,075	64
1962	15,782	61
1963	14,374	56
1964	13,501	53
1965	13,514	53
1966	13,061	52
1967	12,364	49
1968	9,636	39
1969	9,154	37
1970	10,748	44
1971	10,326	42
1972	9,566	38
1973	9,345	36
1974	9,915	38
1975	11,432	43
1976	9,628	35
1977	7,919	28
1978	6,619	24
1979	7,564	28
1980	11,742	42
1981	16,794	62
1982*	25,346	89
1983**	12,946	NA

*Preliminary
**To Date

Source: Dun & Bradstreet

Chart 16
Cash Flow Relative to Capital Outlays (Ratio): Nonfinancial Corporations (1955 to 1982)

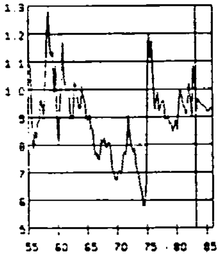


Chart 17
Financial Assets Relative to Short-Term Debt (Ratio): Nonfinancial Corporations (1955 to 1982)

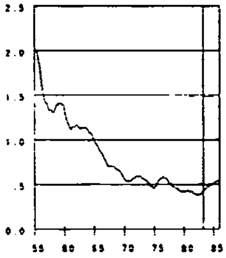


Chart 18
Ratio of Short-Term to Total Debt for Nonfinancial Corporations (1955 to 1982)

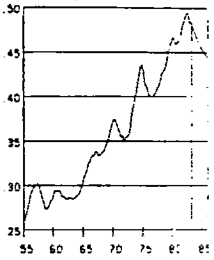


Chart 19
Debt Service Burden for Nonfinancial Corporations*
(1955 to 1982)

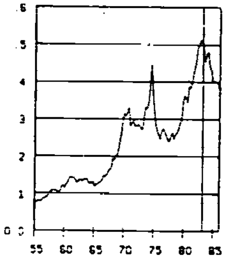


Chart 20
Leverage of Nonfinancial Corporations*
(1955 to 1982)

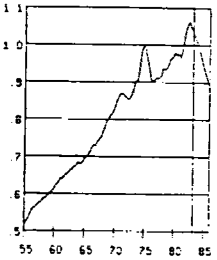
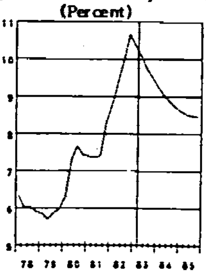


Chart 21
Unemployment Rate: History and Forecast (Percent)



Senator JEPSEN. Thank you, Mr. Sinai. I would like to ask a response from each one of the panel members to the following question. In your opinion, what impact would the cancellation of the July 1 tax cut have on the strength of the current recovery, on interest rates, and on the deficit?

Mr. Sinai, we'll start with you.

Mr. SINAI. If the July 1 tax cuts were to be fully canceled—that would be $30 billion at an annual rate—I do not believe that it would cause the expansion to die out. I believe that we would see major declines of interest rates and there would be offsetting effects. That is, the lower interest rates would stimulate housing, some consumption, and business capital formation. On the other hand, the removal of purchasing power from consumers would lead to reductions in consumer spending. A lot would depend on how the Federal Reserve would respond to such an event. If, at the same time, there was a simultaneous relaxation of monetary policy, then I think we wouldn't lose anything at all by eliminating those tax cuts.

Senator JEPSEN. Mr. Shipman.

Mr. SHIPMAN. I now know why people get confused when they listen to economists because they frequently disagree and I'm going to be odd man out and disagree.

If you look at taxes as disincentives to produce in the above-ground economy, if you increase the disincentive then generally you're going to get fewer people producing goods and services. The deficit is sensitive to the change in GNP. And that sensitivity is about $15 billion for every percentage point change in real GNP.

If you were to rescind the tax cut, the July 1 tax cut, I can't tell you any single point number as to what that would do for GNP in 1983 or 1984, except my strong instincts would be that the economy would be less well off. So GNP would be below what it otherwise would be.

That means that the deficit would be higher than it otherwise would be because the Government gets less tax revenue from a weaker economy.

I would have to think through the effect on interest rates to the extent that the tax rate reduction, if it were rescinded, would increase the tax rate on interest income. Then it would seem to me that interest rates would rise.

So being odd man out, I expect the deficit would rise, GNP would grow less rapidly, and interest rates would rise.

Senator JEPSEN. Mr. Greenspan.

Mr. GREENSPAN. I was starting to agree with Mr. Shipman, but since he wishes to be odd man out, I will restrain myself. [Laughter.]

First of all, it would be a mistake to rescind that tax cut because it's there essentially to come to grips with what we have been burdened with for a number of years; namely, significant bracket creep and, in a sense, an increasing repressive effect in the whole structure of taxation. The most important part of the 1981 legislation was the indexing provision which will come onstream, hopefully, in a year or so. I looked to the earlier tax cuts as reflecting ad hoc attempts to make that adjustment.

We are unlikely to get any significant downward effect on interest rates were that tax cut rescinded, largely because high interest rates are coming, not from the short-term deficits, but from the longer-term deficits. And I am most concerned that merely increasing taxes or cutting tax cuts without comparable 1-to-1 attempts to curb the growth in spending will probably add more to financing higher expenditures than actually cutting the deficit.

So I would be quite surprised if there was a significant decline in interest rates following upon the rescission of that tax cut. One of the real dangers that we are now confronting and one of the things that I think the markets are getting a little bit nervous about at the moment is that this process of expenditure authorization seems to be barely under control. As strongly as we inveigh against the growth in spending, nonetheless, it seems to have a life of its own. And were we merely to increase revenues available to finance it, we would be putting into place a revenue base which will finance the type of outlay growth which I think is getting us into trouble.

So, in summary, the overall effect of rescinding the tax cut would be negative. I don't think it would be significantly negative in the short run because the momentum of the economy is enough to overweigh a number of things. But it would make a difference in periods 1984 and 1985.

Senator JEPSEN. Yes, Mr. Sinai.

Mr. SINAI. Well, since I turned out to be the odd man out, perhaps I might just make one or two comments.

If taxes were cut, the question really was, what would happen if they were cut, so I don't want you to take my comments as meaning I am for or against cutting. But if they were cut, the deficit really has to drop to $30 billion. That is, if the tax reductions were rescinded and the economy would be weaker. And so some tax revenues would be lost. This is really directed to Mr. Shipman.

So the net improvement in the deficit wouldn't be $30 billion. It would be something less, perhaps $25 or $24 or $23 billion. But the end result will have to be a lower deficit, not a higher deficit.

And then with respect to what removing the taxes would do later on—this is for Mr. Greenspan—if the marginal tax rates are raised or the tax cuts are rescinded, then certainly it would mean lower deficits in 1984 and 1985 as well because the gained revenue would continue beyond this coming year.

Senator JEPSEN. Along with your statement about a need for monetary and fiscal policy coordination, I am sure you mean that the deficit would go down only if the fiscal policy was such that it did not automatically spend the tax cut immediately.

Mr. SINAI. Oh, yes, absolutely. I did not assume that if the Government got $30 billion, it would go out and spend it. In fact, the best thing for the financial markets would not only be some sort of tax increase, especially in the outyears, but also more limitations on the spending side, the nondefense spending side, than have come out of the conference committee of the Senate and the House in the last couple of days.

Senator JEPSEN. Vice Chairman Hamilton.

Representative HAMILTON. Thank you very much, Mr. Chairman. What strikes me about the testimony of the three of you is that you are all rather optimistic. Mr. Greenspan, you turn out to be the pessimistic optimist, however, because you see this recovery only going for 6 months or so. And then you foresee a kind of a crunch, as I understand your testimony, and that crunch is so serious that you think we're going to have to have a special political solution involving a domestic summit of our political leaders.

That view of the economy contrasts very sharply with Mr. Sinai and Mr. Shipman, who see a strong, sustained recovery for 2 or 3 years. I think Mr. Shipman's phrase was that 1983 and 1984 will be the strongest years since the Korean war. Mr. Sinai is an optimist also.

Do I read your statements correctly? Mr. Greenspan, you see a real crunch coming. That crunch is so severe, that we're going to have to take extraordinary political measures to deal with it in early 1983. And Mr. Shipman and Mr. Sinai see smooth sailing for several years.

Mr. GREENSPAN. Well, I think that's a little bit more than I meant to say. [Laughter.]

Let me be very explicit. I do think that the momentum of the recovery will remain quite strong through the end of this year. However, when we get into the type of period which Mr. Sinai designated as the one in which capital investment comes onstream in a substantial amount and has historically been the base which has kept the second phase of the recovery going, we will be confronted with a serious problem. And that problem basically is that the cost of capital is too high to create a normal recovery.

I'm not saying that the recovery will go into a crunch. I do not believe that. What I am saying is that growth from that point on will be below what it ordinarily would be. But if we continue the budgetary processes of recent years and look at increasingly larger current services budget deficits, then I do indeed think we run into a major problem perhaps not as soon as 1985, but surely by 1986 or 1987.

And I would like to merely respond to Mr. Shipman's view about there being no relationship between the budget deficit and interest rates.

The problem which he acknowledges is that the interest rate level is reflective of expected long-term inflation rates. And one other statistic which we are, I think, fairly confident of is that over the long run, unit money supply does in fact tend to parallel the level of prices. The financial markets are looking at the required financing of these potential deficits. And they are correctly presuming that the Federal Reserve will have to accommodate those very large Treasury cash requirements. That, in turn, is translated into a rate of increase in unit money supply, which is where these 20-year-long inflation forecasts are coming from.

The problem basically is that while it is statistically correct that the correlation between interest rates and budget deficits is concurrently inverse, that says nothing about the relationship between budget deficits and interest rates.

One does not merely conclude that if you do not get a short-term econometric fit between two variables, therefore none exists. That happens to be one means of inference, often wrong, but nonetheless, somewhat useful.

The question of how one finds out what actually is the process by which events change sometimes requires quite indirect means of examination and I think that this is particularly what the case is.

So I certainly don't want to imply that I think that we are in difficulties in 1984 and 1985. I don't believe that. I do, nonetheless, think that the growth will be less than it otherwise would be. I do believe we are in trouble in the years 1986 and beyond, unless we can successfully resolve what is clearly a corrosive fiscal policy which has regrettably been on an on-and-off state of erosion for well over two decades.

Representative HAMILTON. Do either of you, Mr. Shipman or Mr. Sinai, want to talk about these constraints that Mr. Greenspan mentioned after 6 or 9 months?

Mr. SHIPMAN. If I could, I would like to respond——

Representative HAMILTON. I get a very different impression, from you two, as opposed to Mr. Greenspan. You are much more optimistic over a longer term than he is.

Mr. SHIPMAN. Let me respond to that as far as my prepared statement is concerned. In my oral testimony I mentioned that 1983 and 1984 combined look like two of the best years since the Korean war. I believe I went further on and said that once you go beyond that, our way of forecasting doesn't help much.

Now that isn't to say that I think things are going to be negative. That's not to say that I think they're going to be positive. It merely is to state explicitly I don't know. So I can't be helpful there.

I can theorize and say, if we did this, that should happen, and so on and so forth. But in terms of giving you numbers, I just don't know.

As far as the budget deficits and interest rates that Alan brought up, he's got a very good point. Although he recognizes that the relationship between the change in interest rates and the change in the deficit is negative on a contemporaneous basis, and it is positive on an outyear basis, I am not arguing for the moment that in presenting that, any causality. I could argue causality, but that was not the intent of the comment.

The major factor that we see affecting the change in market rates in interest is a change in the market's expectation for inflation. In other words, the inflation premium.

Now if Alan is correct that that may come from budget deficits, so be it. It may come from something else, too. All I know is that if you do look at the change in expected inflation, for whatever reason the market thinks that will happen, and the change in interest rates over a period starting in 1946, you find a very strong relationship.

I personally don't believe, although I cannot prove, that that comes from budget deficits.

Mr. SINAI. I think I would describe best the pattern that I was talking about as sustained expansion, albeit uneven, but subpar in terms of the history of the first 3 years of expansions. It's subpar because interest rates are remaining quite high. And the interest rate sensitive areas, including business capital formation, just won't grow. For example, business capital formation, which often has grown, in real terms, in double-digit figures in the years 2 and 3 after the end of the recession, it doesn't look to us to be able to grow at more than middle single-digit rates. Growing, yes, but not at that same pace.

Numbers like 3.1 percent growth in real GNP for this year and 4.6 percent for next year and 3½ for 1985 characterize the projections and that isn't 5 to 6 percent, which is the kind of numbers we have had before.

So it's not the boom we've had, but it still is a very positive picture.

Just one remark on the deficits. It is a fact of correlation that contemporaneously, deficits have been normally inversely correlated with interest rates. Interest rates are at their troughs or on the way to their troughs when the deficits are highest. There's a good reason for that, because the Treasury deficits, the Federal Government deficits are high when the economy is weak and the private sector at that time is rebuilding balance sheets and buying the Treasury debt.

But what has happened since 1979 is the following kind of, I think, very rational perception of the financial markets. Starting big deficits in the face out of the proposed budgets and, at the same time, having heard the Federal Reserve announce the "New Fed Policy" where the Federal Reserve said, we will not accommodate deficits, the markets after awhile took the Federal Reserve at its word and the very rational expectation in that kind of a world—big deficits, nonaccommodation—is that higher interest rates will occur in the future. And if you're in the bond market, you don't wait for that to happen. You sell now.

Now the other side of really what is a rock and a hard place situation is what Mr. Greenspan described, that if the Fed does accommodate, you will eventually have inflation that gets factored into inflation expectations and if you're in the bond market, you will sell on that, too.

So there's no way out. The big deficits in the context of monetary growth targeting and the association of deficits and inflation as time goes by mean high bond yields now. And that is part of what drove the economy so low the last couple of years. We had really instantaneous discounting of the out-year deficits, expected deficits, not the contemporaneous deficits, but the expected deficits, into bond prices, which raise yields and which has restrained the economy even today.

Representative HAMILTON. Thank you very much, Mr. Chairman.

Senator JEPSEN. Congressman Lungren.

Representative LUNGREN. Thank you, Mr. Chairman. First, I think we might name some award after Mr. Shipman. You're one of the few witnesses that we've ever had that said "I don't know." [Laughter.]

Perhaps the first economist that's come before us and said that. I guess that makes us feel a little bit better because oftentimes, when we're dealing with economic issues, I think that that is one of our first instincts, is to say we just don't know.

Just a comment before a question. That is, I think we can talk about what effect canceling a tax cut or, looking at it another way, having a tax increase will have on the economy. I seemed to get from some of you over there as economists static analysis. You just suggest that all you do is subtract the amount of money that would come in and not realize that there's got to be an impact on a person. If you tell me that you are going to tax me more, I'm going to respond a little bit differently than if you're going to tax me less, No. 1. And No. 2, I'm very fearful of the overall impact changing decisions which were written in concrete just 2 years ago has on the American worker, on the American investor. If we're going to cancel that, which was overwhelmingly voted by the Congress, what rational basis do you have to think that we are not going to do anything and everything on tax rates in the near future? And that, in my judgment as a politician, not as an economist, or as a viewer of human nature, has to have some impact on how people respond.

We have inflationary psychology; we must also have a taxpaying psychology.

One of the problems we have in trying to sort out the testimony we receive is that there seems to be disagreement on definition. I'd like to address this to all three of you because we also had some varying opinions this morning, sometimes from the same person, about where we are with interest rates.

We have heard successfully that interest rates are historically high, that interest rates are historically low, that interest rates are just about average, that interest rates, real interest rates, are double what they were a couple of years ago. We had some say that they are less than what they were 2 years ago. And I think some of it goes back to how we define real interest rates.

I wish the three of you would give me the benefit of your thinking. How do you define real interest rates? Where are they now? Where have they been? And obviously, depending upon certain assumptions that you take, where will they be going and how does that affect the economy?

Mr. Greenspan.

Mr. GREENSPAN. I would say a formal definition is that rate of interest which would prevail in an economy in which inflation was expected to be zero through the indefinite future.

Specifically, a long-term real interest rate would be the nominal interest rate which we perceive, less what the market's average expected inflation rate would be through the full maturity of the debt instrument. And so if we have, say, an 11-percent, 20-year Treasury yield, and let's say for the moment leave aside how we get this, assuming that the real rate of long-term interest is a 3-percent risk-less rate, then the projected inflation rate is 8, or implicitly so.

Comparable definitions are required for short-term interest rates as well.

My view is that the markets have already discounted a type of long-term budget deficit which will prevail for a while, but perhaps not indefinitely. As a consequence, I don't think that the real long-term interest rate has changed. As far back as I can see, and we have data on a fairly continuous basis going back to 1715, if we take British Consuls into consideration, the long-term interest rate has not veered significantly from 2¾ to 3 percent per annum for risk-less instruments; meaning Government obligations.

And if it hasn't changed back since then, and I suspect from fragmentary evidence even earlier, I see very little reason to assume that since 1979, civilization has altered when there's a fully credible explanation for the rise in nominal interest rates; namely, a significant rise in inflation expectations.

And I attribute that to the deficit. It will remain pretty much where it is until there is a credible change in the deficit outlook. I don't think that long-term interest rates are going to be significantly affected by

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levels of economic activity in the short run although short-term rates will fluctuate depending upon credit demands.

Mr. SHIPMAN. I generally agree with what Alan said, but would like to add one other factor which I think is extremely important.

The world that we were just talking about, that Alan was just talking about, is the world in which there are no taxes. You receive your interest income. You don't pay any taxes on it. You have some guess as to what inflation is going to be. You subtract that from your interest income and that's your real rate.

That's not the world that we live in.

Your interest income is taxed. It is taxed, and has in the past been taxed, at a higher rate than earned income. The first adjustment to the market rate of interest must be to subtract the tax bite out of the market rate of interest. Then from that, make a guess—what do you think inflation will be? And people are making these guesses every single day and that's what makes a market.

When you subtract that, what we call the ex-ante inflation rate, from the aftertax market rate of interest, that's what a I refer to as the ex-ante after-tax real rate of interest, which I mentioned earlier, I am guesstimating is probably around 1½ percent.

The ex-poste or the interest rate, real rate of interest, after inflation that just occurred is subtracted out and no subtraction for taxes, that real rate of interest, which is what you see conventionally measured in the press, is quite high, but I don't think it's important.

Now the problem in arriving at my real rate of interest, if you will, is what is the tax rate. And there are a lot of ways of going about it and all of them are filled with potholes.

But in 1981, the United Kingdom started issuing indexed linked gilts—a gilt being a bond in the United Kingdom. So this is, if you will, a riskless instrument. It is taxed just like every other gilt is in the United Kingdom. There is only one variable that is different, and that is that the interest income and principal is indexed to the retail price index with an 8-month lag, which basically states that the Government, in its indenture, promises to pay in current or constant purchasing power pounds.

Now that gilt is out in the marketplace attracting investors like everything else is. Those gilts presently yield on a yield-to-maturity basis about 2½ percent. That's pretax. Now that interest income is taxed. I don't know what the tax rate is, but it's something above zero.

So that real rate of interest measured that way, I would say, is below and perhaps substantially below 2½ percent. I agree that the real rate of interest measured for the tax effect and the inflation effect is probably pretty low and probably has not changed a heck of a lot over a long period of time.

Mr. SINAI. Well, are you sure you want a third answer, which may get less or more clear?

Representative LUNGREN. If you agree with all of them, that's fine. But I'm just trying to figure out all these different definitions.

Mr. SINAI. No, I'm just having my moment of teasing, as it often goes the other way about how economists confuse people and each other in their discourse.

Let me try and answer, if I might, by using an example. Let's take borrowing on a mortgage instrument. Suppose the mortgage rate is 13 percent and hypothetically, we're talking about a marginal tax rate of 50 percent because it's an easy calculation. The after-tax interest rate, and I agree with Mr. Shipman—this is the first thing you have to do. You have to figure out the relevant concept as a real after tax interest rate.

At 13 percent, if it's 50-percent tax deductible, is 6½ percent after tax. You then must subtract the expected rate of inflation from that in order to get the real after tax rate. Now, the expected rate of inflation conceptually ought to be one that matches the term of that mortgage, where there is some expectation for capital gains appreciation on a house. And mortgages turn over about every 12 years, on average. So suppose it was a 10-year average of inflation rates of maybe 2 or 3 percent. That would give you a real after tax rate of something like 4½ percent.

Now that is extraordinarily high. I think 4½ percent is a little high. It's more like 2½ or 3 percent. But for a real after tax cost of borrowing, the real after tax cost of borrowing for mortgages is extremely high now compared with what it was in the 1970's. In the late 1970's, mortgage rates may have been 8 or 9 percent. A 50-percent tax bracket would make that 4 to 4½ percent. And inflation on homes was 15 percent. If you do the calculation and the cost of borrowing, the real after tax cost of borrowing for a house was negative.

Now the other concept is just a real rate and that would be calculated if you took the mortgage rate less the expected rate of inflation, which would give a real mortgage rate of 8 or 9 percent now, which is, by historical standards, extraordinarily high.

The data show that the real cost of borrowing and real after-tax cost of borrowing are extraordinarily high relative to history. Real short-term interest rates and real after-tax short-term interest rates are about what they were in the early 1960's. And again, for a short-term interest rate, the example would be suppose you have a money market deposit account that is paying 8½ percent, 50-percent tax bracket. After tax, it's about 4¼ percent. The current rate of inflation is running 2 to 3 percent at an annual rate. You've got a very small real after-tax rate, but it is still a positive return on instruments such as the money market deposit accounts.

A similar instrument in the late 1970's would have offered a negative return. You have to use, by the way, for calculating it for a short-term asset, a very short inflation rate because the term of the instrument is much shorter.

So there are real interest rates, real after-tax rates for every instrument and like Mr. Shipman, and I think Mr. Greenspan would agree, I believe the markets equilibrate on the expected real after-tax returns. That's really how investment decisions are made.

Mr. GREENSPAN. Not fully. It's not clear exactly where the marginal equilibration occurs. If you take the marginal tax rates and apply them all the way back, as you well know, you get extraordinarily negative real after-tax rates of return.

I don't think the system works that way. Over a moderately long period of time, I don't think that the system allows negative real rates of return. This leads me to the conclusion that our assumption that what is being determined at that margin is the after-tax rate requires a good deal of qualification. I think you have to distinguish between the real after-tax rate of return to an individual and what is a stable real rate of return in the marketplace around which interest rates and rates of return move? Those are two different things.

One of the problems that I think the Congressman has raised is that we tend to use the real rate of return, real interest rates and the like in about three or four different ways and, as a consequence, we confuse them and we confuse ourselves. It's important to distinguish which one.

We're all in agreement that it's the full maturity of the debt instrument that determines the inflation expectation. But it is a terribly important question to distinguish between what is the real rate of return to an individual or the real after-tax borrowing cost and what is the stable real rate of return in an economy? Those are different things.

If we could figure out the second one, we'd really know a great deal.

Mr. SINAI. It sounds like you're talking about the equilibrium to which we will move in the economy.

Mr. GREENSPAN. It used to be called the natural rate of return.

Mr. SINAI. Yes, and it was in terms of a long-term, high quality, riskless bond paying about 3 percent. And it could be, you would probably agree, that at a given moment of time, we could be off that, although forces might be set up in the economy and financial markets that would eventually drive us back toward that. And with that I would agree.

Senator JEPSEN. In 1946, our national debt was higher than our gross national product and the prime rate then was 1.5 percent. Today the GNP is nearly three times as large as the national debt, but the prime rate is 10.5 percent.

Congressman Hawkins.

Representative HAWKINS. Mr. Chairman, thank you. This morning, Mr. Dederick made a statement that we are now experiencing "an average recovery from an average recession." His description of the worst recession that we have had since the Great Depression and that of an average recession was wrong, and his characterization of this recovery as being an average one, even assuming the 6.6 percent growth rate, was also incorrect. The recoveries have averaged 8.1 percent. This one is much below that.

I would like to submit a written response for the record, to follow the statement that he made this morning, with your permission, Mr. Chairman.[1]

Senator JEPSEN. Your written reponse will appear in the record at that point.

Representative HAWKINS. The gentleman told us in a previous hearing of this Joint Committee that in the first quarter, the average growth rate would be in excess of 4 percent. This administration did correct that in the second quarter, which I think shows how incorrect certain of the witnesses can be before this committee. It certainly does not relate to the witnesses before us today, whose statements have been very thoughtful and a high degree of professionalism, which I think is commendable.

The witnesses seem to assert deficits as being the culprit or the main threat. I'd like to ask them to respond to this question, that since the deficits have accelerated rather substantially since January 1981, under current policies that were supposed to have brought boom, 13

[1] See written response beginning on p. 25.

million jobs and a balanced budget by 1984, what changes in these policies are necessary or do you anticipate that are now going to reduce those deficits and bring about the rather optimistic recovery that seems to be implied?

Mr. GREENSPAN. First, let me reiterate one point which I think requires to be emphasized in any discussion of the long-term outlook, and most specifically, as it applies to economic policy. And that's the points that Mr. Sinai was making relevant to the question of what's happened to inflation.

It's very rare that one can look not only at the individual price indexes, but also the underlying structure of costs and come away with an unambiguous conclusion that inflation is now, for all practical purposes, beaten down. We find, for example, that not only are we getting in the whole wage structure markedly slowing down in the first year settlements, but the deferred settlements in the union wage contracts of 1981 and 1982 are now becoming current and they, too, are in line. The whole structure of price-wage inflation is clearly at this stage suppressed in a manner which one would be hard pressed to find a rapid reversal.

So that for the next 2 years, inflation has got to remain low and will continue to remain low, short of some extraordinary set of circumstances.

What that has done is to alter the longer term outlook, the uncertainties and views about capital investment which are highly beneficial to this economy. While it certainly has not been an unmitigated benefit to capital investment in the short run, largely because of the weakness in demand that is occurring, the combination of tax changes and inflation declines have altered the long-term potential investment outlook when we get the levels of economic activity somewhat back to normal.

What is creating a problem right now is an issue of perception. While the underlying improvements in the capital investment area have been, in my judgment, very significant, they will only emerge if we can bring long-term interest rates down and bring the levels of economic activity back to normal.

But when we do, I think that that will set off one of the major capital goods booms in this country's history. And what, therefore, policy has to focus toward is how to restore a noninflationary view of the world which I think is perhaps the most important element in bringing the unemployment rate down.

Unless we can diffuse long-term inflation expectations, I don't think that we will successfully restore anything resembling full employment in this country. So I would argue that we have to change the long-term budget outlook. I do acknowledge that this is extremely unlikely to be done wholly on the expenditure side. I would also argue, however, that if it's attempted solely or almost solely on the tax side, that we will find over the long run that we will be financing increased expenditures more than we will be reducing the deficit.

And in an aside answer to Allen Sinai, I didn't mean to say that I didn't think the actual unified budget deficit would not be lower if we rescinded the tax cut. I just said that we would be worse off, meaning the longer term outlook for the economy. It's not the short-term deficits which particularly matter.

In summary, I think that some awareness of the importance of this deficit will hopefully lead us to a recognition that we must bring it down. If I believe that it could be brought down wholly from the tax side, I'm so seriously concerned about the deficit that I might almost be inclined in that direction. But I don't believe it can be done that way, even if one wanted to, and therefore, I conclude that some very significant attempts to slow the long-term growth in transfers programs is essential to the restoration of the long-term noninflationary environment and therefore, the restoration of a full employment economy.

Mr. SHIPMAN. I believe when you used the word "deficit," it was followed by the word "culprit," which leads me to believe that the deficit might be the cause of bad things, and certainly there is an awful lot of information around that the deficit is the cause of a lot of bad things.

I would disagree with that. I think it is the consequence of a lot of bad things. It is primarily related to the change in GNP, the change in inflation and the change in defense spending.

The major component of the three that affects the change in the budget deficit is basically the health of the economy. Now it would seem to me that the budget deficit would come down and come down rather dramatically if we had stronger GNP growth, not weaker GNP growth. We have a period in which the deficit has gone up in a secular sense, in which taxes have gone up in a secular sense, both as average taxes and as marginal tax rates.

So I don't look at the deficit as being the culprit. I see the deficit as being the consequence of basically quite slow economic growth. And I suspect that the deficits that we will see in 1983 and 1984 will be substantially less than what are forecasted to be the deficit in 1983 and 1984.

Mr. SINAI. Just one little aside on your point about real growth and how the recovery is going so far. In five of the seven recoveries, the first 6 months have shown a bigger increase in real GNP than what we have had in the first 6 months of this one. As for policy, the time to have done something more about the policies would have been awhile ago when they were clashing and holding interest rates higher and really delaying our recovery.

I think at this point the timing of the fiscal policy stimulus, it really was a kind of time-release capsule, which by design or not, released in about 1983 to provide a good deal of stimulus to the economy and monetary policy is accommodative enough right now as well. So there is nothing to do in the near term in terms of major tampering with these policies, except to pretty much leave them in place.

For the future, though, for the longer run question of what policies or combination of policies could insure a longer period of prosperity and much less inflation problems, there are several possible courses of action to be taken separately or in combination. I think as hard as it is to say, there is something for slow growth at the start as a preventative and a buying of time to let potential output grow a little faster.

So the fact that the economy isn't recovering as fast as it did or as strongly as it did in the five of seven past postwar recoveries doesn't really disturb me. It's good to see it recover. I think the slow growth may well, in the long run, turn out to be a plus.

Second, on fiscal policy, it would seem to me to be very important to cut the growth in spending. Now I'm taking myself out of my political kind of situation and saying that maybe the way to do it is to be equal-handed and to do it in defense and nondefense in almost equal doses. There are really a lot of political constraints, but cutting the growth in Federal Government spending, I think, is essential to the long run health of the economy and an anti-inflationary posture for the economy. That is the way to tighten fiscal policy and take pressure off interest rates.

The tax cuts, especially the ones that create incentive effects for saving and work effort, such as the across-the-board tax reductions, the marginal tax rate reductions, there's a lot to be said for them. So I think cutting spending is a kind of policy that is absolutely essential if we want to promote growth without getting a major reacceleration of inflation quickly.

Then, the third aspect of policy really has to deal with kind of the expectation of inflation. A lot of the inflation comes out of the cost area. In the past, I have suggested tax incentive-based incomes policies to keep wage costs rising more slowly, which is a way of engineering a disinflationary cost shock really without removing income from the working population.

So some combination of all three is possible in the coming years, so that in 1985 or 1986, if we're still here, and I hope we all are still doing what we do and confusing people as economists, I hope we won't be talking about another inflation problem like 1979 or 1980 again.

Senator JEPSEN. Congressman Wylie.

Representative WYLIE. Thank you, Mr. Chairman. I must admit, Mr. Sinai, that you are confusing me somewhat by some of the discussion that has gone on here today. Mr. Greenspan, I heard you on the David Brinkley show and again in Columbus recently. I must admit that I am stuck with the idea that we do need to bring deficits down to sustain economic growth and that deficits do really make a difference and have an impact on interest rates.

I was taken by your discussion here a little earlier about the negative real interest rate and I must admit to a little confusion on that.

What interest rate do you use when you discuss negative real interest rates? Short-term T-bill rate, I guess today, is somewhere around 9 percent. You were talking in terms of, well, we can buy automobiles in Columbus for an interest rate of about 9½ percent now. Other market rates are higher. I think the inflation rate is about 4.5 percent right now. If you take any of those interest rates, there's still a considerable spread between the interest rate and the rate of inflation. And if you deduct that by or split that in 50 percent, you still have some inflationary expectation in the interest, don't you?

Mr. GREENSPAN. Yes, Congressman, I was referring to the fact that if you apply the tax rate to the interest received or the interest cost and then adjust it for the inflation rate, historically, in numerous periods and for protracted periods of time, that number would be negative.

Now what I was arguing is that for a so-called equilibrium force in the economy, I find that noncredible. We were just raising a technical question with respect to where does the market clear. I don't think that by anybody's measure, current real interest rates, by any definition, are negative. I do think they were under a full aftertax basis for quite a long period of time and I find that not credible. This led me to the conclusion that calling the full aftertax real interest rate, the clearing rate in the market, was noncredible. But nobody denies the current level of real interest rates are positive and high.

Representative WYLIE. Long-term interest rates, then, are not adequate to sustain economic recovery or not low enough to sustain economic recovery, then.

Mr. GREENSPAN. I think they will sustain some economic recovery. I think that they will not impede the recovery over the next 6 to 9 months. I think they will impede it thereafter, but they will not end it. I just think that it will create a less-than-normal late business cycle recovery level.

In other words, I'm saying that rather than have recovery to what used to be full employment levels at the tail end of a business cycle, we'll fall short of that, unless long-term interest rates come down.

Representative WYLIE. Mr. Shipman, what causes inflationary expectations if it's not huge budget deficits?

Mr. SHIPMAN. That is probably the most penetrating question that I have heard. I frankly don't know.

Representative WYLIE. That's the second time you've said that.

Mr. SHIPMAN. I have many more, by the way. [Laughter.]

Representative WYLIE. What?

Mr. SHIPMAN. I have many more of those answers. If we could put inflation——

Representative WYLIE. Is it possible that the huge budget deficits do have something to do with it?

Mr. SHIPMAN. Yes, it's possible. Certainly it's possible. But if you look at an alternative source of inflationary expectations which the University of Michigan did, asking households, what do you think will happen to the price of your consumer bundle over the next year, and go back to the mid-1940's and chart this, we find that the ups and downs of those responses are terribly close to the ups and downs of market rates of interest.

During that same period, 40-odd years or so, the budget deficit was high. It was low. It was surplus. It was all sorts of different things.

So if you were to add the budget deficit to the survey data, I expect that you would explain very little incrementally of the interest rate. If you believe what's in the press and the causality that I read all the time that the budget deficit in the outyears is causing people to be skittish about inflation, it very well may be. It may be. We have not done any research on that to suggest that it is or that it isn't. However, my instincts would be that it's probably not a major contributor to expected inflation. Probably not. But I can't prove that.

Representative WYLIE. Mr. Greenspan, should we think in terms of the deficit as a percentage of the gross national product or in total numbers, in the figure of the overall budget?

Mr. GREENSPAN. Technically, neither. It should be related either to some form of savings number or net funds raised. But if we had it, which we don't, it would be the level of private savings that would exist on an ongoing basis, what economists call savings propensities.

The reason I say that is that it's not the absolute size of the deficit that matters. Obviously, that changes through time. Nor is its relationship to the GNP relevant because, in different countries, there are different savings propensities and, consequently, different abilities to finance it.

So as a crude attempt at trying to get the appropriate measure, I would take it as a percent of either net funds raised or aggregative savings.

Representative WYLIE. Mr. Greenspan, how big a concern is the recent rapid growth in the money supply to you? Should the Fed do something to slow the rate of increase?

Mr. GREENSPAN. Not yet. We're trying to get a measure of transaction balances on the ground which is essentially the critical element in the determination of inflation and economic activity.

We are not clear yet as to whether or not the new instruments are, when we combine them in our new M_1 measure, really capturing this phenomenon correctly. I would be more inclined, therefore, to be much more aware of the movements in the broader aggregates—mainly M_2, possibly M_3. If they accelerate with the M_1 variable, then I think we're in a position where some concern ought to be created and some appropriate action taken.

But until we see confirmation in the other aggregates, the mere fact that M_1 is moving, especially at a time when we're so close historically to some very significant changes in the nature of various different types of deposit holdings, does not suggest action at present.

If it continues, however, and if it is confirmed as a major expansion in the financial system by the other variables, including some of the credit aggregates, then I think it's absolutely essential that that be reined in. That will be the first significant sign that inflation, which has been reined in with such heavy cost, is being re-ignited again and the costs the next time to rein it in will be just horrendous.

Representative WYLIE. Do you agree with that, Mr. Shipman? I think my time has expired, but should he comment on that for the record?

Mr. SHIPMAN. I would agree that as the economy picks up, that the various M's will also pick up. I am not terribly concerned about that and I would expect that as the economy goes down, you'll see less growth in the various M's.

I do agree with the comment about inflation. In an environment in which our marginal tax rates rise, as the price level rises; that is, bracket creep, inflation is extremely deleterious to the U.S. economy. It is substantially less deleterious in an environment in which marginal tax rates fall when the price level rises.

I doubt we're going to go to that tax system. So given what we have, inflation, as it feeds through the Tax Code, is a major concern.

Senator JEPSEN. Congresswoman Holt.

Representative HOLT. Thank you, Mr. Chairman.

Senator JEPSEN. Do you have a microphone?

Representative HOLT. Yes. I have served on this committee now for 6 months, and so I feel that I am a great expert now in economic forecasting. I was intrigued by something that you said, Mr. Shipman. I really believe that economic growth is the way to reduce the deficit. It just seems to me that we are going to see really dramatic things happening as that begins to take place.

For example, if real GNP were to grow over the next 6 years 1.33 percentage points faster than the administration forecast, wouldn't we have a balanced budget in 1988? And this gives me some concern about our tax policy. Now Mr. Greenspan, you say in your prepared statement that we probably should have some increase in revenue with maybe a value-added tax. But wouldn't that be a disincentive for the economy to grow, to continue to grow? It would curb consumer spending. It just seems to me that that would be the wrong way to go.

Isn't it better to do all of the things that we are doing to try to encourage people to spend and also to have and invest, rather than having these further taxes?

Mr. GREENSPAN. Of course it reduces incentives and other things equal, reduces the level of economic activity. That's not what our choices are. If you asked me what would I like to see done, I would like to see us lower the level of nondefense expenditures to a point which would bring the budget deficit into line where it would no longer be a corrosive force in levels of economic activity.

I don't believe that that will happen, largely because there are clear differences of political philosophy and budget priorities in the Congress and in the country. We're confronted with a series of least/worst choices.

Representative HOLT. OK. But wouldn't economic growth be the way to go rather than trying to——

Mr. GREENSPAN. It would, but you can't get there from here, largely because the precondition of economic growth is, in fact, the conditions which would lower interest rates. And you cannot get to those lower interest rates in the longer run until we get the deficit down.

So that if one could somehow wave a wand and create a significant increase in noninflationary economic activity without getting interest rates down, then, yes, indeed, that would solve the problem. The trouble, unfortunately, is that we don't know how to do that and I don't think, in fact, it is actually possible.

So what I am led to is that if you want to get the budget deficit down, clearly, you just inflate the economy and that will happen. But that is not desirable because that will merely undercut economic activity.

I do agree that any increase in taxes, other things equal, has a negative effect on economic activity. I am also saying, however, that if we can bring the budget deficit down significantly, even if that includes some tax increases, that that would in fact be a better path for economic growth and ultimately, the stability of the economy than any other path I know.

In other words, I don't know how to get the real economy going in the context of what we call structural deficits. It's not that I think that taxes are not negative. I think they are.

Representative HOLT. Well, historically, have we, Congress, ever reduced the debt as we increased taxes?

Mr. GREENSPAN. No. As I said, Congresswoman Holt, before, that if all we did was to increase taxes, over the long run we would find out that all we did was finance increased expenditures.

Representative HOLT. And I think you pointed out that that is indicated in this budget that we are coming up with right now, is that there's an increase in spending that uses the increase in taxation.

How about the trade deficits? You mentioned the worldwide deficits, the worldwide economic situation. Of course, all of that is tied to our economic situation, our strong dollar. But Secretary Baldrige this morning testified that, or his representative, that even though we had had almost a $50 billion trade deficit last year, that we are going to have an increased trade deficit next year, or they are anticipating that. What's the effect of that on our improved economy? How do we handle that?

Mr. GREENSPAN. Well, I think the question really gets down to an issue of when you have a very strong dollar, as indeed we do, that there is a tendency for capital inflows to occur. Instead of looking at it as a strong dollar creating a large trade deficit, one can assume, and I think perhaps more correctly, that the dollar has become the safe haven currency and that if you have a large inflow of capital, since the balance of payments must balance, you are going to end up with a large trade deficit. And, in part, that's what's happening. There is an extraordinary changes in the view of the American dollar. We're looking at very substantial capital flows and that certainly affects our short-term economic activity.

It doesn't over the long term. It will shift resources from export industries to domestic industries. There's nothing wrong in that. But it certainly is the case that for the short term, our export balances will be poor. I think that more is being made of this as a negative force than I think is in fact the case. I'm not terribly certain what we can do about it or, in fact, how much we should.

The one thing I'm certain we shouldn't do, because I don't think it works to our long-run benefit, is to move to protectionist measures as an endeavor to suppress the trade deficit when, in fact, it may well be being strongly pressured by something which in itself, other things equal, is clearly good, namely, that other people view our dollar as something which they want to hold.

Representative HOLT. I can remember strongly Mr. Carter, Mr. Shultz urging Helmut Schmidt to stimulate their economy when the shoe was on the other foot, and I just wonder. We do hear a lot about the negative impact of this, and I appreciate your answer.

Do any of you gentlemen want to add anything?

Mr. SHIPMAN. If I could, I would like to add a little bit on the value-added tax. Because there is some experience we can look to, if you think back in the latter part of the 1970's when Margaret Thatcher was running for office, she, as a candidate, said that she was going to lower tax rates. Now some people argue that tax rates in the United States are quite high. The unearned income tax rate in the United Kingdom, when she was a candidate, was 98 percent. Putting it in dollar terms, if you had $30,000 and you invested it at 10 percent pretax, received $3,000 pretax, you would get $60 after tax.

She thought, and I think British subjects thought the same, that was a little high. So part of her campaign was to lower that tax rate. And, indeed, she did. Now the highest tax rate on earned income is 60 percent and there's a 15-percentage-point investment tax above that.

As she was doing this, she was getting a bit nervous, however, and thought that she might finance this tax rate reduction with a tax rate increase. So in July of 1979, the value-added tax went from 8 percent to 15 percent, a 7-percentage-point increase. She gave us as little warning as she possibly could because she expected something would happen, and she was right. Retail sales absolutely went through the roof, not because things were good, but because of the knowledge that things were going to get bad.

And when the tax came in, retail sales went into the cellar. So you can observe the pattern, the behavioral pattern, of the various players in the economy. They are people just like you and me. If you think the tax rate is going to rise in the future, it does you well to book it in the present.

I don't think that a value-added tax, put on over what we already have on an income tax, and I read some place that the Tax Code is 40,000 pages, we don't need another tax. I think what we need is to simplify the code and to mitigate high marginal tax rates. I think more than anything else, and this is a guess, certainly, more than anything else, that will allow economic factors, the freedom of choice to produce, consume, invest the way that they think is best. And if I'm at all close to the mark, that would give you a much stronger economy and give you much lower budget deficits.

Mr. SINAI. The problem of our trade deficit is very much related to our budgetary deficit because there again, if the budget deficits are holding interest rates higher, that contributes to a stronger dollar. In the past it led to defensive reactions abroad which slowed to protect currencies, which slowed the economies down of the rest of the world. The higher interest rates from the deficits have added to the debt service problems of the LDC's and the strong U.S. dollar actually helps our inflation, which in turn makes the dollar even more attractive when you subtract our low inflation rate from our high interest rates in attracting capital inflows.

So this is just another incidence where if deficits could be brought down, and it really has to start somewhere. It is that the deficits are both a result of weakness in the economy and a cause of high interest rates. You have to start somewhere bringing them down. That would help value the dollar lower and promote a better trade deficit.

Now with certain lags, eventually the strong dollar through the price mechanism will lead to some reversal or improvement in our trade deficit problem. But those lags are very long. And at the moment, the U.S. economy is growing more slowly, a good deal more slowly, because of weak foreign trade.

Senator JEPSEN. It's been a long afternoon, a long day. The testimony has been excellent. I know that Mr. Greenspan has to leave very shortly, so we hope to be able to wind this up in about 15 minutes. If we don't, Mr. Greenspan, I know that you must leave at that time and we'll expect that you will do so.

I have just one last question, if we could possibly get a one- or two-liner answer to it. Many economic forecasters, several months ago, even weeks ago, were predicting a rather sluggish recovery for the second quarter. Now they foresee a near doubling of the gross national product growth over their previous forecasts. Your opinion, please—how do you account for this turnabout in such a short a time in the economic forecast?

Mr. SINAI. Well, there are really two reasons. One is the drawdown of inventories turned out to be greater in the first quarter than data several months ago indicated. And, the second is that consumers spent heavily in April and May, so that the increase in the portion of GNP coming from consumer spending is just much stronger in the second quarter so far.

Senator JEPSEN. On that line, it was your statement that suggested canceling the tax increase would help reduce the deficit and not effect other areas, was it not?

Mr. SINAI. Well, the question was what would happen if the——

Senator JEPSEN. If we canceled the tax cut.

Mr. SINAI. I really didn't offer an opinion whether it should or shouldn't happen. And also, qualified that with a response that would depend very much on what the Federal Reserve did in response to that.

Senator JEPSEN. Consumer spending is one of the first signs, according to the testimony received this morning, of an economic recovery. Do you think that consumer spending is going to increase or decrease when consumers get the first real tax cut they have had in decades on the first of July of this year.

Mr. SINAI. I think that consumer spending will continue to rise. It may not rise as strongly as it did in the second quarter, and that $30 billion tax cut on July 1 actually will, initially, for the first month or two, pump consumer saving a little bit, which was drawn down very much in May to support the expenditures. There's some evidence that consumers are spending in anticipation of that tax cut now.

Senator JEPSEN. Do you think that consumers will save primarily for the first couple of months, rather than spend it?

Mr. SINAI. Yes, it would be similar to last year. I think there's some hint that they are spending in advance of the tax cut on July 1 now and in July and August will still spend at a reasonably good clip. But the real rate of growth of consumer spending in the third quarter will likely be less than in the second quarter.

Senator JEPSEN. Mr. Shipman.

Mr. SHIPMAN. On the same issue of a July 1 tax cut, first of all, our work in forecasting is not very good when you look at quarterly forecasts and we don't do them. All the forecasts are annual. So we're forecasting interyear trends and not intrayear trends.

The July 1 tax cut, although it's said that it comes in July, actually came January 1, because it's a cut on the income booked in the tax year 1983.

So we wouldn't expect to see any major change in activity, although I reiterate that we don't forecast within the year, any major change in activity, any major stimulus because of the July 1 tax cut and see it in the latter half of the year. We said that that tax rate reduction is on all the income booked for the whole year. So the incentives, back to a word that I had used before, the incentives are the same on January 1 as they are on July 1, or October 12, or any other date.

So after saying that, I can't really give you a substantive answer in terms of what will happen to savings or spending as a function of the change in the tax rate on July 1.

Senator JEPSEN. Mr. Greenspan.

Mr. GREENSPAN. I would agree with much of what has been said. The only problem with the second quarter forecast is that it got revised up, not only because of inventory change, but because the pattern of consumer expenditures as originally estimated was much lower than it is turning out to be. In other words, a goodly part of the earlier projections of the 4- to 5-percent real growth in the second quarter were based on earlier data which has subsequently been revised.

So what we are hostage to is not only what is going on in the real world, but on our ability to measure it. And that is less than adequate. You can guess that the revisions are always upward when the economy is moving. I think we all tilted the numbers in a way.

But I remember looking at monthly GNP data for the month of March based on the old, unrevised data. It looked as though it was going to be very difficult to get a significant rise in the second quarter. When they re-estimated, they incorporated a broader sample of the March retail sales, and it turned out that they were just far too low. That is one of the problems that forecasters have, and one of the reasons why you will find, before this committee, rather substantial fluctuations in short-term forecasts. It's not that anything is changed in the economy as much as it is in our data estimating system, which is probably the best in the world but still inadequate.

Senator JEPSEN. Congressman Lungren.

Representative LUNGREN. Thank you, Mr. Chairman. We don't have time to go into this. I just at some point in time would love to talk to the three of you about how interest rates are pressured by deficits. I assume that is primarily because of the "crowding out" phenomenon. It seems to me that interest rates would also be affected by those potential savings that are taken by taxes. These funds would not be available to be borrowed and would have a similar effect.

One of the problems we have here in the Congress is when we talk about bringing the deficit down, because that will help bring interest rates down. We don't look on the side of it where you bring deficits down by merely raising taxes, which does have some effect ultimately on interest rates by taking out of the capital savings pool.

Because both Mr. Greenspan and Mr. Sinai have suggested that the deficits are our real sticking point, our real problem area, let me just ask you this question. Where do you think the deficits have to be for sustained economic growth? I don't care what framework you use, either dollar figures or percentage of GNP or percentage of savings or whatever parameters you use. But can you give us a fix on that? Is there a ballpark figure that either of you would look at for what the Congress ought to be shooting for?

Mr. SINAI. I think we're likely to have sustained economic growth even with the deficits projected as they are. I guess it's a question of how high, on average, one wants the sustained economic growth to be and the kinds of conditions that would be created with regard to any future resurgence of inflation.

I think the general estimate for what are called structural deficits—and this may be of interest to Congresswoman Holt—is that at full employment we would still have $100 billion or so deficits. That is, growth would remove not all of the deficits. Growth to full employment would not remove all of the deficits in these calculations.

So I think of a $100 billion reduction from current projections as being very salutary sustained over 3 or 4 years to the financial markets and to the longrun health to the economy, both on the interest rate side and the inflation side. And if you ask how does one go about doing that, that's where the real problem is. I don't think that anyone disagrees with the desire to lower deficits. The question is the means and maybe the thing to do is to take one-third out of defense spending, one-third out of nondefense spending and raise taxes by one-third so you have an equal problem for all opinion segments in getting that $100 billion reduction.

Representative LUNGREN. Well, we raised taxes awfully fast in the previous 4 years and we had the highest interest rate and the highest inflation that we've had.

Mr. Greenspan, you talk about the corrosive effect of deficits. What level do they have to get down to so that they don't have this corrosive effect?

Mr. GREENSPAN. I'd say that if the current services budget is projecting a continuous decline in the longer term budget deficit in the context of a marked slowing in the rate of spending, in a way which makes the deficit projections credible—a deficit of $130 billion or $100 billion, it's clearly enough to change the views of the financial community.

If you could somehow get it down to $50 or $60 billion in the context of the size of the economy of 1988, for example, I think that that would be as close as you are going to get to balance and probably have all of the advantages of being in balance.

Senator JEPSEN. Congressman Wylie.

Representative WYLIE. Thank you, Mr. Chairman. What about the employment rate? This was touched on a little earlier and I think you made a significant observation, Mr. Greenspan, that the long-term inflationary expectations will govern the unemployment rate.

Now the unemployment rate has come down rather decidedly, I would say, from about 10.7 to around 10 percent, last month.

Do we have reason to be optimistic in this regard, if I may phrase the question in that term?

Mr. GREENSPAN. I think we have reason to be optimistic that the unemployment rate will decline. However, we should be concerned that it is declining less than we would like. But the biggest danger is that an endeavor to create a quick fix of the unemployment situation probably will have the effect of lowering it short term, but in the context of, say, 1988, probably would be adding twice as much then as you are lowering it now.

So I think we have no choice but to recognize that the process is going to be slow, but that the only way that we have to solve it is to bring the inflation rate wholly under control, allow interest rates to adjust to that inflation rate, and restore the type of relationships which our economy had prior to the inflation binge of the 1970's.

Representative WYLIE. Thank you. Thank you, Mr. Chairman.

Senator JEPSEN. Congresswoman Holt.

Representative HOLT. I have no further questions.

Senator JEPSEN. Does any of the panel members have any final statements for the record that they would like to make before we adjourn?
Mr. Greenspan.
Mr. GREENSPAN. No, Mr. Chairman.
Senator JEPSEN. Mr. Shipman.
Mr. SHIPMAN. No, Mr. Chairman.
Senator JEPSEN. Mr. Sinai.
Mr. SINAI. No, Mr. Chairman.
Senator JEPSEN. I thank all of you for coming today. It has been a very interesting exchange and testimony that has been presented here.
I want the record to show that if we ever have another Joint Economic Committee hearing in this room, that we have the microphones brought up to speed. Otherwise, it is the chairman's desire that we never have another hearing in this room.
Thank you. The committee is adjourned.
[Whereupon, at 4:12 p.m., the committee adjourned, subject to the call of the Chair.]

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