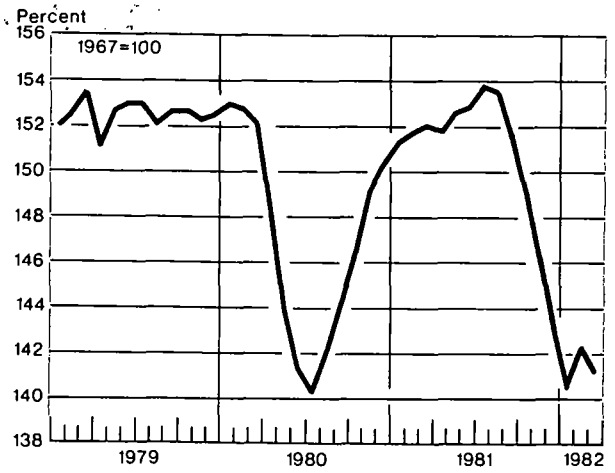
Current economic developments

Business activity declined further in the first quarter, and inflationary pressures continued to subside. Interest rates, which had backed up near the end of the year, continued to rise in January and did not change significantly through the balance of the quarter. Looking ahead, two main factors are widely cited to support a view that a turnaround in economic activity will begin by the second half of the year First, inventory liquidation appears to be winding down Also, disposable incomes will receive a large boost in July from a 7 4 percent increase in social security payments and a 10 percent reduction of income taxes. Nevertheless, many believe that whether the economy can sustain a recovery for an extended period of time may depend in large measure on the future course of interest rates Despite the improvement in the inflation outlook and the weakness in the economy, concerns continued that rates would remain high, in part because of the Federal budget outlook

Chart 1

Industrial Production



Sources Board of Governors of the Federal Reserve System and United States Department of Labor, Bureau of Labor Statistics

Inventories and the first-quarter decline in GNP

In each of the recessions in the postwar period, inventory liquidation has been the primary factor in the decline of gross national product (GNP) in at least one of the quarters during the recession Completion of the liquidation has generally occurred near the turning point in economic activity According to preliminary estimates, real GNP declined in the first quarter at an annual rate of about 4 percent. Industrial production plunged in January, as severe weather conditions interfered with production schedules, and fell back again in March (Chart 1) This decline in production

facilitated a large runoff of inventories. According to preliminary estimates by the Department of Commerce, a drop in business inventories of $17.5 billion, by itself, more than accounts for the estimated decline in real GNP in the first quarter.

If the inventory adjustment is nearly over, it will remove a large negative factor from the measured change in GNP and may set the stage for a recovery in the second half of the year. Evidence is mounting that the auto inventory adjustment is about over. Stocks changed little in March. However, retail sales (excluding autos) were weak throughout the quarter, declining by approximately 4 percent in real terms. This casts some doubt on whether the inventory correction in the nonauto sectors has been completed as of yet, although the rate of decline should be more moderate in any event. In fact, even if the reduction of stocks were to continue but at a slower rate, it would represent a positive contribution to GNP growth.

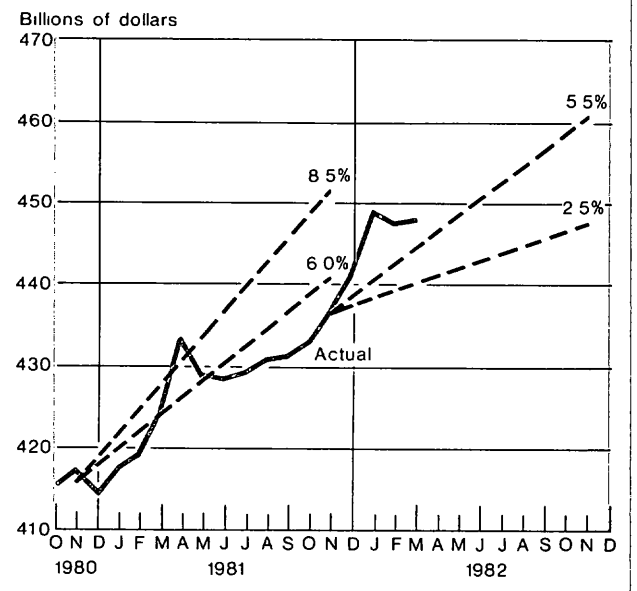
The persistence of high interest rates: January money growth and budget deficit projections

The prospects for a strong and sustained recovery that will last more than a few quarters depends on a number of factors, ranging from energy prices to business and consumer response to the recent tax cut. One of the most important factors is the future course of interest rates. Despite weakness in the economy and a decline in the inflation rate, nominal interest rates increased early in the quarter and remained high throughout. An important backdrop to the run-up in short-term rates early in the quarter was a surge in the growth of the money stock in December and January. In these two months, M-1 grew at an annual rate of about 16½ percent and, by the end of January, was well above the upper bound of the target range (Chart 2). In February and March, M-1 declined slightly on balance. This helped alleviate some of the fears of a further rise in rates, although as the quarter ended the markets began to focus on the prospects of a surge in money growth in April.

Another sustaining factor for high interest rates, especially in the intermediate- and long-term maturity areas, has been market concern over the Federal budget outlook. The President's February budget proposal, as anticipated, forecast a $100 billion deficit for 1982. However, for 1983 and 1984, the enactment of deficit-reduction measures of $56 billion and $84 billion would, according to the budget proposal, reduce the deficits to only about $90 billion and $80 billion, respectively. Subsequent analysis by the Congressional Budget Office (CBO) and others suggested that, on the basis of technical inaccuracies alone, even these deficit figures might be understated by $25 billion for 1983 and $35 billion to $45 billion for 1984, and less optimistic economic assumptions would raise the number even further.[1] It has now become clear that, without additional spending cuts and tax increases like those contained in the President's budget or those proposed by others, the markets could be faced with financing a 1983 deficit in excess of $180 billion and a 1984 deficit of at least $220 billion.

Chart 2

M-1: Levels and Targets



Source Board of Governors of the Federal Reserve System

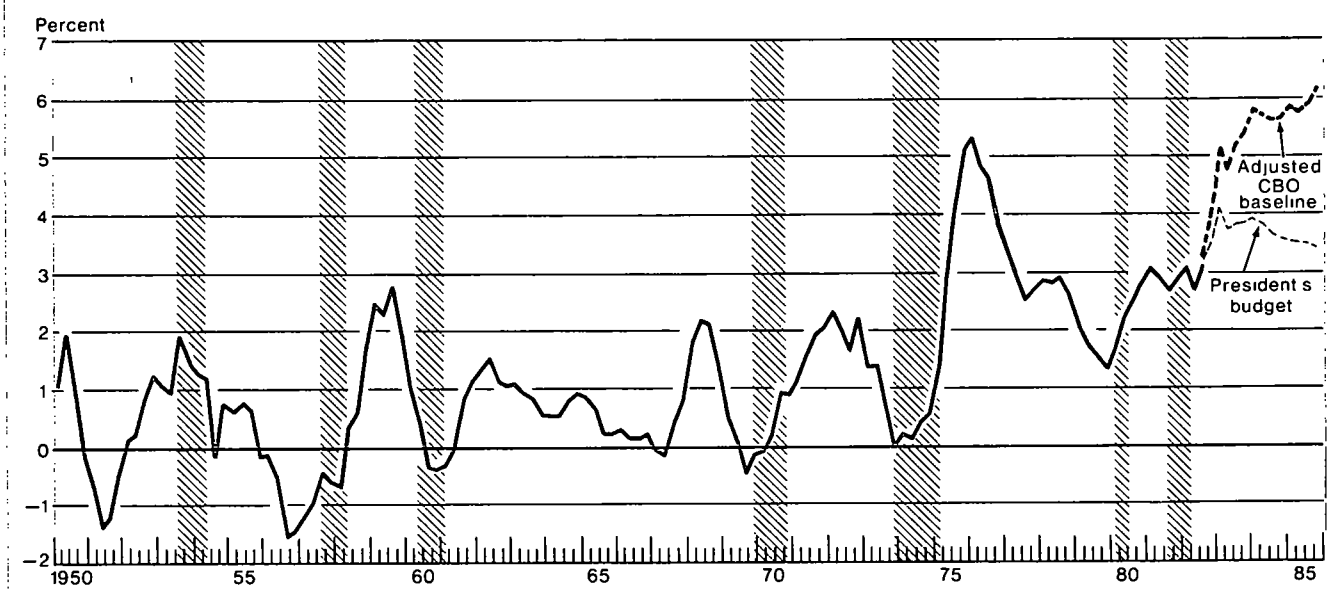
Assuming an end to the recession by the second half of this year, an increase in the deficit in fiscal 1983 during the first year of recovery would not be without precedent. In five of six recessions in the postwar period, the deficit as a percentage of GNP peaked after the end of the recession (Chart 3):

- Some tax payments, such as corporate and individual income tax *final* payments, are lagged and, in contrast to withheld taxes, show their greatest response to a recession in the year following the resumption of economic growth.

[1] See "An Analysis of the President's Budgetary Proposals for Fiscal Year 1983", Congressional Budget Office (February 1982) and statement of James R Capra before the Senate Committee on the Budget (March 5, 1982)

Chart 3

The Government Deficit as a Percentage of GNP



Shaded areas represent periods of recession, as defined by the National Bureau of Economic Research

Source Congressional Budget Office, An Analysis of the President's Budgetary Proposals for Fiscal Year 1983

- Also fiscal stimulus, in the form of tax cuts or discretionary spending increases has usually been put into place just before or slightly after the resumption of real growth and continues to affect the budget figures for some time afterward. This factor appears to be part of the fiscal outlook for 1983. For example, the July cut in individual income taxes will result in an increase in fiscal stimulus, more than offsetting the net spending cuts enacted to date.

In the past, the deficit as a percentage of GNP generally continued to rise until real GNP reached its pre-recession peak What is different this time is that well into what is supposed to be a recovery period (1984 and 1985) the deficit could continue to rise both in absolute terms and as a percentage of GNP (as shown by the adjusted CBO baseline in Chart 3) [2] At best, the deficit would rise in absolute terms and decline only slightly as a percentage of GNP (as shown by the President's budget) It is this pattern that has been cited by market participants as an important factor sustaining the high level of interest rates. An inability of the Congress and the Administration to enact changes that would significantly cut the size of the 1983 deficit is not necessarily viewed as an important problem for 1983 *per se* as it is a signal that the figures for 1984 and 1985 in Chart 3 may become a reality

[2] The CBO baseline is a budget projection that shows what the budget would look like with no changes in the laws and policies in effect at the end of calendar year 1981 For the purposes of analysis, an adjustment has been made to the baseline to make it reflect the real growth of defense in the Administration's budget proposal

The Government deficit and interest rates

The prospects of large budget deficits in the future may be affecting both the real and inflation components of nominal interest rates Measured against either the current inflation rate or a short-run forecast of the inflation rate, real interest rates have been at a postwar high—between 6 and 8 percent when measured on a basis unadjusted for taxes High budget deficits, combined with a Federal Reserve policy of not accommodating such deficits, are generally considered to affect not only short-term rates but more importantly also the longer maturities The reason for this is that, despite a potential rise in personal and business saving rates as a result of the tax cut, the quantum jump in the deficit

over the next few years would, on balance, result in a smaller share of savings being available for private borrowers. However, assuming the economy sustains some kind of recovery (in part because of stimulative fiscal policies), private credit demands are expected to increase. A confrontation between rising private credit demands and a reduced availability of savings for private investment would mean continued high real interest rates in the future. The credibility of the Federal Reserve's commitment to its money growth targets is critical to this line of reasoning. Expectations are said to be keeping real rates in the longer maturities high right now, precisely because the market believes the Federal Reserve will not cushion the effects of the future deficits on funds availability by absorbing significant amounts of Government debt. A reinforcing effect is that the expected high real rates also may add to risk premiums because of the fear of the financial failure of corporations that are forced to borrow at high rates both now and in the future.

The deficit also might be affecting that part of current nominal interest rates related to inflation expectations. Although current inflation rates are low, the inflation component of interest rates is actually comprised of market participants' expectations about future inflation. Some analysts suggest that the market foresees higher inflation because large deficits could generate irresistable pressure on the Federal Reserve to accelerate money growth with an accompanying increase in inflation and inflationary expectations. A competing explanation is that market participants believe that large deficits during an economic recovery are inherently inflationary, irrespective of what the Federal Reserve is doing.

Although projections of future deficits may be an important reason for the current high level of rates, there are limits to how fast or by how much interest rates would decline if projections of future budget deficits were reduced. First, the fiscal outlook is not the only factor holding up interest rates. For example, for long-term rates, it is possible that, even in the absence of the deficit problem, there would be considerable market skepticism about the likelihood of a longer term slowing of inflation, given the record of progressively higher upward ratchets of inflation after temporary improvements over the past fifteen years and the accompanying deterioration of the long-term bond market. This may limit somewhat the size of the reductions of long- and intermediate-term rates that would result from enactment of a deficit-reduction program. In addition, Federal outlays have been consistently underestimated and Congressional and Administration budget targets have been far from the mark over the past few years.[3] Consequently, it may take some time and possibly even some actual experience with lower Treasury borrowing to counteract market skepticism about the ultimate effects of an agreed-upon set of deficit-reduction targets.

[3] In testimony before the House Budget Committee on March 16, 1982, Henry Kaufman, citing previous overruns of budget resolution targets, suggested that it would take more than enactment of Congressional budget resolution targets to convince the financial markets that the outlook for the deficit had been improved substantially

James R Capra