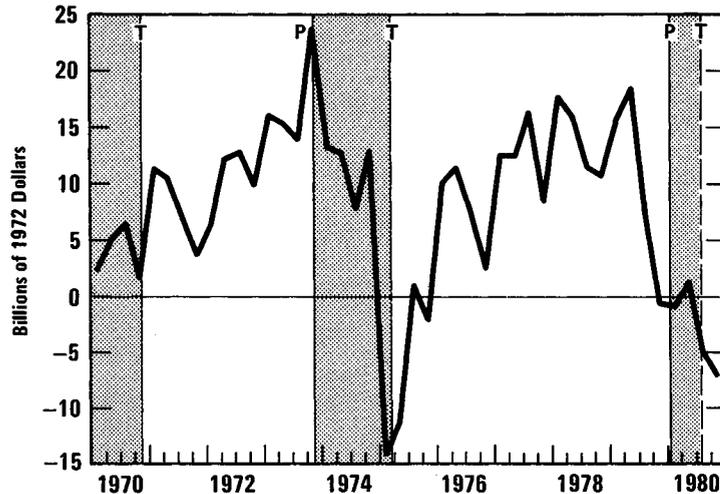


Figure 7.
Change in Business
Inventories,
Adjusted for Inflation



SOURCE:
U.S. Department of Commerce,
Bureau of Economic Analysis.

The first factor does not appear to be an adequate explanation for the unusual inventory behavior. Final sales fell at an exceptionally rapid rate early in 1980, and the general outlook suggested weakness in future sales and production.

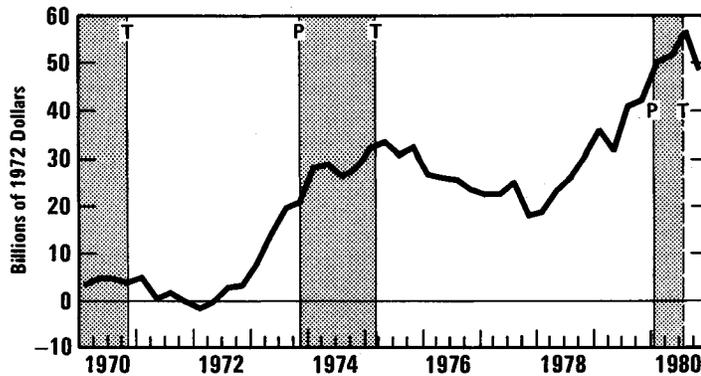
A better case can be made for the second factor. Most inventories are financed with borrowed funds. It is reasonable to expect that stocks will be cut back if interest rates rise significantly. And that is apparently what happened. The general reduction in inventory investment began with the run-up in interest charges in late 1978 and continued through 1979. As a result, inventories were quite lean by the time total spending contracted early in 1980. In effect, much of the inventory adjustment occurred before the slowdown in final sales, instead of after it as had been typical in previous downturns.

Net Exports

Constant-dollar net exports of goods and services rose by \$6.3 billion in 1980, with fourth-quarter exports \$2.6 billion above a year earlier and imports \$3.7 billion lower (see Figure 8). Merchandise export growth, adjusted for inflation, slowed considerably as major U.S. trading partners experienced economic downturns in the first half of 1980. Meanwhile, real merchandise imports fell: automobile imports continued at close to the 1979 rate, while lower petroleum product imports accounted for about

Figure 8.
 Net Exports,
 Adjusted for Inflation

SOURCE:
 U.S. Department of Commerce,
 Bureau of Economic Analysis.



half of the overall decline. On the services account, real exports and imports both increased in 1980, although at slower rates than in the previous year.

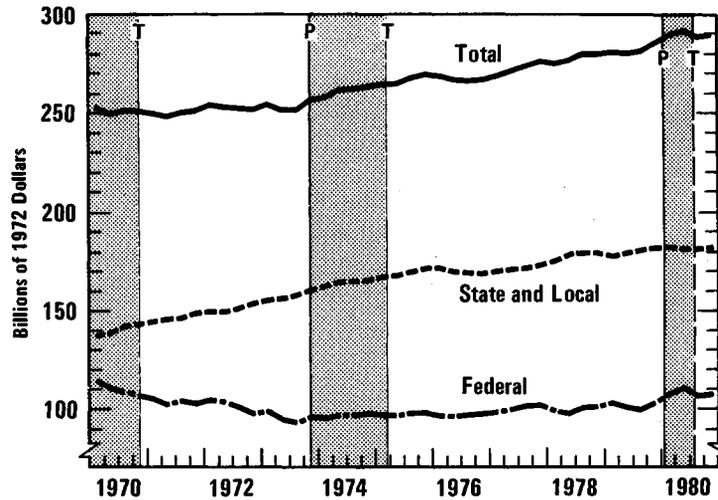
Midyear upturns in industrial production of many major U.S. trading partners slowed or reversed toward the end of 1980, suggesting that near-term exports may continue falling. In addition, the reductions in petroleum imports realized last year are probably not sustainable at a similar rate, as increased fourth-quarter petroleum import figures may indicate.

Relatively high interest rates helped buoy the exchange value of the dollar in the early part of 1980 and again at the end of the year. As high interest rates boost the exchange value of the dollar and attract some capital flows to the United States, however, the appreciated value of the dollar and the high inflation rates underlying the interest rates work to hurt U.S. exporters' competitive positions. Should interest rates ease to lower levels in 1981, capital flows may continue if the differential between U.S. and foreign interest rates remains. On the negative side, the persistent inflation that erodes U.S. competitiveness in high-productivity products will probably continue to hurt U.S. exports of such goods.

Government Purchases

After adjustment for inflation, government purchases rose 1.6 percent in 1980 (see Figure 9). The increase is wholly attributable to the federal sector. Over the year, federal defense

Figure 9.
Government
Purchases,
Adjusted for Inflation



SOURCE:
U.S. Department of Commerce,
Bureau of Economic Analysis.

purchases rose 5.3 percent in real terms, and nondefense purchases 1.7 percent. Real state and local government purchases increased slightly in 1980. While most spending categories grew very modestly, outlays for structures fell by 5.6 percent, reflecting, in part, the high cost of borrowing. State and local budget surpluses, exclusive of social insurance trust funds, fell only slightly last year despite the recession. Slowed revenue growth in the second quarter pushed the balance into deficit, but only for one quarter.

LABOR MARKETS AND PRICE DEVELOPMENTS

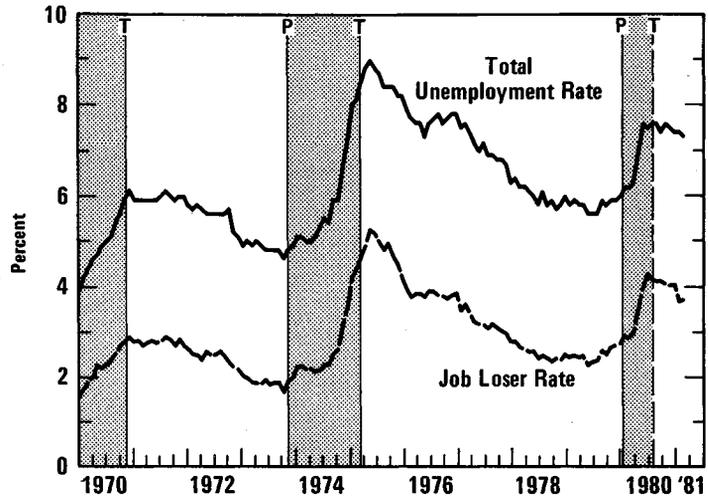
Labor Market

The unemployment rate rose sharply during the 1980 recession, from 5.9 percent in 1979:4 to 7.5 percent in 1980:3--an increase of 1-3/4 million in the number of unemployed workers (see Figure 10). Like the change in total production, the unemployment rise was concentrated in the second quarter. Between March and May 1980, the jobless rate increased by 1.3 percentage points. For the remainder of the year, the unemployment rate hovered around 7-1/2 percent.

The impact of the recession was not evenly distributed throughout the work force. The downturn in production hit hardest

Figure 10.
Unemployed Workers
as a Percent of the
Civilian Labor Force

SOURCE:
U.S. Department of Labor,
Bureau of Labor Statistics.



in goods that are sensitive to interest rates and postponable--automobiles and related products, housing and related products, and capital investment. Consequently, workers in these areas were affected disproportionately (see Table 8). Thus, the unemployment rate increase was concentrated among workers with the most stable attachment to the labor force--adult males and full-time workers (see Table 9). Job losers accounted for about 90 percent of the rise in joblessness.

The recovery in production during the second half of the year brought with it some improvement in labor-market conditions. Employment growth resumed, and average weekly hours rose. But significant slack remained in the labor market as 1981 began. The unemployment rate was 7.3 percent in February 1980--1.1 percentage points (about 1-1/3 million workers) above a year earlier. Aggregate weekly hours of production of nonsupervisory workers in February 1981 were below year-ago levels in construction (-9.0 percent), durable goods manufacturing (-7.2 percent), nondurable goods manufacturing (-1.3 percent), and transportation and public utilities (-1.6 percent).

Inflation

Despite the recession, the Consumer Price Index (CPI) rose 12.4 percent in 1980--the second most rapid rise in three decades (see Figure 11). The most rapid increase was 13.3 percent in 1979.

TABLE 8. PERCENT CHANGE IN THE INDEX OF AGGREGATE WEEKLY HOURS WORKED

	Jan. 1980 to July 1980	July 1980 to Jan. 1981
By Industry		
Goods-Producing Industries	-10.5	8.0
Mining	-2.0	10.8
Construction	-12.4	11.9
Manufacturing	-10.5	7.0
Durable goods	-12.8	8.1
Nondurable goods	-7.2	5.5
Service-Producing Industries	-0.5	1.8
Transportation and public utilities	-1.1	-1.2
Wholesale and retail trade	-2.8	2.8
Financial, insurance, and real estate	2.0	1.3
Services	1.7	1.8
By Nature of Output		
Auto- and Housing-Related Goods		
Transportation equipment	-13.0	9.5
Primary metals	-20.8	18.0
Lumber and wood	-16.7	12.1
Furniture and fixtures	-17.0	12.9
Rubber and misc. plastics	-18.2	17.0
Capital Goods		
Nonelectrical machinery	-8.2	3.0
Electrical machinery	-11.1	7.8
Instruments	-4.8	3.0
Miscellaneous Consumer Goods		
Printing and publishing	-3.7	3.9
Chemicals	-6.3	3.9
Apparel	-4.7	3.4

SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

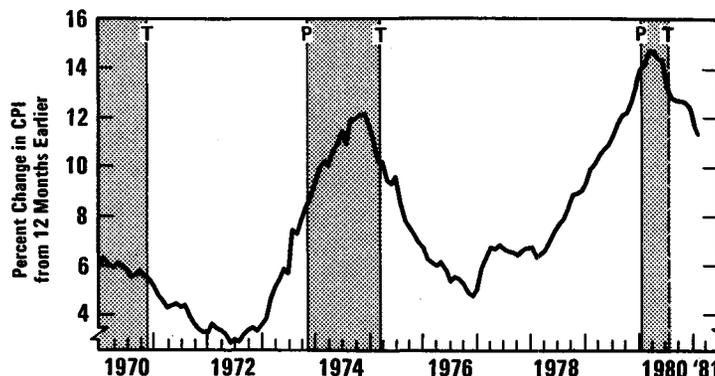
TABLE 9. UNEMPLOYMENT RATES (Percent of civilian labor force)

	1979	1980				1981	
	Q4	Q1	Q2	Q3	Q4	Jan.	Feb.
All Workers	5.9	6.2	7.3	7.5	7.5	7.4	7.3
Demographic Breakdown							
Males, 20 years and older	4.4	4.8	6.2	6.6	6.3	6.0	6.0
Females, 20 years and older	5.7	5.8	6.4	6.4	6.7	6.7	6.5
Teenagers	16.2	16.4	17.9	18.4	18.3	19.0	19.3
Married men, spouses present	3.0	3.4	4.4	4.8	4.4	4.2	4.1
Women who maintain families	8.4	8.7	8.6	8.9	10.2	10.5	9.6
Full-time workers	5.5	5.8	7.0	7.3	7.3	7.1	7.1
Occupation							
White-collar workers	3.3	3.4	3.7	3.8	3.9	3.9	3.7
Blue-collar workers	7.5	8.1	10.5	11.1	10.7	10.2	10.1
Craft and kindred workers	4.8	5.2	7.2	7.4	7.1	6.8	7.2
Service workers	6.8	7.0	8.0	8.3	8.1	8.0	8.7
Industry							
Construction	10.6	11.8	15.6	16.3	14.4	13.3	13.2
Manufacturing	6.0	6.7	9.1	9.4	9.0	8.4	8.4
Transportation and public utilities	4.1	4.3	4.9	5.5	5.0	5.8	5.5
Trade	6.4	6.5	7.4	7.7	8.1	7.6	7.6
Previous Employment Status							
Job losers	2.7	2.9	3.9	4.1	4.0	3.6	3.7
Job leavers	0.8	0.8	0.9	0.8	0.8	0.9	0.8
Reentrants	1.7	1.7	1.8	1.8	1.8	1.9	1.9
New entrants	0.8	0.8	0.8	0.8	0.8	0.9	0.9

SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

The items within the CPI that led to the acceleration in 1979 were the same ones that did the most to maintain the high rate of inflation in 1980 (see Table 10). Mortgage interest costs rose 34.7 percent in 1979 and 27.6 percent in 1980. Direct energy costs rose 37.4 percent in 1979 and 18.1 percent in 1980. Food prices increased by about 10 percent in both years.

Figure 11.
Consumer Prices



SOURCE:
U.S. Department of Labor,
Bureau of Labor Statistics.

Excluding mortgage interest costs, energy, and food, consumer prices were up 9.9 percent in 1980--compared with 8.6 percent the preceding year. The jump reflected the typical lagged response of production costs--especially wages--to an increase in energy prices and interest rates.

The heavy weight assigned to interest rates, most notably mortgage interest rates, in the CPI contributed greatly to its volatility in 1980. Interest rate movements have an exaggerated impact on the CPI because the interest rate level is a function of

TABLE 10. INFLATION RATES BY SELECTED CATEGORIES OF THE CPI

	1978	1979	1980
All Items	9.0	13.3	12.4
Energy	8.0	37.4	18.1
Mortgage Interest Costs	22.0	34.7	27.6
Food	11.8	10.2	10.2
Remaining Items	7.3	8.6	9.9

SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

TABLE 11. INFLATION AS MEASURED BY THE CPI, WITH AND WITHOUT MORTGAGE INTEREST COSTS (Annual rates of change)

	1980			
	Q1	Q2	Q3	Q4
All Items	16.5	13.1	7.7	12.9
All Items Less Mortgage Interest Costs	13.3	10.0	10.2	11.2

SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

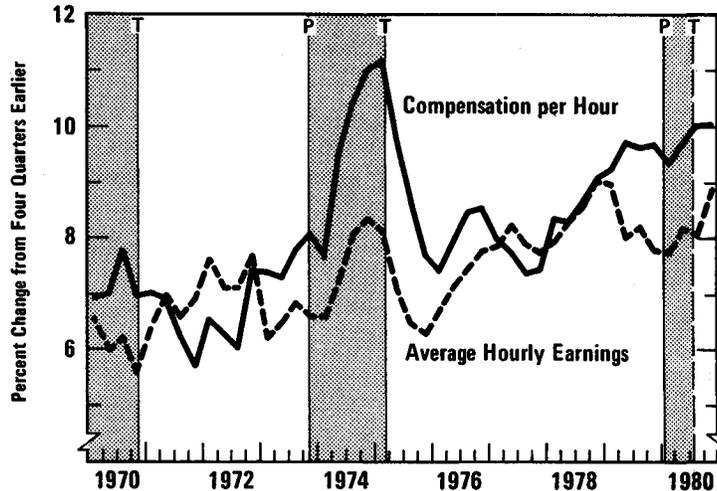
inflation, while, in turn, inflation is driven by interest rates. In 1980, for example, the quarterly movements in consumer prices without mortgage interest costs were quite different from the behavior of the total CPI (see Table 11). The distortion resulting from interest-rate volatility does not, however, change the basic message that prices rose very rapidly in 1980.

Costs of Production

Labor Costs. Labor costs account for about three-quarters of total business costs. Thus, rapid increases in labor costs put strong upward pressure on product prices. Compensation per hour in nonfinancial corporations rose at a 10.7 percent annual rate in the first three quarters of 1980--somewhat higher than the 9.8 percent gain in 1979 (see Figure 12).

Empirically, the three most important determinants of wage movements are labor-market slack, past price inflation, and government intervention. Labor-market slack increased substantially in 1980. The increase of 1-1/2 million unemployed workers was concentrated among those workers with the most stable attachment to the labor force, rather than among teenagers or labor-force reentrants. But the sharp increase in labor-market slack was not sufficient to prevent an acceleration in wage growth, largely because of workers'

Figure 12.
 Compensation
 Per Hour and
 Average Hourly
 Earnings



SOURCE:
 U.S. Department of Labor,
 Bureau of Labor Statistics.

efforts to catch up to the previous acceleration of inflation, some labor scarcity for particular types of employment and in particular areas, and increases in the minimum wage and payroll taxes.

Catch-up to past inflation has been the most important factor keeping compensation increases around double-digit rates. The evidence suggests that many workers have been able to maintain their customary rates of real wage improvement despite economic changes working against them. Such adverse changes include rising oil prices, a slowing of productivity growth, competition from foreign manufacturing capacity, and the attempts by government to shift resources to the elderly, the sick, and the poor. Other workers have been less successful in defending their customary real income positions, as can be seen from changes in the structure of wages.

Direct government actions also pushed up labor compensation last year. The minimum wage was increased by 7 percent on January 1, 1980--from \$2.90 per hour to \$3.10. At the same time, maximum earnings subject to Social Security taxes rose 13 percent. Together, the two changes are estimated to have added a quarter of a percentage point to the increase in compensation per hour last year.

Labor Productivity. The impact of rising labor compensation on unit production costs can be offset by rapid growth in

output per hour. Unfortunately, this has been lagging badly for a number of years, although it picked up somewhat during 1980.

Output per hour in nonfinancial corporations, as measured by the Department of Commerce, rose at a 2.4 percent annual rate from the fourth quarter of 1979 to the third quarter of 1980. This was a significant improvement from the 0.8 percent decline in 1979, and is about the same as the nearly 2-1/2 percent average annual growth rate in the postwar period through 1973. Improving productivity performance is fundamental in the battle against inflation.

Nonlabor Costs. Unit nonlabor costs rose at a 19.3 percent annual rate in the first three quarters of 1980, up from the 10.6 percent increase in the previous year. Unit nonlabor costs include depreciation, interest, indirect taxes, and payments for inputs from outside the nonfinancial corporate sector. Thus, they reflect both the rapid run-up in interest rates and the passthrough of sharply higher world oil prices.

Total unit costs increased at a 10.9 percent annual rate during the first three quarters of 1980, well above the 9-1/2 percent rise in prices for nonfinancial corporations. As a result, unit profits fell by 4.5 percent--a decline that followed a 15.4 percent drop in 1979. Such a squeezing of profits lessens the direct impact of cost increases on prices, but offers little for the future. Profits are the chief source of investment funds as well as the major incentive to invest in productive plant and equipment, and business fixed investment is an important determinant of productivity growth. Consequently, a poor profit performance today can hurt productivity growth in the future, aggravating future inflation. (Profits are analyzed in detail in Chapter VI.)

CHAPTER III. MONETARY AND FISCAL POLICY

Rapid inflation and changes in the financial structure make it particularly difficult to characterize monetary and fiscal policy, or to assess their contribution to economic developments in 1980. Money aggregates grew very rapidly in the second half of the year, suggesting an expansive monetary policy. But at the same time, interest rates rose to record levels, implying restraint. In regard to fiscal policy, rapid growth in spending (17.4 percent) and the large deficit (\$59.6 billion) in fiscal year 1980 suggest a stimulative federal budget, even when the budgetary effects of economic slack are taken into account. At the same time, however, payroll tax increases and the interaction of inflation with the progressive income tax structure have sharply increased tax burdens for most working people.

Recent announcements by the Federal Reserve (Fed) indicate a continued strong policy commitment to the goal of reducing inflation. Indeed, its monetary targets appear to leave little room for a strong expansion of real economic activity unless the rate of inflation subsides substantially more than expected by most forecasters. The Fed is aware of the implication of its monetary policy and has recommended a restrictive fiscal policy to help reduce inflation. But if the individual and corporate tax reductions proposed by the Administration are implemented by mid-1981, the budget will not provide fiscal restraint in 1982 unless federal spending is also reduced substantially. Even with sizable spending cuts in fiscal year 1982, the budget deficit is likely to remain large. Federal borrowing will continue to put some upward pressure on interest rates, dampening the stimulative effects of tax incentives for investment and economic growth.

MONETARY POLICY

In recent years, prospects for a return to price stability have rested on a planned, gradual, but steady reduction in the rate of money growth. Since the mid-1970s, the Federal Reserve has announced successively lower annual money growth targets. Although money aggregate growth accelerated in the 1977-1978 period, some retardation has been attained since then (see Table 12). At the same time, no reduction in inflation has been achieved.

TABLE 12. GROWTH RATES OF SELECTED MONETARY AND RESERVE AGGREGATES, 1976-1980 (Fourth quarter to fourth quarter)

Year	M1A	M1B	Adjusted Monetary Base	Adjusted Bank Reserves
1976	5.5	6.0	7.8	4.0
1977	7.7	8.1	8.4	6.1
1978	7.4	8.2	9.4	8.1
1979	5.0	7.7	8.3	5.5
1980	5.0	7.3	8.3	5.7

NOTES: M1A: the public's holdings of currency and demand deposits at commercial banks.

M1B: the public's holdings of currency and checkable deposits at depository institutions.

Adjusted Monetary Base: currency in circulation and bank reserves adjusted for reserve requirement changes.

Adjusted Bank Reserves: adjusted monetary base less currency held by the public.

SOURCES: Federal Reserve System, Board of Governors; and Federal Reserve Bank of St. Louis.

Dissatisfied with its success in controlling money growth, the Fed adopted a new operating strategy on October 6, 1979. Under the new procedure, the Fed was to give less attention to restricting short-term variations in interest rates and more attention to a steady reduction in the growth of bank reserves. Under the old procedure with its heavy emphasis on interest rate targets, the Fed usually increased the supply of bank reserves (and money) when interest rates rose, and reduced reserves (and money) when interest rates fell. Interest rate movements could, thereby, pull money growth away from the target paths.

Proponents of the new procedure believed it would increase the ability of the Fed to hit the money growth targets. Opponents argued that, by diminishing the Fed's role as financial market stabilizer, the new procedure would lead to large fluctuations in interest rates and increased economic instability. Both sides can now claim vindication: 1980 was one of the most turbulent years for interest rates in the postwar period; and, by one money aggregate measure (M1A), the Fed achieved its target.

A closer look at the last year suggests, however, that the effect of the new operating procedure as implemented was not as different from the old as many expected. It probably was not the main cause of the ups and downs of financial markets, nor does it appear to have given the Fed control over money growth.

Interest Rates

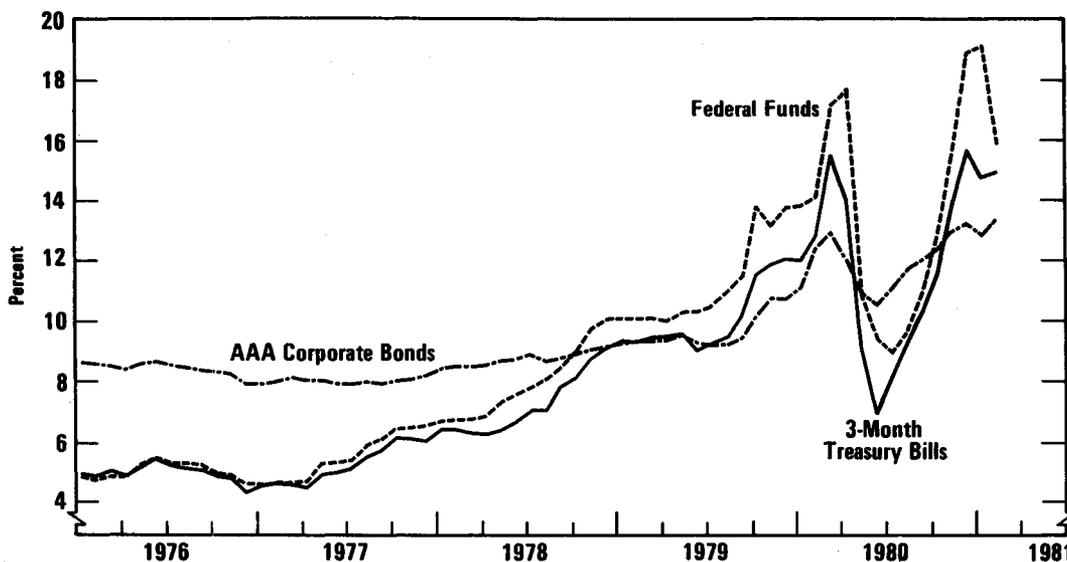
The closely watched prime interest rate charged by commercial banks opened the year at 15 percent, held steady until late February, rose to a peak of 20 percent in April, and then dropped rapidly to 11 percent by August. ^{1/} After late August, though, the decline was reversed, and by year-end the prime had reached a new peak of 21.5 percent. The long-term securities markets also endured huge price and rate movements; some analysts thought that the swings in long-term market rates threatened the very existence of those markets. The general pattern, with its two record peaks in rates, is illustrated in Figure 13.

The principal causes of these unprecedented movements in interest rates appear to have been:

- o Sharp changes in the pace of economic activity;
- o Changes in inflationary expectations;
- o A more flexible financial structure; and
- o The Fed's new operational procedures.

^{1/} Although "prime" suggests that this is the lowest rate charged the most creditworthy commercial borrowers, bank loans below the prime rate are fairly common.

Figure 13.
Interest Rate Behavior



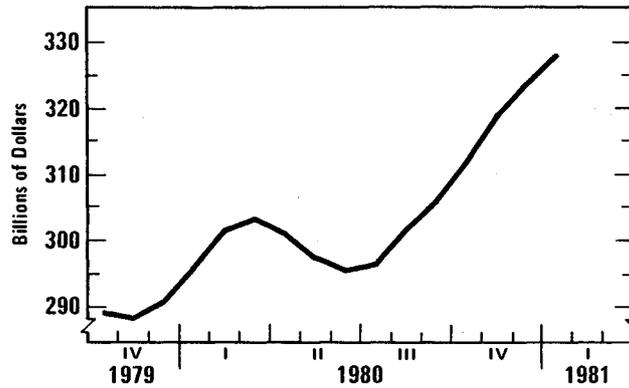
SOURCES: Federal Reserve System, Board of Governors; Moody's Investors Service, Inc.

First, the quarterly pattern of economic activity during 1980 matched the direction of interest rate movements shown in Figure 13. The 3.1 percent annual rate of growth in real GNP during the first quarter paralleled the upward movement in interest rates, and the record-breaking 9.9 percent drop in real GNP during the second quarter shadowed the fall in rates that occurred after the March 14 credit controls. ^{2/} When the economy turned up quickly during the last half year, rates rose again. Thus, swings in the pace of economic activity during 1980 were accompanied by similar changes in the demand for credit (see Figure 14); and these changing credit demands--absent offsetting changes in supply--were reflected directly in interest rate fluctuations.

Second, because the inflation rate was high and variable, the range of expected changes in inflation rates could have been quite

^{2/} For a discussion of this credit control policy, see Congressional Budget Office, The Economic Outlook at Midyear 1980 (July 1980), pp. 43-44, and Chapter II of this report.

Figure 14.
**Commercial and
 Industrial Loans
 Extended by
 Commercial Banks**



SOURCE:
 Federal Reserve System,
 Board of Governors.

wide. Large shifts in expected inflation appear to have been triggered in a relatively short period by increased political and military unrest in the Middle East, and by fluctuations in economic activity and changes in money growth. Fluctuations in anticipated inflation rates were quickly incorporated into interest rates. When inflationary expectations rose, for example, interest rates increased as lenders attempted to protect the real value of their capital and as borrowers expected to repay with increasingly depreciated dollars.

Despite the "new procedure" announcement of October 6, 1979, the Fed apparently did permit variations in the growth of reserves in order to resist even wider interest rate movements during 1980. The Fed set the stage for 1980 by permitting total bank reserve growth of 5.5 percent during 1978-1979. In January-March 1980, when interest rates were moving up, reserves grew at an annual rate of 10.1 percent. During the interest rate collapse of the second quarter, however, bank reserves declined at a 2.7 percent annual rate. In the last half year, reserve growth resumed at an 11.2 percent rate (over 13 percent in July-October). Indeed, with hindsight some observers suggest that the Fed delayed too long in responding to the rapid monetary growth in the second half of 1980, thereby boosting inflationary expectations and interest rates late in the year.

Another cause of the increasing frequency and amplitude of movements in interest rates is the changed structure of U.S. financial institutions. ^{3/} The removal of many interest rate ceilings, such as limitations on maximum rates paid and charged and the introduction of floating rate deposits, has rendered markets better able to cope with wider swings in interest rates. This has made interest rate fluctuations more likely. In the past, when these restrictions were in force and competitive rates rose above the legal ceilings, markets tended to stop functioning--that is, transactions halted. Thus, 1.3 million housing starts (the 1980 pace) would not have occurred in the 1960s or early 1970s in the face of a 13 percent mortgage interest rate. In those years, most mortgage lenders were prohibited from charging such rates or paying the double-digit time deposit rates necessary to obtain funds. Lending would have halted before interest rates reached double-digit levels, and housing starts would have dropped sharply.

With deregulated interest rates, economic activity is less subject to restraint from the complete absence of financing; rather, it is restrained by the cost of financing. This means that interest rate fluctuations will be greater and adjustments in activity more continuous than when the credit markets were prohibited by regulations from functioning at high interest rates.

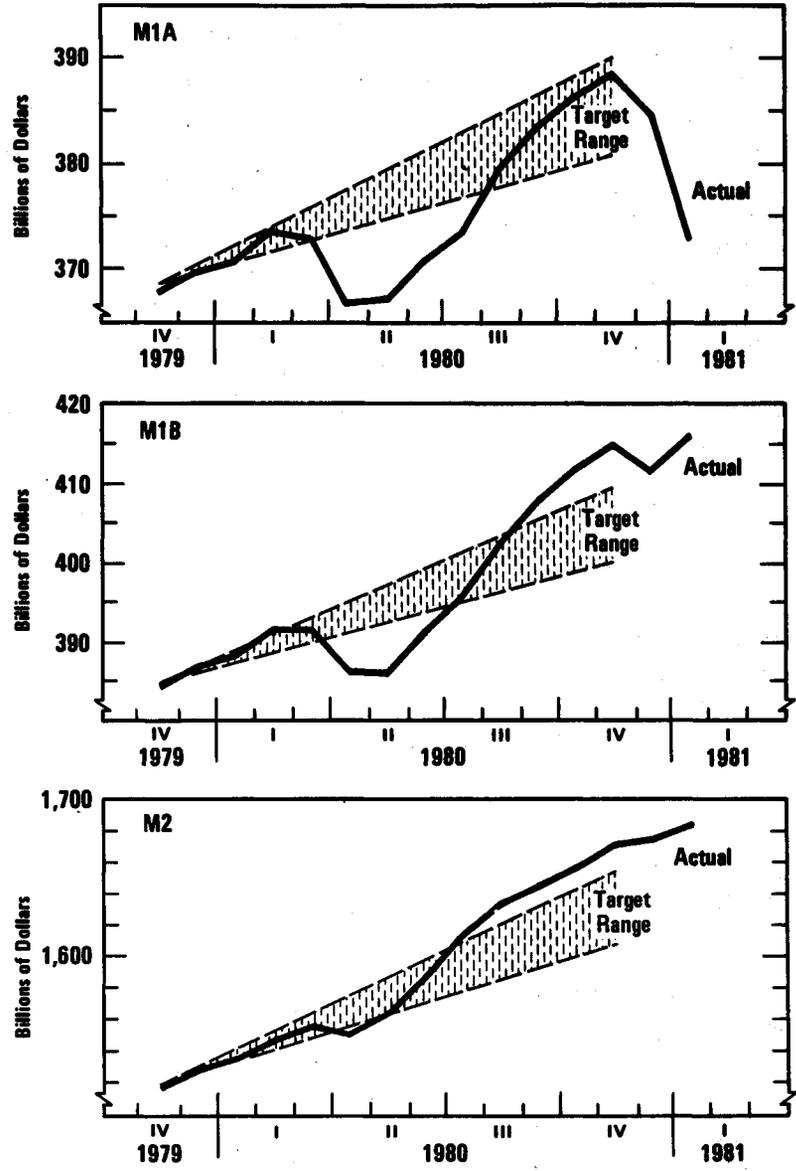
Finally, the new operating procedure, which emphasizes steady growth in the supply of money and credit, can result in wide fluctuations in short-term interest rates (the price of money and credit) as a result of unexpected shifts in demand. This may have happened, at least for short periods, in 1980.

The Monetary Targets

Three of the Federal Reserve's monetary targets for 1980, together with the patterns of monetary growth that occurred, are shown in Figure 15. Measured by last-week-in-December values, M1A was at the bottom, M1B was near the mid-point, and M2 was at the top of the target ranges. In evaluating the success of the Fed in hitting its targets, however, average figures for quarters or

^{3/} This is emphasized in Economic Report of the President (January 1981), pp. 107-15.

Figure 15.
**Money
 Aggregates:
 Target Ranges
 and
 Actual Levels**



NOTE: **M1A** consists of currency plus commercial bank demand deposits held by the nonbank private sector excluding those held by foreign banks and official institutions; target growth for 1980 was 3.5 to 6.0 percent.
M1B consists of M1A plus other checkable deposits at all depository institutions; target growth for 1980 was 4.0 to 6.5 percent.
M2 consists of M1B plus overnight repurchase agreements and Eurodollars, money market mutual fund shares, and savings and small-denomination time deposits at all depository institutions; target growth for 1980 was 6.0 to 9.0 percent.

SOURCE: Federal Reserve System, Board of Governors.

longer periods are more meaningful. ^{4/} Comparing the average level in the fourth quarter of 1980 with the similar figure for 1979, M1A was within its target range, but both M1B and M2 were above the upper bounds of their targets by 0.8 percentage point.

The Fed has indicated that the overshoot in M1B (currently considered to be the most important of the aggregates for the economy) was due to larger than expected shifts of funds into ATS and NOW account components of M1B from other assets not included in M1B. ^{5/} This interpretation suggests that the M1B target miss occurred for "technical" reasons and had little real significance.

The experience illustrates the inherent weakness of attempting to hold the Fed accountable for slowing the growth of a measure of money so subject to "technical" distortion. Some of the switches between assets that "artificially" inflate M1B--for example, from demand deposits to NOW accounts--also "artificially" deflate M1A. M2 is unaffected by these shifts because it includes all of these assets, but it also contains forms of money, such as money market mutual funds, that are outside the immediate control of the Federal Reserve.

Given the weakness of M1A, M1B, and M2 as indicators of the Fed's success in carrying out its mandate to slow the rate of money growth gradually, some observers have suggested that the Fed's targets be specified for aggregates more closely controlled by the central bank such as the monetary base or total bank reserves. Others believe that such a change would shift the Fed's focus to variables less directly linked with economic performance.

^{4/} Weekly values of the monetary aggregates are subject to considerable random influence or statistical "noise." In the first week in January 1981, for example, M1B rose more than \$12 billion, or more than the width of the M1B target range for 1980. Presumably, a significant portion of this large change was transient and without economic significance.

^{5/} ATS accounts permit automatic transfers from savings deposits to demand deposits to cover checks drawn on the demand accounts. NOW accounts are those on which interest and dividends are paid and from which owners can make third-party payments by use of negotiable orders of withdrawal.

The Outlook for Monetary Policy in 1981

For 1981, the Federal Reserve has reduced the growth ranges for M1A and M1B by 0.5 percentage point. The M2 target is unchanged from 1980. Thus, the target ranges will be 3.0 to 5.5 for M1A, 3.5 to 6.0 for M1B, and 6.0 to 9.0 for M2 measured from the fourth quarter of 1980 to the fourth quarter of 1981. Serious "technical" factors will again mar the meaningfulness of M1 growth in 1981. Effective December 31, 1980, all depository institutions in the United States were authorized to issue NOW accounts. (NOW accounts were formerly restricted to New England.) These accounts, included in M1B, will attract funds from commercial bank demand deposits (M1A) and from savings deposits (M2). The extent of these deposit switches and the degree to which they will inflate M1B and deflate M1A is unknown. The Fed argues that such switches are without economic significance and that the M1B target should be raised to fully accommodate these switches. That is, if deposit shifts are expected to add 2.5 percent to M1B growth, then the upper end of the M1B target range should be 8.5 percent (the unadjusted target of 6 percent plus the 2.5 percent due to "technical" factors).

Nonetheless, the Fed has made it clear that such adjustments in the targets to allow for account shifting do not constitute a departure from its anti-inflation policy. Speaking to the Senate Banking Committee in January 1981, Chairman Volcker said:

. . . so long as inflationary forces are so strong and are expected to remain strong, money and credit targets . . . are likely to imply strong pressures on credit markets whenever business is strongly expanding, calling into question the sustainability of the advance.

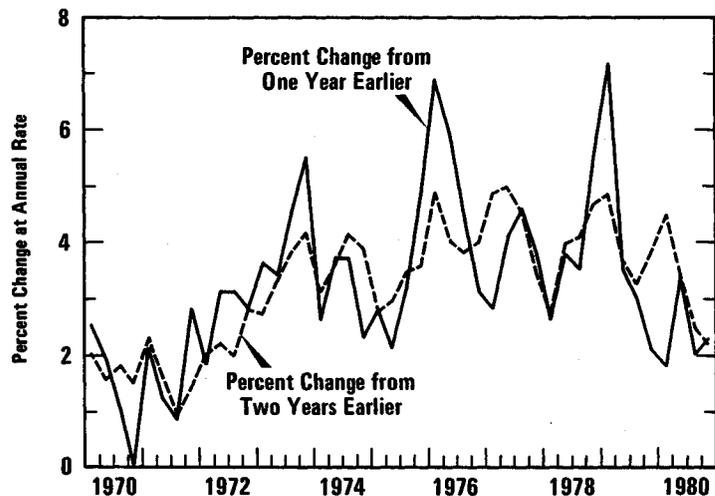
The thrust of the Federal Reserve policy over the next year or so may be expressed quantitatively in terms of money growth, money velocity (how fast money is turned over) and expected growth in nominal GNP. The rate of growth in money plus the rate of growth in velocity is approximately equal to the rate of growth in real output plus the inflation rate (nominal GNP).

For 1981, the Fed target for M1B is 3.5 to 6.0 percent (ignoring the expansion caused by deposit switching). During 1970-1980, the average four-quarter rate of growth in M1B velocity was 3.2

percent. If the Fed hits the upper end of the M1B target range, and if velocity increases at its 1970s' four-quarter average pace, nominal GNP will grow 9.2 percent (6.0 plus 3.2) in 1981. Faster nominal GNP growth might occur for, say, a one-year period but high growth is not likely for a long period. The maximum velocity increase over a two-year period in the 1970s was at a 5.0 percent annual rate (see Figure 16). Thus, an average two-year maximum money target of 5.75 percent per year (6.0 in 1981 and 5.5 in 1982) and peak velocity growth of 5.0 percent would be consistent with nominal GNP growth of 10.75 percent per year.

Thus, historical experience suggests that the Fed is intent on providing monetary growth consistent with a maximum nominal GNP growth of about 10 percent per year over the next two years. If inflation continues at 10 percent, real GNP growth will be close to zero. Thus, assuming the Fed achieves its monetary targets, significant and sustained real growth is unlikely unless there is a commensurate decline in the inflation rate.

Figure 16.
Behavior of M1B
Velocity



SOURCE:
Federal Reserve System,
Board of Governors.

FISCAL POLICY

The budget deficit increased sharply during fiscal year 1980, largely because of the decline in economic activity, to \$59.6 billion--more than double the fiscal year 1979 deficit (see Table 13). Growth in receipts slowed to 11.6 percent (from 15.9 percent in fiscal 1979), reflecting the weakness of the economy and the

TABLE 13. ACTUAL AND PROJECTED BUDGET TOTALS WITH CURRENT POLICY ASSUMPTIONS, FISCAL YEARS 1979-1982 (In billions of dollars, on a unified budget basis)

	1979 Actual	1980 Actual	1981		1982
			Second Budget Resolution	CBO Current Policy Estimate <u>a/</u>	CBO Current Policy Estimate <u>a/</u>
Revenues	465.9	520.0	605.0	599.1	670.0
Outlays	493.7	579.6	632.4	660.3	743.0
Percent change	9.5	17.4	9.1	13.9	12.5
Surplus or Deficit (-)	-27.7	-59.6	-27.4	-61.2	-73.0

a/ Current policy estimates assume a 10 percent reduction in personal income tax rates in July 1981, corporate income tax depreciation changes equivalent to those contained in the Senate Finance Committee bill (H.R. 5829), and a continuation of current spending programs adjusted for inflation.

delayed impact of the 1978 tax law changes on net personal income tax collections. Outlays increased by 17.4 percent, largely in response to higher inflation, unemployment, and interest rates.

Current Policy

In the Second Concurrent Resolution on the Budget for Fiscal Year 1981, the Congress adopted targets of \$632.4 billion for outlays and \$605.0 billion for revenues, with a resulting \$27.4 billion deficit. The resolution allowed for a net tax reduction amounting to \$10.1 billion in fiscal year 1981.