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**CABINET AFFAIRS STAFFING MEMORANDUM**

Date: 11/27/84 Number: 169095CA Due By: J

Subject: Cabinet Council on Economic Affairs Planning Meeting -

November 29, 1984 - 8:45 A.M. - Roosevelt Room - TOPIC: Financial Market Developments

	Action	FYI		Action	FYI
<b>ALL CABINET MEMBERS</b>	<input type="checkbox"/>	<input type="checkbox"/>	CEA	<input checked="" type="checkbox"/>	<input type="checkbox"/>
Vice President	<input checked="" type="checkbox"/>	<input type="checkbox"/>	CEQ	<input type="checkbox"/>	<input type="checkbox"/>
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Commerce	<input checked="" type="checkbox"/>	<input type="checkbox"/>	Deaver	<input type="checkbox"/>	<input checked="" type="checkbox"/>
Labor	<input checked="" type="checkbox"/>	<input type="checkbox"/>	Darman (For WH Staffing)	<input checked="" type="checkbox"/>	<input type="checkbox"/>
HHS	<input type="checkbox"/>	<input checked="" type="checkbox"/>	McFarlane	<input checked="" type="checkbox"/>	<input type="checkbox"/>
HUD	<input checked="" type="checkbox"/>	<input type="checkbox"/>	Svahn	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
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SBA	<input type="checkbox"/>	<input type="checkbox"/>	CCNRE	<input type="checkbox"/>	<input type="checkbox"/>

**REMARKS:**

There will be a Cabinet Council on Economic Affairs Planning Meeting on Thursday, November 29, 1984, at 8:45 A.M. in the Roosevelt Room.

The agenda and background papers are attached.

**RETURN TO:**

- Craig L. Fuller  
Assistant to the President  
for Cabinet Affairs
- Don Clarey
- Tom Gibson  
Associate Director  
Office of Cabinet Affairs
- Larry Herbolsheimer



THE WHITE HOUSE

WASHINGTON

November 27, 1984

MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

FROM: ROGER B. PORTER *RBP*

SUBJECT: Agenda and Papers for the November 29 Meeting

The agenda and papers for the November 29 meeting of the Cabinet Council on Economic Affairs are attached. The meeting is scheduled for 8:45 a.m. in the Roosevelt Room.

The Council will consider financial market developments and monetary policy. The Working Group on Financial Market Developments has prepared three papers for the Council's consideration.

The first, from Gregory Ballentine, concerns the economy and the budget. The paper discusses the effect of quarterly economic results on budget deficit estimates and briefly addresses the relationship between long-term deficits and the economy. A copy of his paper is attached.

The second, from William Poole, concerns general monetary policy. The paper discusses monetary decelerations and business cycle peaks, the reasons for procyclical money growth, the costs of interest rate targeting, and recent Federal Reserve policy. A copy of his paper is attached.

The third, from Beryl Sprinkel, concerns U.S. monetary policy and its effect on the domestic and international economies. The paper discusses the potential effect of current monetary growth on U.S. GNP growth, trade balance, and interest rates and its effect on economic growth in other countries, particularly in Europe and lesser developed countries. In addition, the paper discusses current market conditions and Federal Reserve policy. A copy of his paper is attached.

Attachments

THE WHITE HOUSE  
WASHINGTON

CABINET COUNCIL ON ECONOMIC AFFAIRS

November 29, 1984

8:45 a.m.

Roosevelt Room

AGENDA

1. Financial Market Developments (CM # 111)



EXECUTIVE OFFICE OF THE PRESIDENT  
OFFICE OF MANAGEMENT AND BUDGET  
WASHINGTON, D.C. 20503

November 27, 1984

MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

FROM: J. Gregory Ballentine *JGB*

SUBJECT: The Economy and the Budget

Quarterly Economic Results and Deficit Estimates

- o As part of the overview of the budget situation, alternative forecasts are frequently used to indicate possible deficit baselines.
- o These alternatives usually show that:
  - More optimistic forecasts can lower the deficit, but cannot reasonably be expected to eliminate it.
  - More pessimistic forecasts result in a growing current services deficit.
- o In contrast with such alternative five year forecasts, economic news for a given quarter has relatively little effect on the deficit.
  - Quarterly economic numbers are volatile; thus one quarter's good or bad news should not be used to change a long-term forecast.
  - Quarterly changes that do not alter the long-term forecast are not large enough to alter estimates of future deficits significantly.

Numerical Effects of Quarterly Economic News

- o On December 19, the Q4 GNP flash will be released. Further, at about that time we will have the actual interest rate and unemployment rate figures for most of Q4/84. Assume, for purposes of this memorandum only, that those figures are incorporated in the forecast for Q4/84 with no change in the growth rates or interest rates in the rest of the forecast (1985 - 1990).
- o If the flash real GNP growth is 2% lower in Q4 than what we forecast, receipts will be lowered by about the following amount:

(\$, billions)

<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1988</u>	<u>1989</u>	<u>1990</u>
4.2	4.8	5.2	5.6	6.3	6.8

- 2% lower real GNP for one quarter means about 0.5% lower GNP for a year. That translates into about \$19.5 billion to \$28.8 billion less GNP a year for 1985-1990. At the margin, about 25% of GNP is taxed.
- o If, in addition, the Q4 deflator is 0.5% below the forecast, this reduction in revenues is about 25% larger.
- o The outlay effects of such a reduction in real growth and inflation are slight.
  - A reduction in real growth may raise unemployment, raising U.I. outlays. If the unemployment rate rises by 0.3% in Q4/84--Q4/85, 0.29% in 1986, and 0.1% in 1987, then outlays rise by \$1.2 billion in 1985, \$1.0 billion in 1986, and \$0.5 billion in 1987.
  - The 0.5% reduction in the deflator, if it results in a corresponding reduction in the CPI, lowers COLA indexed outlays by the following amounts:

(\$, billions)

<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1988</u>	<u>1989</u>	<u>1990</u>
--	-0.2	-0.3	-0.4	-0.4	-0.4

- o Notice that an increase in the unemployment rate raises U.I. outlays only in the year the unemployment rate is increased. A one-quarter reduction in the deflator, however, raises outlays in all future years. (Assuming the deflator does not increase above forecast in a future quarter.)

- o Recently, more rapid growth than expected has been associated with interest rates above our forecast, and slower growth with interest rates below the forecast. If Q4/84 interest rates are 0.6% below the forecasted level (and then return to the forecast in Q1/85), outlays will be reduced as shown below. (These figures include the debt service cost of the revenue and outlay changes discussed above.)

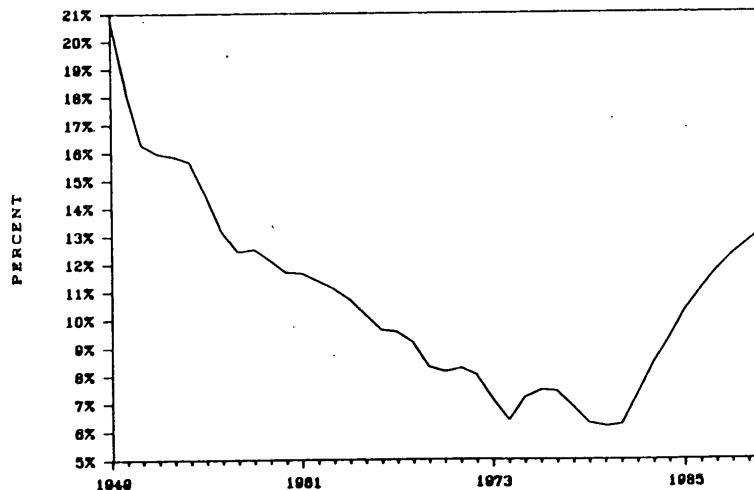
(\$, billions)

<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1988</u>	<u>1989</u>	<u>1990</u>
2.0	5.6	4.6	2.4	1.0	0.3

Long-term Deficits and the Economy

- o Until very recently, and in spite of persistent, though small, Federal deficits, the Federal budget has allowed a type of "crowding in" of real capital in the economy in almost every year.
- o This is because Federal debt held by the public has fallen as a share of total private wealth.

**FEDERAL LIABILITIES TO PRIVATE WORTH**



- o Federal debt is part of the total private wealth, but it is a kind of false wealth. Whereas corporate bonds, stocks, or other private financial instruments are ultimately backed by some real asset, Federal government bonds are not.
- o Consequently, while an individual holding \$100,000 in Federal debt has \$100,000 in wealth, society has no corresponding wealth. (Note that there is no link between Federal debt and holdings of real capital by the Federal government.)
- o Thus, for individuals, Federal government bonds are a substitute for other forms of wealth; forms that are backed by real assets. This substitutability is the essence of the crowding out phenomenon. For a given amount of private wealth, the more that is accounted for by Federal debt, the less will be our real capital stock.
- o As long as Federal debt grows less rapidly than total private wealth, there is a kind of crowding in that allows domestically owned real capital to grow faster than total wealth (i.e., faster than total saving causes wealth to grow).
- o This phenomenon allowed domestically owned real capital to grow approximately 25% faster than total wealth over the period 1949 to 1965, almost certainly contributing to the rapid growth in the 1960's.
- o In contrast, from 1965 to 1980 domestically owned real capital grew only 3.8% faster than total wealth.
- o For the first time since World War II, Federal debt relative to total wealth began a sustained rise in 1981.
- o As a result, the growth in domestically owned real capital will lag the growth in private wealth throughout the 1980's.



COUNCIL OF ECONOMIC ADVISERS

WASHINGTON, D. C. 20500

~~MARTIN FELDSTEIN, CHAIRMAN~~  
 WILLIAM A. NISKANEN  
 WILLIAM POOLE

November 27, 1984

MEMORANDUM FOR CABINET COUNCIL ON ECONOMIC AFFAIRS

FROM:

William Poole

*William Poole*

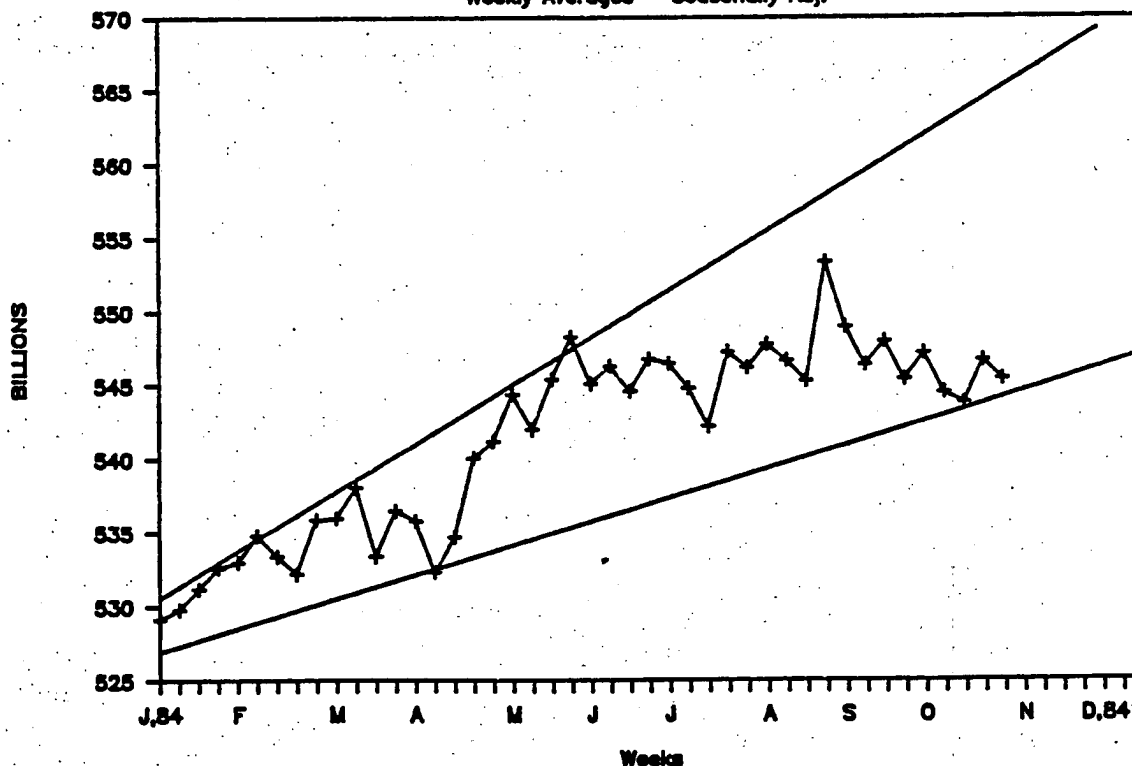
SUBJECT:

Monetary Policy

Last Friday the Federal Reserve reported that M1 declined by \$1.3 billion in the statement week ending November 12. The money stock is now slightly below its level last June. In June, M1 was at the upper side of the Fed's announced 4 - 8 percent target growth range; now M1 is only slightly above the lower side of the target range. The chart below shows what has happened.

M1 VS. TARGET RANGE

Weekly Averages - Seasonally Adj.



1984

Slow money growth and the obvious signs that at present the zip has gone out of the economic expansion have led some analysts--a distinct minority--to predict a recession next year. This prediction depends at least as much on forecasting Federal Reserve policy as on forecasting the economy's course under given policy assumptions. Nevertheless, almost all business cycle experts believe that continued zero money growth will make robust GNP growth in 1985 impossible.

Before taking up the question as to why recent money growth has been so slow, it is worth reviewing the long-term record to provide a better basis for assessing the risks to the economy of present monetary policy.

### Monetary Decelerations and Business Cycle Peaks

Evidence that sharp money stock decelerations are systematically associated with business cycle peaks is presented in the series of charts on the next few pages. The charts, which repay careful study, show monthly levels of M1 and M2 from 1907 to 1972 and M1 from 1970 through October 1984. (Monthly money stock data are not available prior to 1907). Business cycle peaks and troughs are indicated by vertical lines. The time trends in the charts show the "established" rate of money growth during the expansion phase of each business cycle; each of these established trends is extended forward into the contraction phase of the cycle.<sup>1</sup>

A careful study of these charts suggests the following generalization: at the business cycle peak, give or take a few months, the money stock is always observed to have fallen below its established growth trend by 3 to 4 percent. The regularity is striking. Over the whole history of the monthly money stock series there has never been a recession when money growth is rising.

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<sup>1</sup>The trends were determined using the same methodology for all expansions: the "established" trend is the highest 24-month growth trend, estimated through a least-squares regression, reached during an expansion. The charts for the period from 1907 to 1972 have been photocopied from a paper of mine published in The Journal of Finance in 1975. The charts showing M1 from 1970 to present have been drawn for this memorandum with the established trends determined as in my 1975 paper but using the present official definition of M1, which differs somewhat from the definition used in 1975. The World War I and II cycle peaks have been excluded for technical reasons.

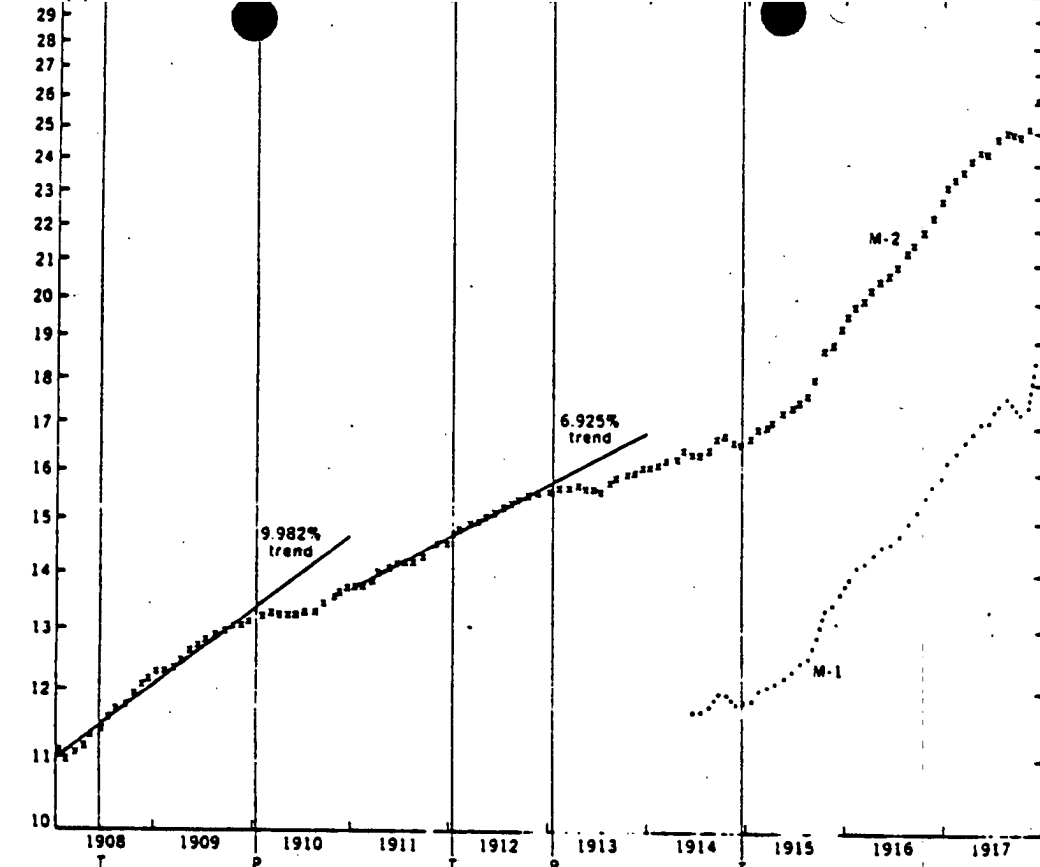


FIGURE 1  
Money Stock 1908-1972

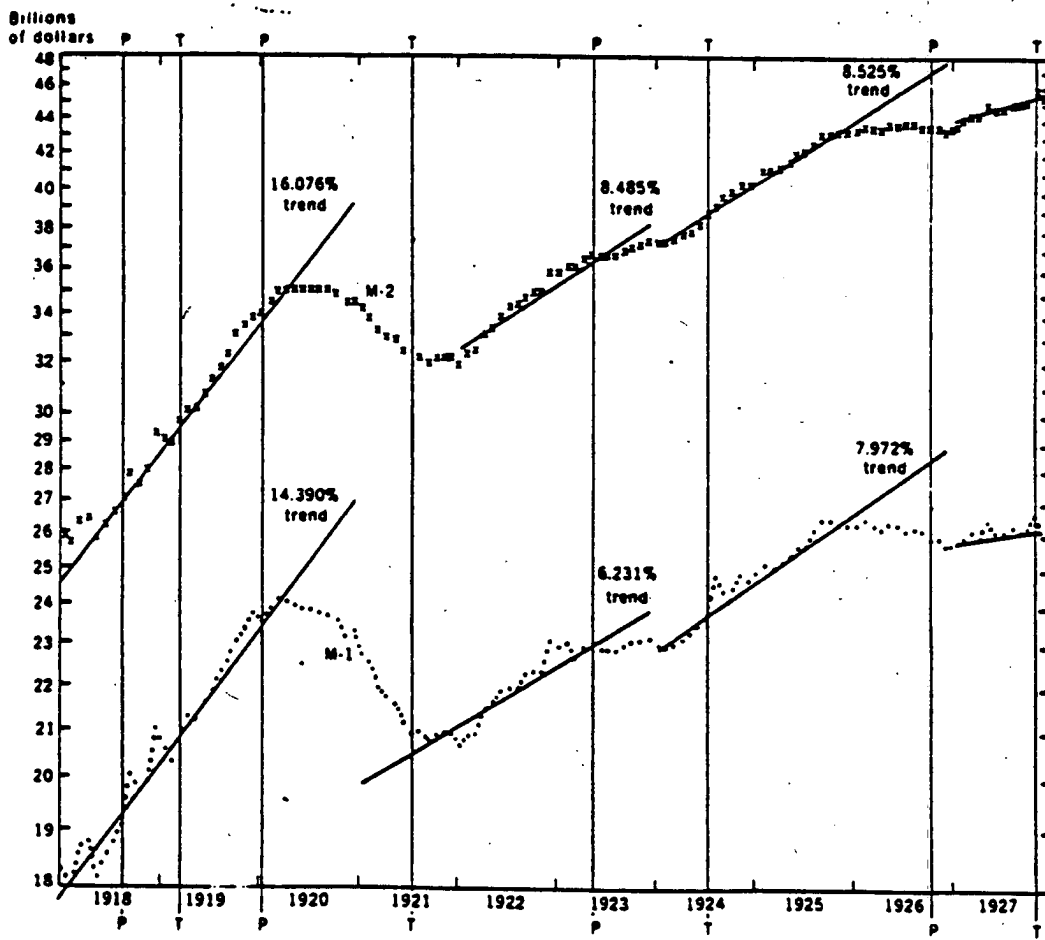


FIG. 1 (continued)

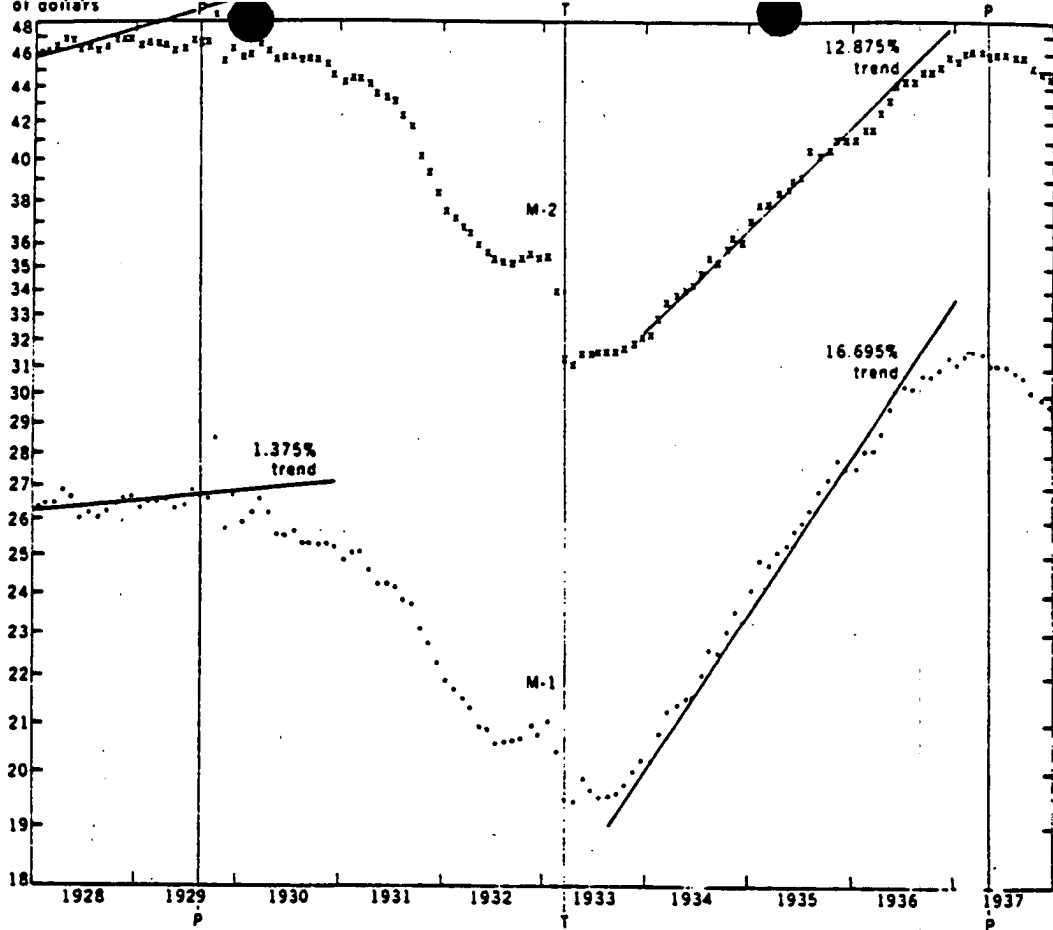


FIG. 1 (Continued)

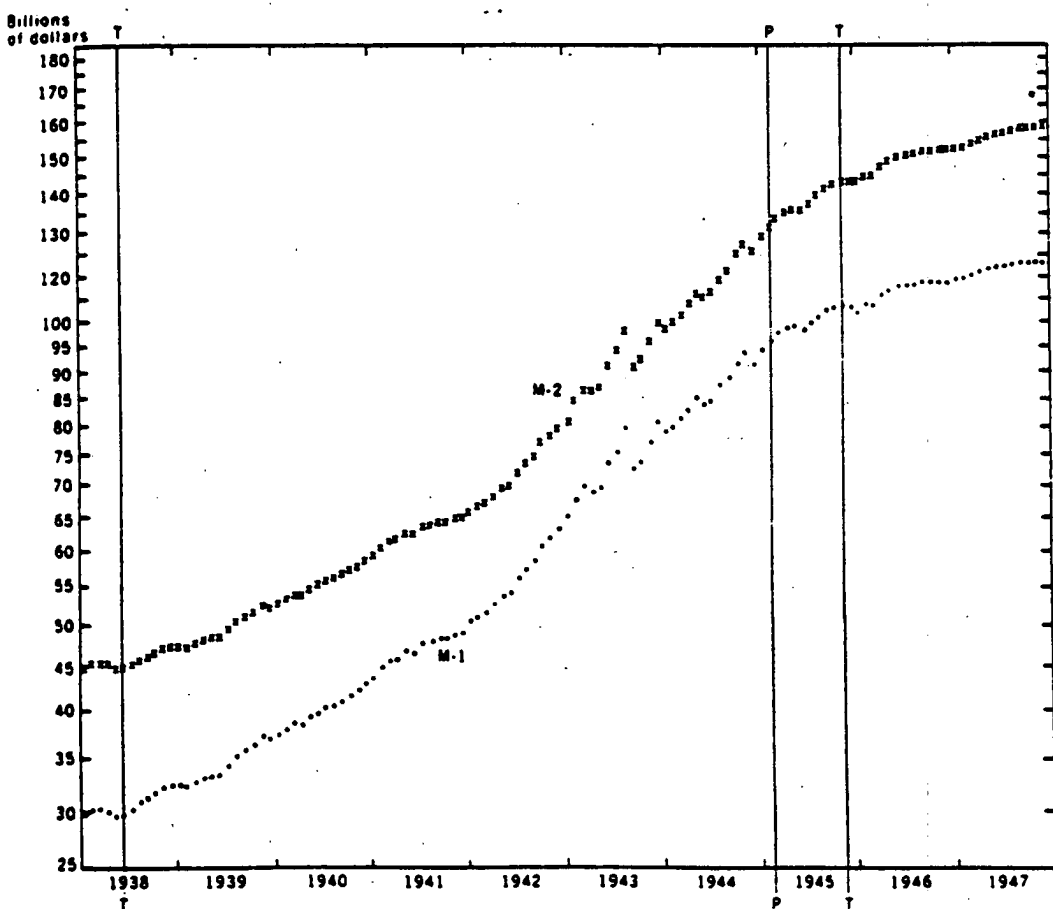


FIG. 1 (Continued)

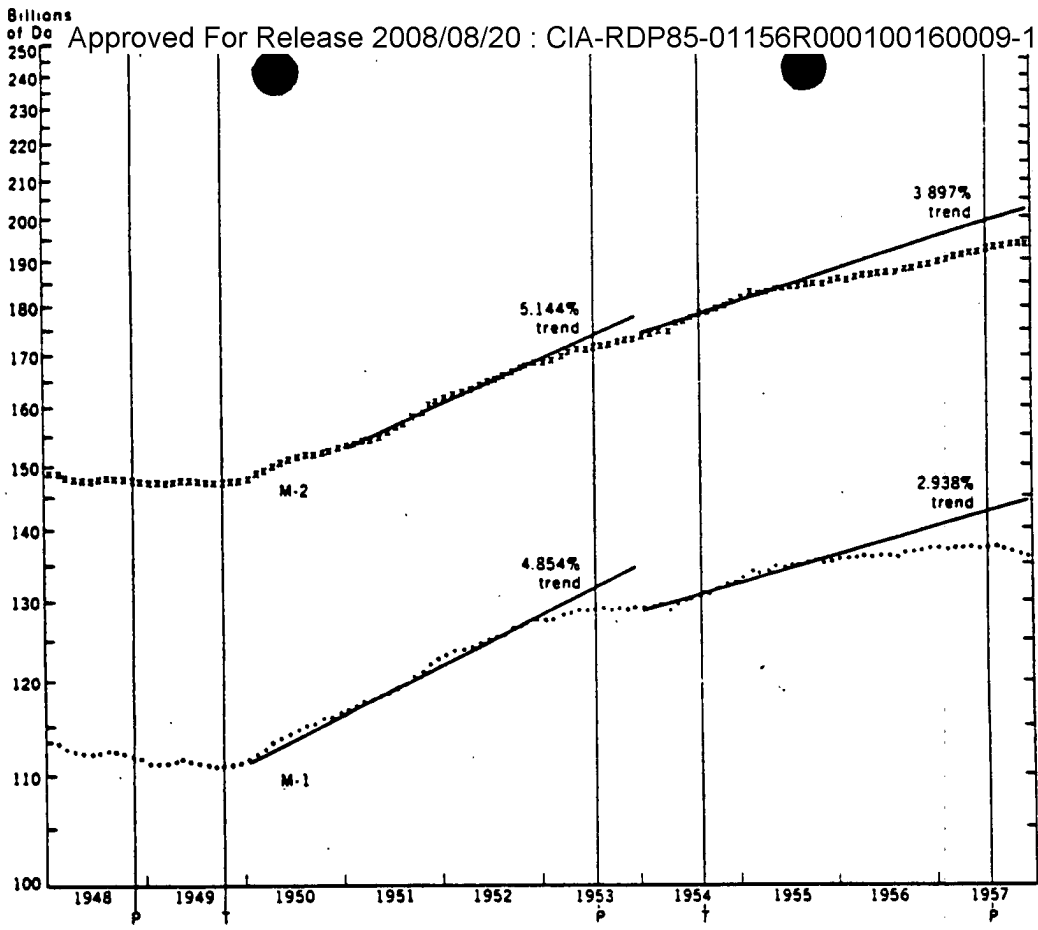


FIG. 1 (Continued)

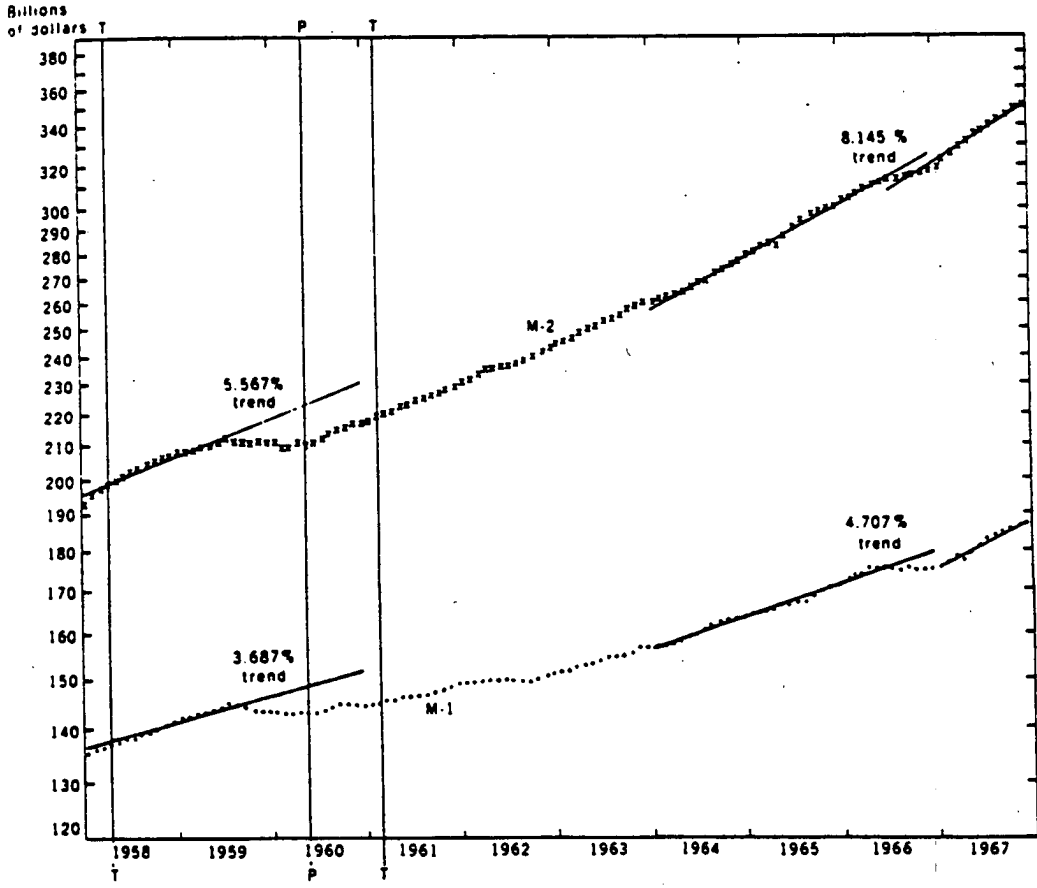


FIG. 1 (Continued)

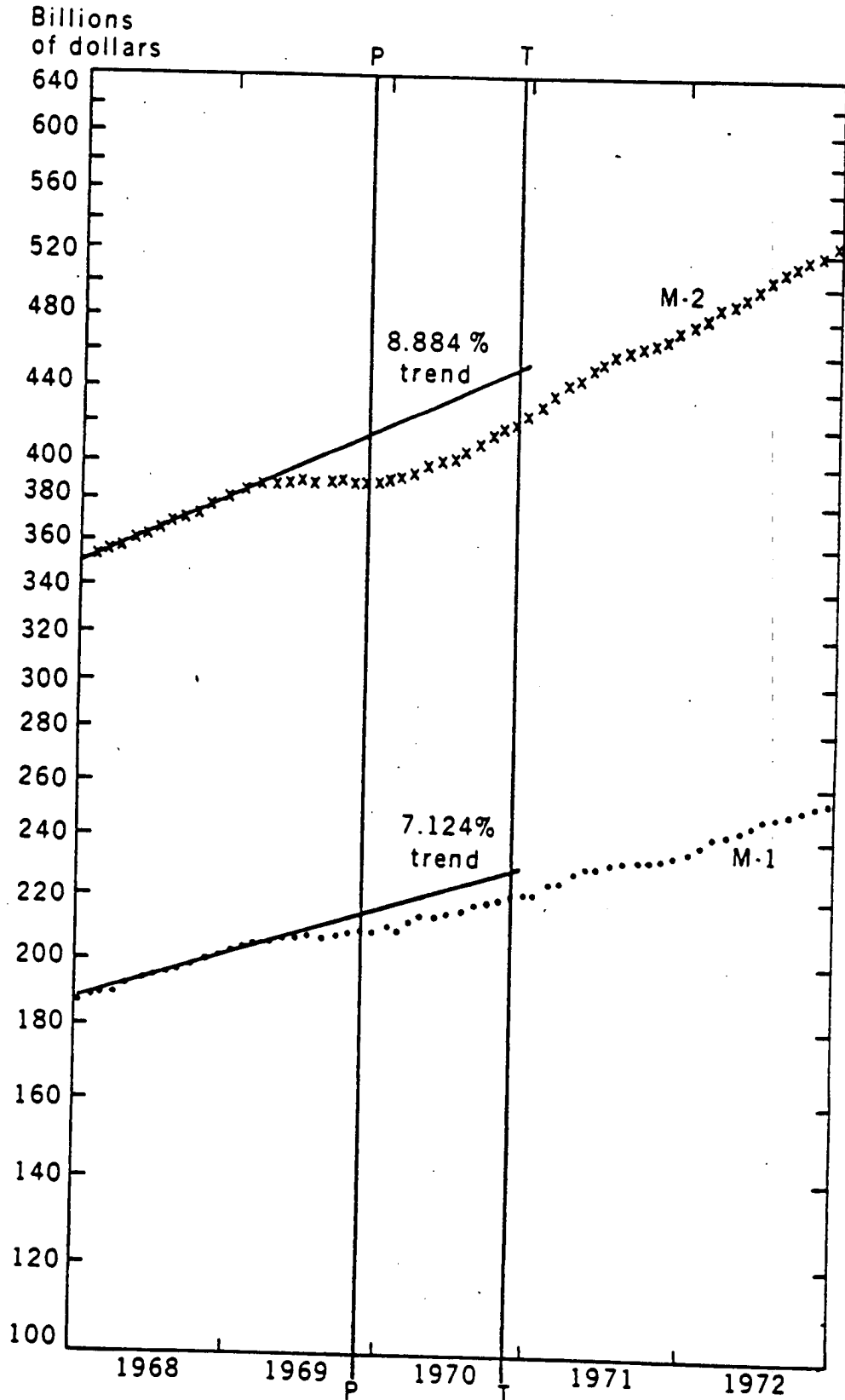
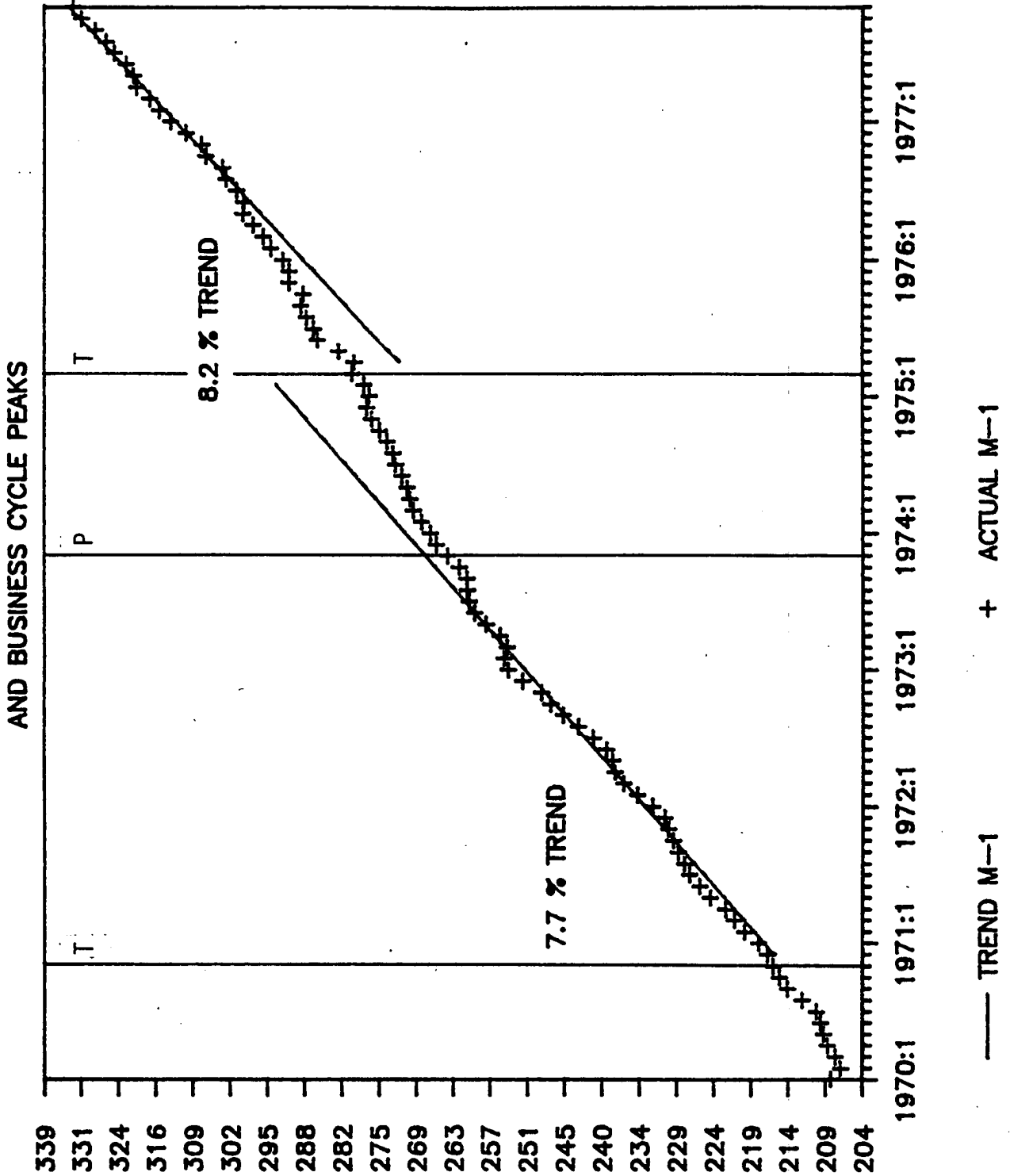
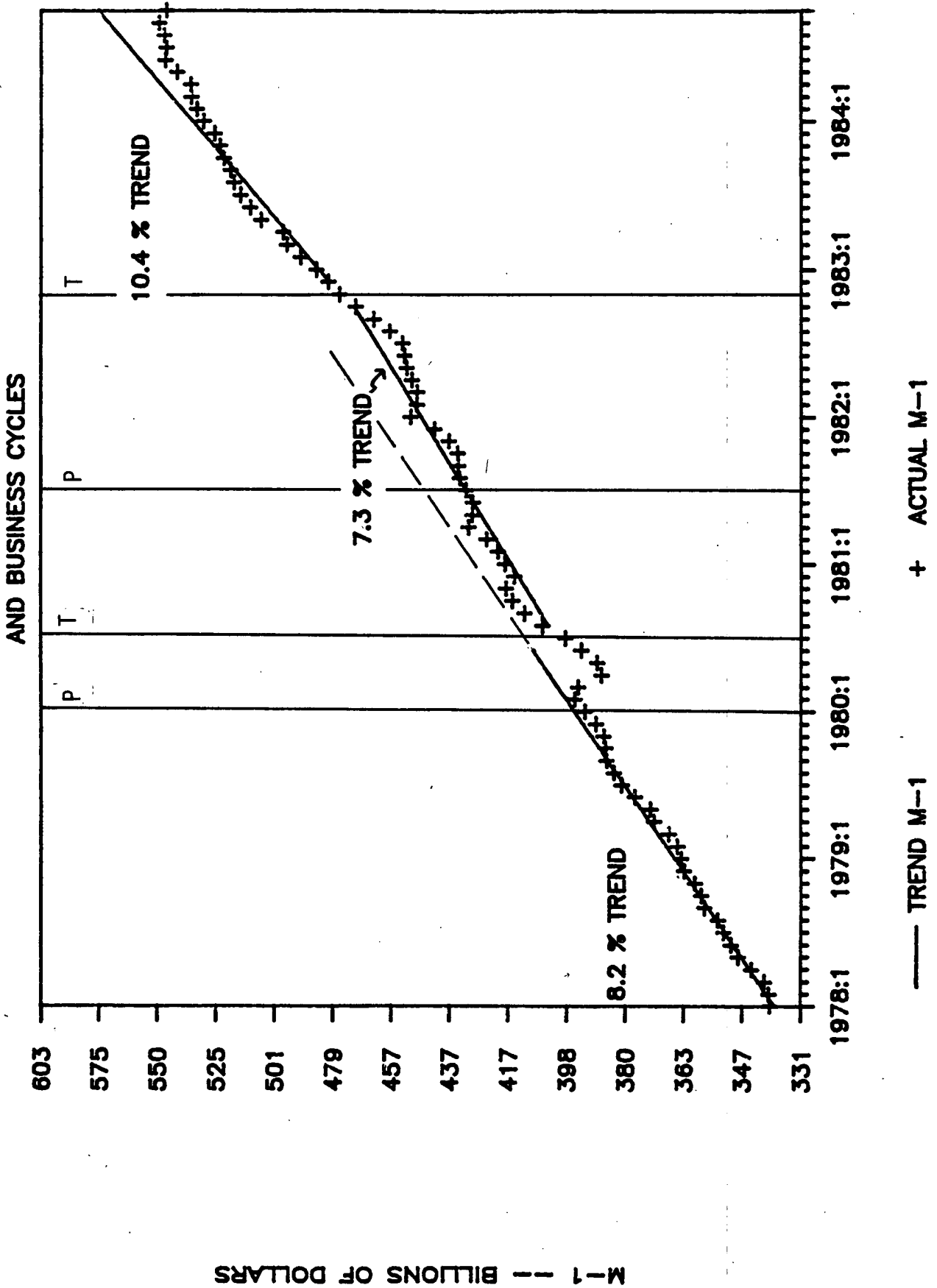


FIG. 1 (Continued)

# MONETARY DECELERATIONS AND BUSINESS CYCLE PEAKS



# MONETARY DECELERATIONS AND BUSINESS CYCLES





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The 1973-75 recession experience is quite typical of the historical regularity. The downturn in M1 growth preceding the November 1973 cycle peak is clearly evident in the chart as is the slower money growth during the subsequent contraction. However, the evidence for the case of the January 1980 cyclical peak is less clear. The money stock had not dropped significantly below its established trend at the time of this cycle peak. It seems likely that the unexpected imposition of credit controls in March 1980 brought about a recession sooner than would have developed naturally; after the fact, the NBER chose January as the cycle peak month. In any event, money growth declined sharply after the cycle peak as the recession developed; needless to say, declining money growth as the recession took hold was hardly a constructive development.

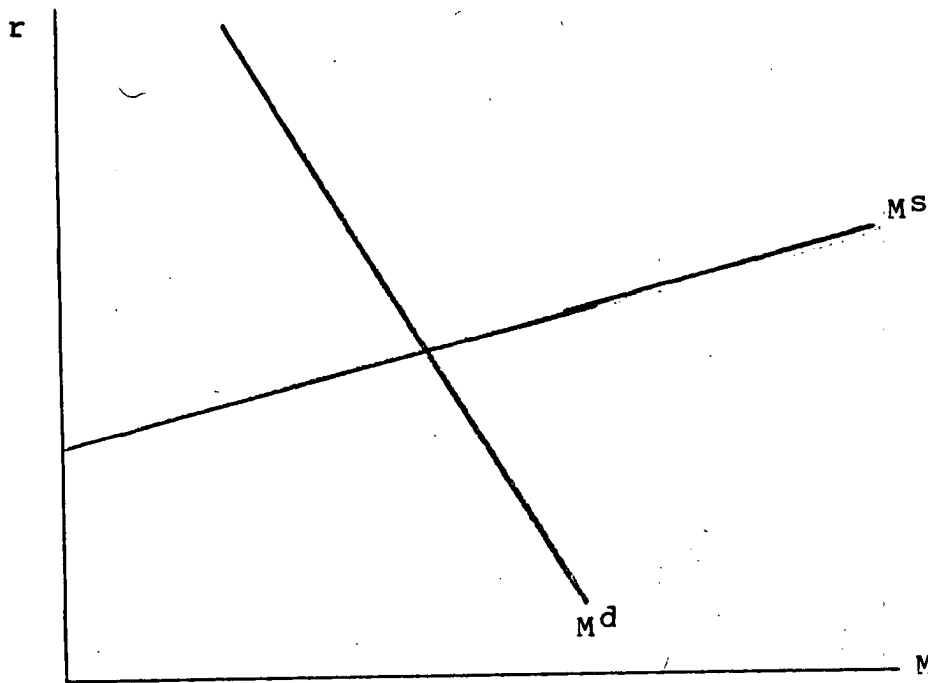
A problem arises in interpreting the role of monetary policy in the 1981-82 recession. If that recession is taken as an episode separate from the previous cycle, then M1 never fell much below the established 7.3 percent trend growth shown in the chart. On the other hand, if the previous trend line is extrapolated out to the cyclical peak in July 1981, as shown by the dashed trend, then the decline in the money stock below its established trend once again seems to precede the peak.

#### Why Money Growth is Procyclical

The proximate explanation of procyclical money growth is that the money creation mechanism under the Federal Reserve (and before the establishment of the Federal Reserve as well) tends to produce rising money growth when interest rates are rising and falling money growth when interest rates are falling. This relationship is the normal everyday one; it dominates the outcome unless the Federal Reserve takes vigorous action to overcome the normal pattern.

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The Federal Reserve's monetary policy procedure can be described with the aid of the simple diagram below.



The short-term interest rate is on the vertical axis and the money stock on the horizontal axis. Since the diagram is meant to describe short-run nominal money stock determination, the general price level is taken as predetermined or at best only slowly adjusting.

The downward sloping money demand curve shows the quantity of money balances the public desires to hold at a given interest rate. At a lower interest rate the opportunity cost of holding money is lower in terms of the foregone money market yield, and so the public desires to hold larger money balances. As GNP grows the transaction demand for money grows and so the money demand curve shifts rightward. Likewise, as GNP falls during recessions, the demand curve shifts leftward because the public wants to hold less money.

The Fed's money supply curve is also shown in the diagram. The supply curve is drawn as nearly horizontal because week by week the Fed is ordinarily willing to supply vastly different quantities of money at only slightly

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different interest rates. Or to put it differently, through conscious design the Fed implements monetary policy in the short run by targeting the federal funds rate and other short-term interest rates in a relatively narrow range. The Fed does not literally peg interest rates but cushions pressures for rates to move. The Fed cushions rate pressures by adding or draining bank reserves from the economy so that the stock of money changes more or less dollar for dollar as the public's demand for money changes at the targeted interest rate. By targeting interest rates, the Fed gives up control over the money stock.

### The Cost of Interest Rate Targeting

By targeting interest rates, the Fed can temporarily smooth rates against various disturbances. If these disturbances are rapidly self reversing, then Fed interest rate smoothing would have little cost and perhaps significant benefit. However, with interest rate targeting the Fed creates significant risk for the economy because some interest rate changes serve the valuable function of helping to stabilize output, employment and the price level. Unfortunately, it seems impossible to smooth temporary interest rate disturbances while permitting fundamental rate adjustments because neither the Fed nor anyone else can contemporaneously sort out interest rate changes that are temporary and self-reversing from those that are needed to stabilize the economy.

The two most important persistent and destabilizing disturbances to the economy involve, on the one hand, adjustments upward or downward in inflation and anticipated inflation and, on the other hand, weaknesses in aggregate demand that can cause a slide into recession. An example of the first risk is the late 1970s situation: when inflation got out of hand in 1978-79, the Fed finally recognized that it had to let interest rates rise substantially to bring money growth and inflation under control. An example of the second risk is staring us in the face today.

Real GNP growth has declined recently. A decline in interest rates as business activity levels off would automatically raise incentives for spending on investment and consumer durables and thereby help to stabilize the economy. Perhaps all that is necessary to keep the present noninflationary recovery going is a temporary drop in rates. By interest rate smoothing, the Fed is resisting the downward pressures on rates as the economy weakens. If rates are kept too high, temporarily reduced real growth in the third quarter could turn into the cumulative weakness that characterizes recessions.

Recent Federal Reserve Policy

There is considerable evidence that the Fed is responsible for the recent flat M1 growth through its standard policy of attempting to smooth interest rates. After moving fairly aggressively in the spring and early summer to constrain money growth, the Fed seems thereafter, until last week, to have pursued its standard passive policy of cushioning interest rate changes. At the end of the summer the market appeared to be bringing the T-bill rate down ahead of the Fed-controlled federal funds rate. The evidence that the market is leading the Fed was particularly strong in early November as the market pulled the T-bill rate down while the Fed permitted the funds rate to rise

If the Fed, by draining bank reserves, were preventing the funds rate from falling as fast and far as the market wants, the evidence should be in the reserve numbers. It is. Last June total bank reserves averaged \$38.3 billion, compared to 38.1 in September. Moreover, total reserves fell further in October and early November, to \$37.6 billion in the statement period ending November 7. The Fed is simply not providing the reserves growth necessary to support a growing money stock.

Early this year I argued that money growth in the upper half of the Fed's target range of 4 - 8 percent was appropriate. In June M1 was only slightly below the 8 percent track. Given the present developing slowdown in the economy it seems clear that we would have been better off if the money stock had remained in the upper half of the target range.

The established trend rate of money growth so far during this expansion, at 10.4 percent, is much too high to be an appropriate target for the future. From the abnormal behavior of velocity in 1982-83, and other information, part of that 10.4 percent established trend should be discounted, but there is no way to be sure how much. I had arrived at my 6 - 8 percent M1 growth recommendation from discounting 3 - 4 percentage points of the money growth from mid 1982 to mid 1983, and then balancing the risk of rekindling inflation against the risk that an excessively sharp deceleration of money growth might lead to recession.

My intuition about these matters should be of less interest than the fact that no one--monetarist, Keynesian, or whatever--would last June have recommended essentially zero money growth for five months as the economy weakened. As has happened so often in the past, week-by-week concern over interest rates has led to an unplanned, unwanted, and undesirable evolution of the money stock.

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Where do we go from here? First, I doubt that near zero money growth has continued long enough to seal in a recession. However, the odds on a recession are increasing substantially with every passing month of very low money growth. A quick resumption of moderate money growth is essential. I believe that a 5 - 7 percent M1 growth target range is appropriate.

Second, the apparent turn to an easier monetary policy with the cut in the discount rate last week provides absolutely no assurance whatsoever that money growth will resume. There is no way for us to know, or for the Fed to know, whether Fed interest rate targets are falling fast enough to assure a resumption of money growth. In terms of the diagram on page 10 above, if the economy is weaker than we now expect, the public's demand for money curve will be shifting to the left. If the Fed does not shift its money supply curve--interest rate target--down and out rapidly enough, money growth will remain low. We must focus on Fed creation of bank reserves and not on interest rates. Fortunately, in the statement period ending November 21 total bank reserves were up by \$700 million. Reserves growth must continue if money growth is to resume. The Fed can control reserves growth accurately if it lets go of interest rates.

Third, over the longer run there is no reason to believe that we will see smooth money growth within the target range. Indeed, there is every reason to believe that money growth will continue to be volatile. Nothing in the record over the last decade provides good reason to be optimistic on this matter. Concentration on interest rates will assure this outcome in the future as it has in the past. An improvement in monetary policy, both for next year and the long run, will require that this fixation on interest rates be abandoned.

#### Policy Implications: A Summary

1) Although interest rate smoothing may at times be advantageous, at times like these it is particularly destabilizing. If we are approaching a potential cyclical peak, a major side effect of interest rate smoothing is to increase the risk of recession. Given the historical evidence that major decelerations in money growth are associated with cyclical turning points, the Fed should abandon interest rate targeting and concentrate on stabilizing M1 growth.

2) From 1965 until 1979, concern for unemployment led society to be slow to constrain money growth. Now the situation is reversed and the Fed must not let concern over

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a potential acceleration of inflation lead to excessively slow money growth.

3) Concern over inflation ought not to be expressed in terms of advocacy of a monetary policy of maintaining high interest rates. Low inflation will yield low nominal interest rates. A policy of excessively high interest rates can only yield recession. How can we know when interest rates are "excessively" high? The safest standard is the money growth rate. Our position should be that we expect the Fed to achieve moderate and steady money growth within announced target ranges.