

percent in 1981, and by 1984 are expected to be over 14 percent. <sup>8/</sup> This increase in the average effective payroll tax rate will raise the tax burden on labor income relative to that on nonlabor income, and will augment the effects of bracket creep on relative tax burdens.

Corporate Taxes. In contrast to the upward movement of effective personal and social insurance tax rates in recent years, corporate taxes have generally declined as a percent of economic profits during the 1975-1980 period. <sup>9/</sup> This rate is estimated to have fallen by four percentage points between 1980 and 1981, and is projected to decline eight percentage points more by 1984. The estimated rate of 26 percent in 1984 is nine percentage points below the rate observed in any year during the 1946 to 1980 period, and significantly augments the reduction in personal tax rates on unearned income contained in the Economic Recovery Tax Act of 1981.

The major component of the business tax reduction in the 1981 tax law is the new Accelerated Cost Recovery System (ACRS)--the so-called 15-10-5-3 provision. While ACRS shortens the tax lives of depreciable assets appreciably, <sup>10/</sup> and is more advantageous

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<sup>8/</sup> The ceiling on maximum taxable earnings under the Social Security program is projected to increase from \$29,700 in 1981 to \$37,800 in 1984 according to an indexing formula. The combined employer-employee OASDHI tax rate rose from 13.3 percent in 1981 to 13.4 percent in 1982, and is scheduled to remain at this level until 1985.

<sup>9/</sup> Recent studies of the effective tax rate on corporate income include: Martin S. Feldstein and Lawrence Summers, "Inflation and the Taxation of Capital in the Corporate Sector," National Tax Journal (1979), pp. 445-70; and Jane G. Gravelle, "Inflation and the Taxation of Capital in the Corporate Sector: A Comment," National Tax Journal (1980), pp. 473-84. These studies take account of the taxes paid by corporate stockholders and creditors, which are not reflected in the effective NIPA corporate tax rates displayed in Figure 6.

<sup>10/</sup> It should be noted, however, that the benefits of shorter depreciation periods are temporarily reduced by less beneficial depreciation rates, which are to be restored partly in 1985 and fully in 1986.

than immediate expensing in some cases, its impact on the profitability of different types of assets is not neutral (see Appendix A). Moreover, the continued use of historic-cost, as opposed to replacement-cost, depreciation means that depreciation costs (and thus the effective tax rate on income from depreciable capital) will remain sensitive to the rate of inflation. In contrast, the effective tax rate on labor income will become relatively immune to inflation after 1984, when indexation of tax brackets, personal exemptions, and the zero bracket amount begins.

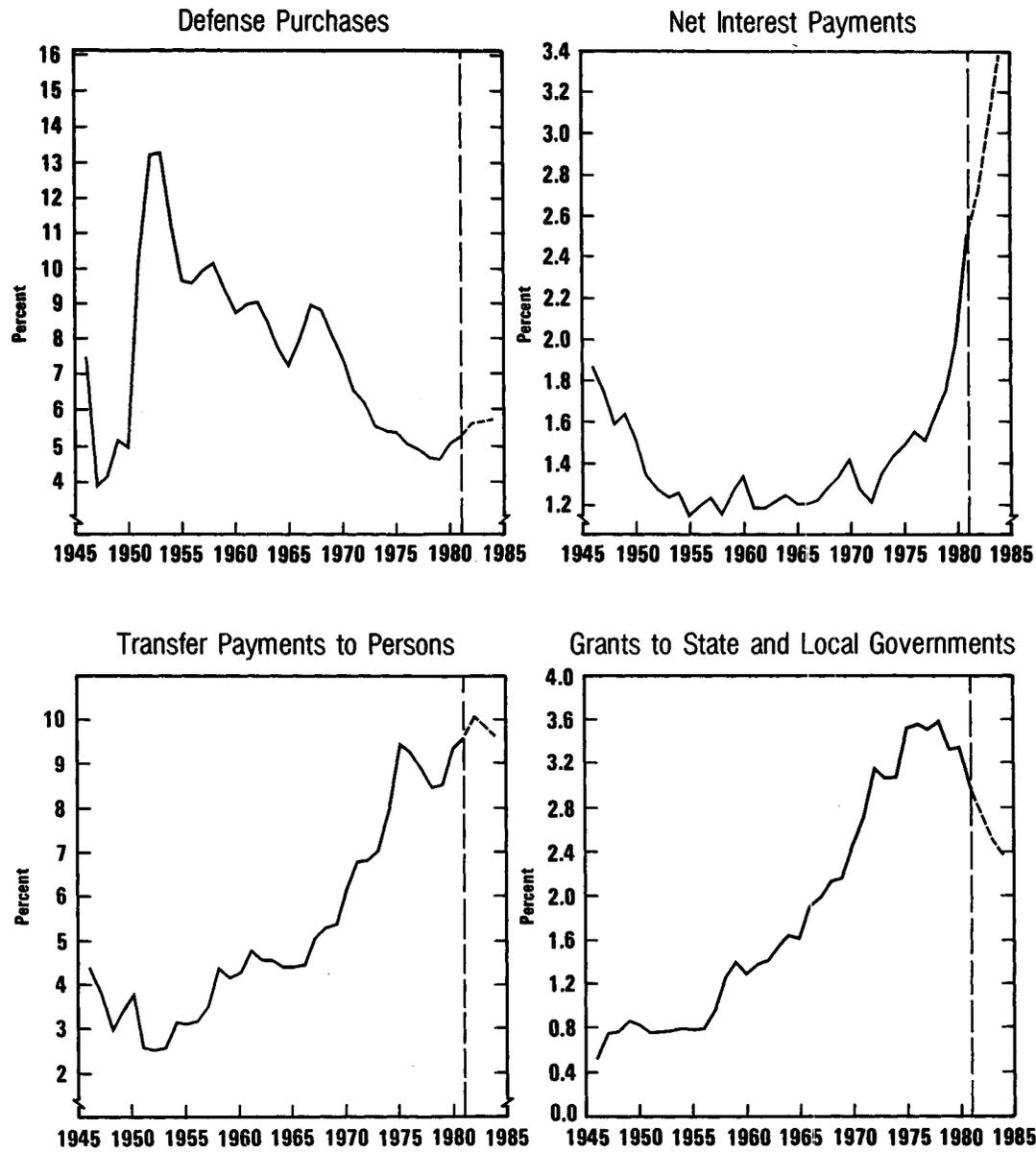
The Structure of Federal Spending. During the 1982-1984 period, the flow of federal transfers to persons and to state and local governments will be reduced considerably relative to GNP, while net interest payments and defense outlays rise (see Figure 7). Since many of the personal transfers and state and local grants are used to support consumption spending by low-income groups and capital spending by state and local governments, these structural changes in federal spending programs could alter the composition of output in favor of private capital formation. At the same time, however, they may cause hardship for persons dependent on transfer programs and increase the financial burdens of state and local governments, especially while the economy is weak and unemployment rates remain high.

#### Aggregate Measures of Fiscal Policy

The federal deficits recorded in recent years suggest that the budget has been stimulative. On a high employment basis--which attempts to abstract from the effects of a slack economy on the deficit--the budget has shown little change in most years. CBO projections of year-to-year changes in the high-employment budget indicate that fiscal policy will become increasingly stimulative this year and next year (see Table 7). However, when the projected changes in the high-employment budget in fiscal years 1982-1983 are compared with potential GNP in those years, the combined 1982-1983 stimulus does not appear to match the maximum stimulus encountered during the Vietnam War buildup in fiscal years 1966 and 1967.

There are reasons, though, why the high-employment budget may not be a good measure of fiscal stimulus at the present time. Among other things, it does not compensate for the changes in the composition of federal spending and in the tax structure described above. Moreover, to the extent that those budget changes encourage

Figure 7.  
Federal Expenditure Categories as a Percentage of GNP



NOTE: Broken line indicates projections.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Congressional Budget Office.

TABLE 7. ALTERNATIVE MEASURES OF FISCAL STIMULUS, ASSUMING NO POLICY CHANGES  
(By fiscal years, in billions of dollars, NIA basis)

	FY 1981	FY 1982 <u>a/</u>	FY 1983 <u>a/</u>
Federal Deficit (-)	-54.4	-103.0	-134.0
High-Employment Budget			
Deficit (-)	-0.3	-5.7	-43.2
Change in deficit	16.4	-5.4	-37.5
Deficit as a percent of potential GNP	-0.0	-0.2	-1.2
Expenditure Increases			
Measured at high employment	85.8	67.3	71.2
Due to changes in economic slack <u>b/</u>	4.6	8.9	-2.2
Total	90.4	76.2	69.0
Receipt Increases			
Measured at high employment	102.2	61.9	33.7
Due to changes in economic slack <u>b/</u>	-15.7	-34.4	4.3
Total	86.5	27.5	38.0
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Addendum <u>a/c/</u>			
Receipts impact of 1981 tax act on:			
Personal taxes	-0.0	-27.5	-73.1
Corporate taxes	-2.8	-9.1	-18.0
Receipts impact of:			
Personal income tax bracket creep	14	30	50
Social Security tax legislation <u>d/</u>	10.8	2.0	5.9

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Congressional Budget Office.

a/ CBO estimates.

b/ Calculated as the change in actual or projected expenditures (or receipts) minus the change in expenditures (or receipts) measured at high employment. For example, if real growth is less than potential growth, expenditures will increase relative to high employment expenditures, and receipts will fall relative to high-employment receipts.

c/ These estimates are the changes in yearly receipts, measured relative to a baseline, that are due to inflation or to tax law changes. In contrast, the other entries in the table reflect the additional effects of real growth and the level of economic activity.

d/ The fiscal year 1981 and 1982 figures reflect only the impact of the Social Security tax changes occurring in those years. The fiscal year 1983 estimate, however, incorporates both the fiscal year 1982 and 1983 tax law changes.

saving and investment, the high-employment budget may exaggerate the inflationary potential of the projected fiscal stimulus.

The Unified Budget Deficit: Fiscal Years 1981-1983. The budget deficit for the fiscal year ending September 30, 1981, totaled \$57.9 billion, down slightly from the \$59.6 billion deficit recorded for the previous year. Receipts rose to a level of \$602.6 billion--an increase of \$82.6 billion--concentrated in higher individual, social insurance, and excise taxes. Net corporate tax collections declined somewhat. Outlays increased 14 percent to a level of \$660.5 billion. CBO budget estimates show sharply rising deficits in coming years if no further action is taken to reduce spending or raise revenues. The economic projections presented in this report, and the budget policies embodied in the continuing resolution and in subsequent appropriations and authorizations, indicate deficits of \$109 billion in 1982 and \$157 billion in 1983 (see Table 8).

Federal Borrowing. Most federal borrowing from the public reflects the need to finance on-budget deficits. Additional borrowing is required to finance the deficits of off-budget entities such as the Federal Financing Bank and the Postal Service. In fiscal year 1981, off-budget deficits amounted to \$21 billion

TABLE 8. UNIFIED BUDGET TOTALS AND ESTIMATES, FISCAL YEARS 1980-1983 (In billions of dollars)

	Actual		CBO Estimate	
	1980	1981	1982	1983
Outlays	579.6	660.5	740	809
Revenues	520.0	602.6	631	652
Deficit	59.6	57.9	109	157

SOURCES: U.S. Office of Management and Budget and Congressional Budget Office.

TABLE 9. BUDGET DEFICITS, OFF-BUDGET DEFICITS, AND FEDERAL BORROWING, FISCAL YEARS 1980-1983 (In billions of dollars)

	1980	1981	1982 <u>a/</u>	1983 <u>a/</u>
Total Federal Financing Requirements	73.8	78.9	129	176
Federal budget deficit	59.6	57.9	109	157
Deficit of off-budget federal entities	14.2	21.0	20	19
Federal Borrowing from the Public	70.5	79.3	129	176
Other Means of Finance	3.3	-0.4	0 <u>b/</u>	0 <u>b/</u>
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Memo: Interest on Publicly Held Debt	60.4	78.9	99	123

SOURCE: U.S. Office of Management and Budget.

a/ Congressional Budget Office estimate.

b/ CBO assumption.

(see Table 9). CBO estimates that off-budget financing needs will amount to about \$20 billion in 1982 and \$19 billion in 1983. Taking into account the projected budget deficits in 1982 and 1983, total federal financing requirements are estimated to be \$129 billion and \$176 billion, respectively. Interest payments on the publicly held debt are projected to total \$99 billion in fiscal year 1982 and \$123 billion in 1983.

#### MONETARY POLICY

A principal objective of Federal Reserve policy over the last several years has been to slow inflation through a gradual reduction in the rate of growth of the monetary aggregates. Although interpretation of money aggregate growth has been complicated by

changing definitions, it appears that the effort to reduce money growth has met with mixed success (see Table 10). M2, a relatively broad aggregate that includes balances held for investment as well as for transactions purposes, has accelerated somewhat since 1978. However, the growth of M1B--a narrower aggregate containing transactions balances exclusively--has declined.

Many economists believe that the growth of M1B is more relevant than M2 to nominal GNP growth because M1B consists only of balances held for financing market transactions, whereas M2 consists heavily of funds held as financial investments. Policy-induced changes in M2 are therefore less likely to be closely correlated with changes in GNP, and some tests confirm that the

TABLE 10. MONEY GROWTH RATES, 1978-1981 (Percent change, fourth quarter to fourth quarter)

	M1B	M2
1978	8.2	8.3
1979	7.5	8.8
1980	7.3	9.6
1981	5.0 (2.1)	9.5

NOTE: M1B consists of currency in circulation plus checkable deposits at commercial banks and thrift institutions. The figure in parentheses for 1981 is the growth rate of M1B adjusted for inflows from M2 resulting from nationwide introduction of NOW accounts on January 1. M2 includes M1B plus savings and small time deposits at commercial banks and thrift institutions plus money market mutual funds, overnight repurchase agreements, and certain overnight Eurodollars. The definitions that were in use before 1980 were slightly different; they have been revised since then to take account of changing conditions in money markets. The figures for all years shown in the table, however, are based on the new definitions.

SOURCE: Federal Reserve System, Board of Governors.

statistical relationship between M2 and GNP is weaker than that between M1B and GNP. 11/

From this perspective, the reduced rates of M1B growth suggest that monetary policy became increasingly restrictive in the last few years. The same conclusion is suggested by the rising trend of interest rates, which indicates a slowdown in the growth of credit supplied relative to demand. Given the reduction in inflation, the rising trend of nominal interest rates after the middle of 1980 was translated into sharp increases in real rates of interest, as discussed later in this chapter. Perhaps the most remarkable credit market development in recent years has been the dramatic rise in long-term real rates of interest. In view of the detrimental effects of rising real rates on residential and business investment, and on state and local government spending, it is not surprising that real economic growth has been weak.

#### Monetary Policy and Credit Markets in 1981

The growth of M1B was below the Federal Reserve's target range throughout 1981, as Figure 8 shows. 12/ More important, as the discussion below will emphasize, M1B was below its target at the end of the year despite a surge in December. M2, by contrast, grew at rates at or above the target range throughout the year.

The behavior of deposit flows and other components of the monetary aggregates is shown in Table 11. Although demand deposits at commercial banks declined, all checkable deposits at banks and thrift institutions (the principal component of M1B) increased

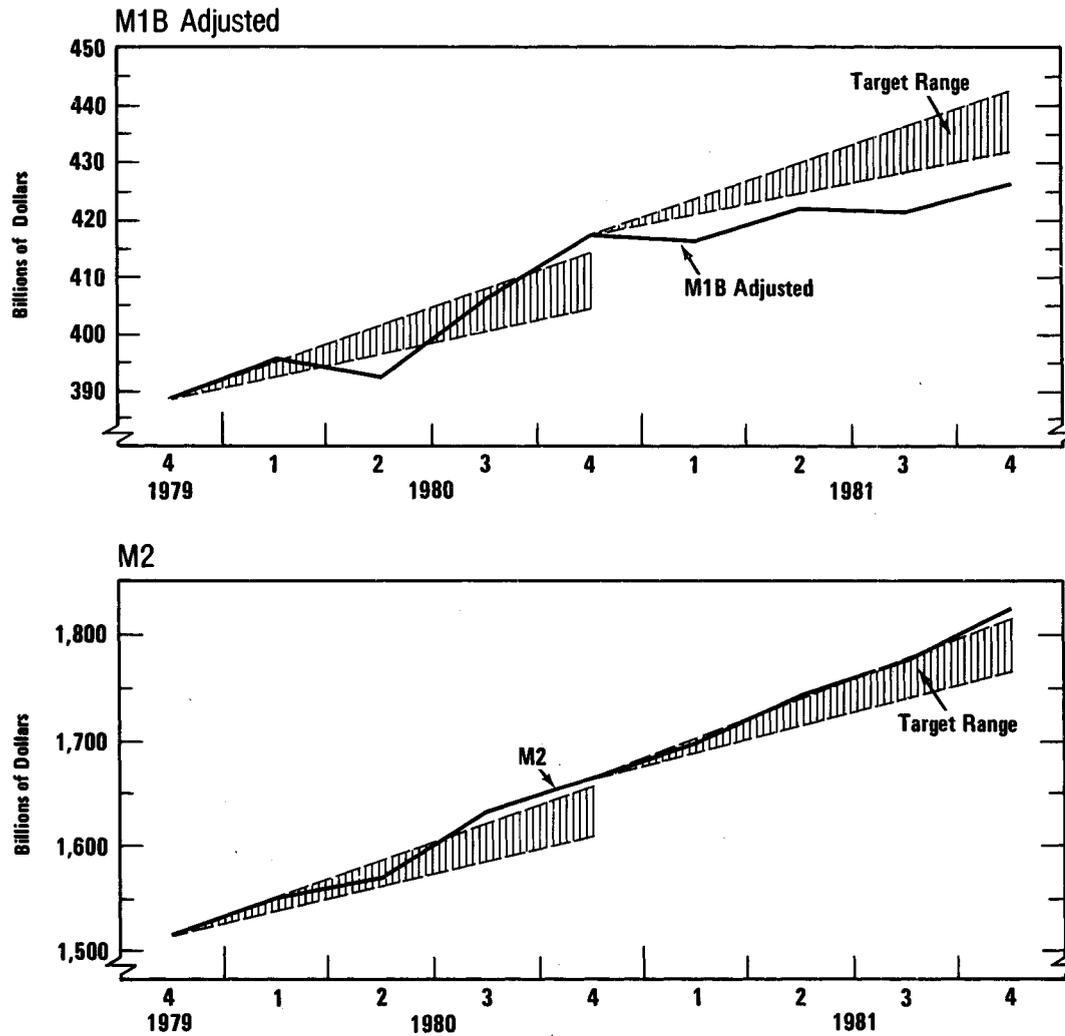
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11/ In a different spirit, it has been argued that M2 may be no less effective than M1B as an instrument for controlling GNP, and that the fact that M2 consists largely of investment funds paying high rates of return implies that relatively rapid growth in M2 may still be consistent with implicitly targeted GNP growth rates. See David E. Lindsey, "Nonborrowed Reserve Targetting and Monetary Control," paper presented at a conference on "Improving Money Stock Control: Problems, Solutions, and Consequences," St. Louis, Mo., October 31, 1981.

12/ The figures for M1B have been adjusted by the Federal Reserve to discount for inflows of funds into NOW (Negotiable Order of Withdrawal) accounts after the introduction of these accounts on a nationwide basis in early 1981.

Figure 8.

### Monetary Aggregates: Target Ranges and Actual Levels



NOTE: **M1B Adjusted:** Averages of daily figures for (1) demand deposits at all commercial banks other than those due to domestic banks, the U.S. government, and foreign banks and official institutions less cash items in the process of collection and Federal Reserve float; (2) currency outside the Treasury, Federal Reserve Banks, and the vaults of commercial banks; (3) travelers checks of nonbank issuers; and (4) negotiable order of withdrawal (NOW) and automatic transfer service (ATS) accounts at banks and thrift institutions, credit union share draft accounts, and demand deposits at mutual savings banks. Adjusted by the Federal Reserve Board for major shifts into NOW accounts from interest-earning assets included in M2.

**M2:** M1B plus savings and small-denomination time deposits at all depository institutions, overnight repurchase agreements at commercial banks, overnight Eurodollars held by U.S. residents other than banks at Caribbean branches of member banks, and money market mutual fund shares.

SOURCE: Federal Reserve System, Board of Governors.

TABLE 11. DEPOSIT FLOWS AT COMMERCIAL BANKS AND THRIFT INSTITUTIONS AND CHANGES IN MONEY MARKET FUNDS, 1981 (In billions of dollars, seasonally adjusted )

	Checkable Deposits <u>a/</u>	Savings and Small Time Deposits		Money Market Mutual Funds <u>b/</u>
		Commercial Banks	Thrift Institutions	
1981:1	3.3	7.1	5.9	16.2
1981:2	6.9	5.1	-0.6	26.4
1981:3	-1.2	8.3	-4.9	26.3
1981:4	4.7	13.0	3.0	30.2

SOURCE: Federal Reserve System, Board of Governors.

a/ At all depository institutions.

b/ Not seasonally adjusted.

throughout most of 1981. Savings and small-denomination time deposits at commercial banks and thrift institutions, which are part of M2, grew throughout the year, though the growth at thrift institutions was quite weak. Money market mutual funds, finally, another component of M2, grew strongly throughout the year.

Interest rates, after recovering from the severe downturn of 1980, reached levels at or near their historical peaks in early 1981. Short-term rates began to decline significantly in late summer as economic activity slowed, though they turned up again late in the year. The reason short-term rates rebounded is not clear. Perhaps the Federal Reserve attempted to take corrective actions, or market participants anticipated a further tightening of monetary policy, in the wake of the unexpected surge in money growth late in the year.

Long-term rates, unlike short rates, continued to rise until the recession was well underway, reaching new record levels in September. Moreover, long-term rates seemed hesitant to decline thereafter, despite the recession. Just why long-term rates have remained at such high levels is a matter of dispute.

- o Some analysts hold that long-term rates remained high because of the persistence of high inflationary expectations. This could be explained by two factors. First, inflationary expectations adjust slowly to actual changes in inflation. Second, investors may not believe that the reduction in the rate of inflation in 1981 will be permanent. In support of this second factor, it has been argued that prospective large and rising budget deficits could ultimately induce the Federal Reserve to help finance those deficits through an accommodative increase in the rate of money growth, an outcome that would raise the rate of inflation higher than otherwise. 13/
- o Some economists believe that the increased volatility of interest rates since the Federal Reserve changed its operating procedures to focus greater attention on reserve targets (October 1979) has added large uncertainty premiums to long-term rates.

#### Monetary Policy Indicators in 1981

The growth of money aggregates and the behavior of short-term interest rates are the most closely-watched indicators of monetary policy. In either case, however, inferences concerning the effect of monetary policy on economic activity are sometimes difficult to draw.

Money Growth and the Role of Velocity. The economic impact of a policy-induced reduction in the rate of money growth can be cushioned by increases in the velocity of money--the ratio of GNP to the money supply. 14/ Some increase in velocity can be expected to occur when policy changes induce slower money growth since a reduced supply of money and credit raises interest rates, inducing households and firms to conserve on money balances. In order that the Federal Reserve may plan its monetary growth targets in light

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13/ Interest rates on long-term obligations may rise in anticipation of upward interest rate pressures, such as those from large federal deficits, since prospective future increases in interest rates make such obligations less attractive now.

14/ Velocity represents the number of times an average dollar in the money supply is used to finance transactions over a given period of time.

of their likely impact on GNP, however, the timing and magnitude of this velocity increase must be predictable.

The velocity of M1B has behaved erratically during the past several years, often increasing rapidly as households and firms adopted new techniques of cash management. While it seems clear that these increases came in response to the high levels of nominal interest rates, the magnitude and timing of the changes in velocity have been difficult to anticipate. As a result, it has been hard for the Federal Reserve and for outside observers to judge in advance what rates of money growth are appropriate to achieve a given rate of GNP growth. 15/

The range of growth rates for M1B targeted by the Federal Reserve for 1981, however, clearly represented a tight policy in the sense that they permitted very little growth in real GNP. Indeed, if M1B had been permitted to grow at rates near the top of its target range, and if, at the same time, velocity growth had been high by historical standards (at the top of the range observed during the previous ten years), the expected rate of inflation would have permitted only moderate real GNP growth--certainly no more than 3 percent in 1981. In fact, however, growth in M1B-adjusted in 1981 was below the Federal Reserve's target range. Even the very sharp acceleration in velocity growth--to 7.0 percent--was insufficient to keep real growth over the year from being sluggish.

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15/ Some progress has recently been made in predicting the behavior of M1B velocity on the basis of short- and medium-term interest rates. These results have in turn been used by some observers to argue that M1B growth in 1981 was less restrictive than otherwise. See Thomas D. Simpson and Richard D. Porter, "Some Issues Involving the Definition and Interpretation of the Monetary Aggregates," in Controlling the Monetary Aggregates III, Federal Reserve Bank of Boston Conference Series No. 23 (1980); and David E. Lindsey, "Non-borrowed Reserve Targeting and Monetary Control," paper presented at a conference on "Improving Money Stock Control: Problems, Solutions, and Consequences," St. Louis, Missouri, October 31, 1981.

Money Growth Rates and Inflation. If inflation had fallen sharply in 1981, however, rates of monetary growth like those targeted by the Federal Reserve would not have braked the growth in real output as severely. Indeed, the rationale for a tight monetary policy is that it should cause inflation to fall. Why, then, did inflation not fall more than it did in the face of the slow monetary growth of 1981?

Monetary restraint may influence prices through two channels. One is by reducing total spending and, with it, pressures for increases in wages and prices. The other channel is by changing people's inflationary expectations: if people expect that money growth rates will be low and that reductions in inflation will result, they may alter their behavior in ways that help slow inflation, such as reducing wage and price demands and stepping up rates of saving and productive investment.

Inflation does not appear to be strongly sensitive to a reduction in aggregate demand, and the effects that do occur through this channel probably come only after a lag of several quarters; the more immediate effects are on real GNP growth instead. The channel of expectations, for its part, is still poorly understood. Economists have yet to agree on how expectations about future inflation are formed, or on the part played in their formation by expected money growth (or for that matter, on how expectations of future money growth are formed).

#### Real Interest Rates in 1981

An alternative means of appraising monetary policy is to look at the performance of real interest rates--that is, nominal interest rates minus some measure of expected inflation. High real interest rates represent a tight monetary policy because they restrain spending by households, business firms, and state and local governments. It is difficult, however, to estimate real rates because expected rates of inflation are not observable.

One way of approximating the behavior of real interest rates is by using ex post real rates--nominal rates minus the actual

rate of inflation subsequently observed. 16/ This estimate represents real rates accurately if participants in financial markets anticipate inflation correctly. Ex post real rates on three-month Treasury bills are shown in Figure 9. The rates reached unprecedented highs of over 8 percent early in the year. They have declined somewhat since then, but have remained at very high levels--levels approached during the recent past only during the early stages of the 1980 recession. 17/

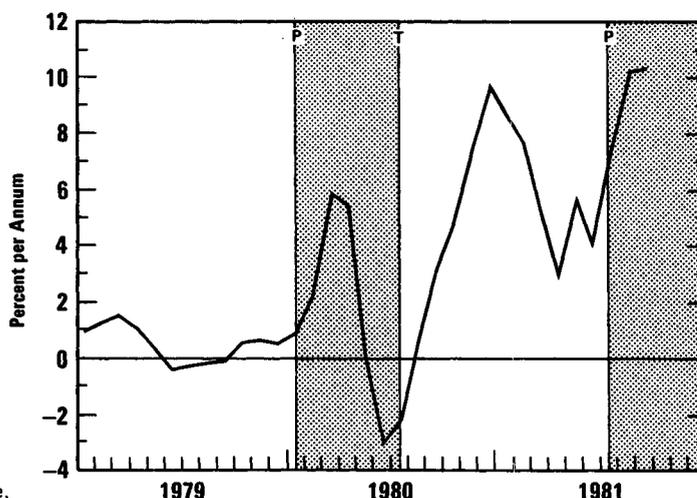
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16/ This approach was used recently by Professor Alan S. Blinder of Princeton University in testimony before the Subcommittee on Domestic Monetary Policy of the House Banking Committee, July 28, 1981. His remarks are reprinted as "Monetarism is Obsolete," Challenge (September-October 1981), pp. 35-41. Some economists dispute the contention that effective real interest rates have recently been high. They argue that since interest is tax deductible, including the part representing an expected inflation premium, real after-tax interest rates have been lower than they appear when tax effects are not taken into account.

17/ Some analysts also draw inferences about the behavior of real interest rates by watching the performance of the ratio of corporate earnings or dividends to the value of corporate stock. Short-term shifts in this ratio reflect movements in the real yield on corporate capital, which in turn may be related to shifts in the real interest rate. The recent behavior of this variable weakens the inference that real interest rates have recently been high: earnings/price ratios reached extremely high levels by historical standards in early 1980, but have declined sharply since then. The performance of corporate stock prices and earnings, however, have become quite difficult to interpret with confidence because of the complicated impacts of inflation, nominal interest rates, and the tax structure. For a discussion of these issues, see Marcelle Arak, "Inflation and Stock Values: Is Our Tax Structure the Villain?" Federal Reserve Bank of New York Quarterly Review (Winter 1980-1981), pp. 3-31. For a discussion of the interaction of monetary policy and stock prices in the absence of such complications, see James Tobin, "Monetary Policy in 1974 and Beyond," Brookings Papers on Economic Activity (1974), vol. 1, pp. 219-37.

Figure 9.  
 Estimate of Real Interest Rate for  
 3-Month Treasury  
 Bills (New Issues)

NOTE:  
 See text for information about  
 calculation of real interest rates.  
 P and T lines represent business  
 cycle peak and trough dates.



SOURCE: Congressional Budget Office.

### The Monetary Policy Outlook for 1982

The Federal Reserve has announced that M1B will be known in the future simply as "M1," and is due to announce its 1982 target ranges for this aggregate and for M2 during February. While there is as yet no firm evidence on what these ranges will be, the Federal Reserve's previously announced tentative ranges are: for M1, 2.5 to 5.5 percent; and for M2, 6 to 9 percent, the same as in 1981.

Although it is possible that these targets may allow significant real economic growth during 1982, the prospects for velocity growth and inflation suggest that the money supply will be an important factor in restraining the recovery in the second half of 1982 and in 1983. CBO expects velocity to grow only moderately, partly because interest rates are expected to be lower than last year and partly because velocity growth is usually sluggish during recessions. Inflation, for its part, is expected to be lower than in 1981 but to remain at significant levels, due mainly to continued wage momentum (see Chapter IV). To illustrate the possibilities, if 1982 M1 growth is 4.0 percent (at the middle of the presumed target range) and if velocity growth is 5.6 percent (not as high as in 1981, but historically high), and if the GNP deflator grows at 7.3 percent (at the middle of the range forecast by CBO), then real growth from the fourth quarter of 1981 to the fourth quarter of 1982 could be no more than a relatively weak 2.3 percent.

Any of these factors could easily turn out to be more or less favorable to growth. The difficulty of making predictions is illustrated by the behavior of M1 in the last few months, when a strong and unexpected surge put that aggregate above the level of the lower target range for the fourth quarter of 1982. If this unexpected surge does not reverse itself, the Federal Reserve may conclude that the jump in the money stock represents an inconsequential shift in the public's money holding habits and raise its targets accordingly. Alternatively, the Federal Reserve might conclude that it needs to reverse the recent increase in money. In the latter case, the economy may face extraordinarily high interest rates during the remainder of the year as monetary policy endeavors to hold the money supply within the present target range.

The Federal Reserve will also announce soon the 1981 level against which money growth in 1982 will be measured. The choice may be either the actual level during the final quarter of 1981 or a level within the 1981 target range. If it follows past practice, the Federal Reserve will choose the actual 1981 level. Since that level was significantly below the target range, this decision would mean that the longer-term money growth rate between 1979 and 1982 could be quite low indeed. Even if the authorities allowed M1 to grow at the top of the presumed target range for 1982, as has been assumed in the CBO forecast, the average annual growth rate for M1 would be only 3.8 percent between 1980 and 1982 and 4.9 percent between 1979 and 1982 (not including growth that occurred in 1981 because of the nationwide introduction of NOW accounts). If M1 growth is kept at the bottom of its target range in 1982 as it was in 1981, these growth rates would be lower still. Any of those possibilities implies a continuation of the sluggish longer-term pattern for economic growth that was described at the beginning of this section, unless velocity accelerates more than seems likely.

The outlook for velocity growth in 1982 is, of course, uncertain. CBO's forecast calls for interest rates below their record 1981 levels, which suggests that the velocity of M1 may not grow as strongly as in 1981. There is evidence, however, that rapid increases in velocity may occur independently as a result of new account sweeping techniques developed by money managers in response to past increases in interest rates. If this happened, the economic outlook could be much brighter. The possibility underscores the hazards of economic forecasting in the present environment.

## CONCLUSION

Given policies currently in place, the next several years promise a combination of restrictive monetary policy, designed to shrink inflation, and a stimulative fiscal policy intended to generate rapid economic growth. The economic effects are difficult to predict, especially given the large magnitudes of the policy changes. The prolonged large deficits implied by these policies are the most worrisome aspect. Some economists foresee a clash between monetary and fiscal policy that will have serious adverse effects on economic activity. Such an outcome would be made less likely by further spending cuts and tax increases to permit smaller deficits. Moreover, smaller deficits would reduce the danger of crowding out private investment and would have favorable effects on longer-run economic growth. Finally, tight credit conditions tend to have very uneven effects, which are particularly adverse for housing, autos, and other durable goods and the investment sectors. If smaller deficits permit easier credit conditions, the adverse structural effects of monetary policy would be reduced.

