100B, W·81: Mtrls Start Search

I clear.

Ch. 3, Mult.

b) Picture a high. panic. – spiral.

Now picture upward spiral.

" " " " stopping short, +

they ask why?

In criticizing, note ~~key~~ cautionary role of cons. But in a lig. panic, ~~key factor~~ cautn. factor is higher cost of holding IC, + this cd. not come from ~~int~~ low C.

Likewise, upswing comes from higher prop. to hold IC, (new K).

---

1. p. 35 "Y" may mean GNP, NNP, or NI, no matter.
2. p. 35 Caps. are in current $; l.c. refer to real amts. or deflated. Thus, $Y = P \cdot y$

$$y = Y/P$$

where P is price index.

a) 3. Chaps. 3-5 look at demand as controlling, & then w. fixed P. introduce P as a variable. But empl. is always locked to output. No factor substn.

4. Goes into l.c. notation – w ? should. But all same at first

c) 5. B + h are vague, hence confusing, re what ~~it~~ they mean – cf. ±I.

i (inv.) is net of disinv. (or paybacks). There is always a huge churning + turnover of inv. – paybacks.

i is only net outlay above ~~the~~ recoveries.

We can Δ both the income & product sides of eqn. by treating recovery as $\S_s$ & reinv. as part of the i.

We can Δ by varying amt. "& &" depending on how much recovery & reinv. we treat.

The custom is to single out one part of "& & &": depreciation of durable K: & new durable K.
The bulk of & & & is sale of goods & replmt. This gets hidden. Decisions here are made to look as tho $c \to i$, w/o any use of K. In fact, autonomous decisions here are made by investors.

Altho we talk of det'g y, actually the controlling role is gross durable inv. Data are available on gross durable inv. Savg then includes depreciation.

But suppose inv. shifts from durable to "current" K. Data will show a drop, when actually things are going to rev up. Leads to error, esply since i has so much leverage, drives the final model.

Anyway, bes. of this, is accurate to think of Ch. 3 as referring to GNP, not NI. So think of $y \equiv$ GNP

6. "Product" ~~(actually~~ side of accts. creates inc; (in the model). Inc. side disposes of inc.

~~C & I & G~~ $c + i \to y \to c + s$

The product side is missed by spending; + spending drives the model. ~~An identity is changed to an assumption about causation.~~

The appearance of C on both sides gives model what appears first a) definitional, acctg.
b) circular
c) leveraged

quality.

7. $s = i$ by defn.

d) 8. $\bar{i}$ ≡ intended inv.

$\Delta inv \equiv un$ " " (in "invy." they say)

$i = \bar{i} + \Delta inv.$

This converts acctg. identity into eq. cond.
(Eq. cond. is, $\Delta inv. = 0$) ($i = \bar{i}$)
Try + fail; + try, + fail; etc.

9. p. 37, ~~begin~~ ~~it~~ introduce a misleading ass: system changes ~~y~~ ~~this~~ bcs, "consumers" (i.e. everyone) decide to save less, consume more.

This is unlikely. Savg prefs. are stable. Inv. choices are ~~slight~~ changeable. A change usually comes from desire to change stocks.

10. Increased inv. is going to occur not just bcs. K-ists desire to Δ stocks; but also if they anticip. Δ sales bcs. of nature of past invts.

They anticip. replmt. needs, + funds therefrom. This occurs when past higher cc. have pushed them into quicker K.

They then inv. more; + Δ Y, so all consume more. No need here for attempt at Δ stocks. Same not inv., maybe zero. Higher gross invs.

In the model, there is no place for this, except Δ C. So it is attributed to higher C.

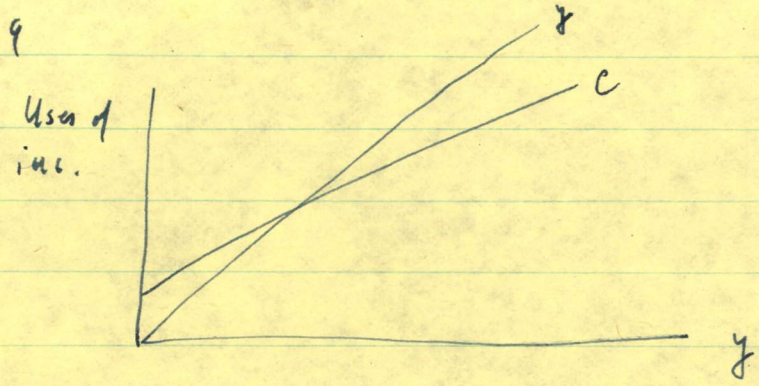
11. Model might allow for unanticip. S, too. A sudden, unexpected Δ Y might just Δ S, no need for disinv. Depends on who gets the Y. Hungry unempl. might cons. more.

12. $c' \equiv$ mpc

$s' \equiv$ mps

$t' \equiv$ mgnl. % to taxes.

17. p. 39



(B+L put in taxes from start. I will ignore. They are like S; G is like inv. Add later.

B+L treat them the same as C & E bcs. they are solely concerned w. spending. W.r.t. spending, they are alike. But otherwise, are very different:

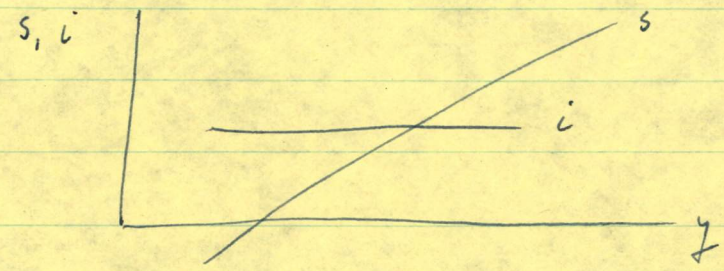
— involuntary
— reduce incentives (wedge effect)
(services not sold)
— no investor is involved usually, or K stock

The parallel treatment implies that $g > t$ raises y until $t = g$. Hiring more people to give free services, or do nothing, has same effect as hiring people to produce saleable goods. (Hard to buy that idea.)

(They even call $s + t \equiv$ "total social saving"! That is really ~~bullpoo~~ a corruption of language!)

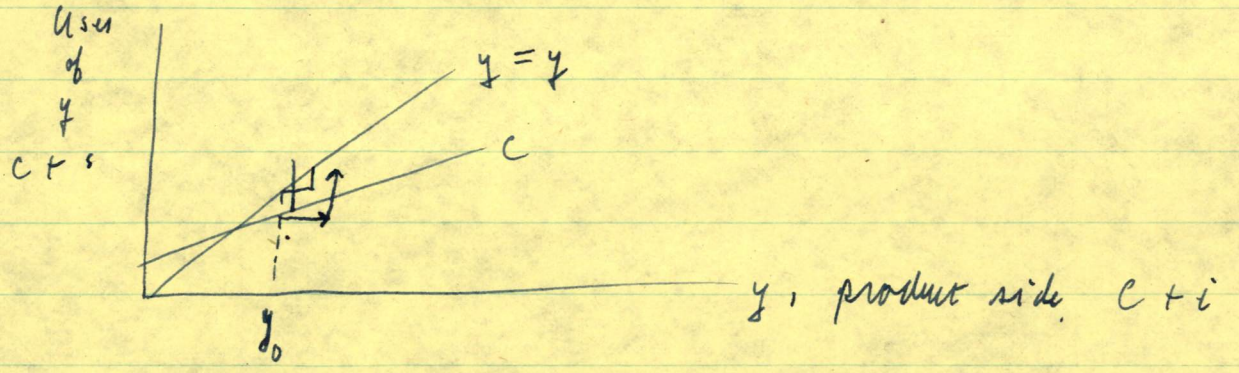
14.

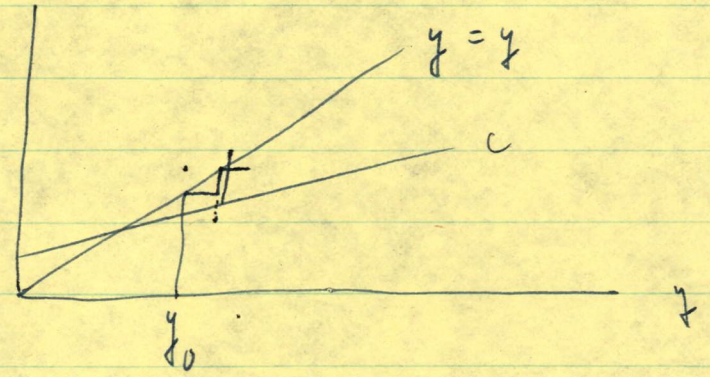
p. 42,



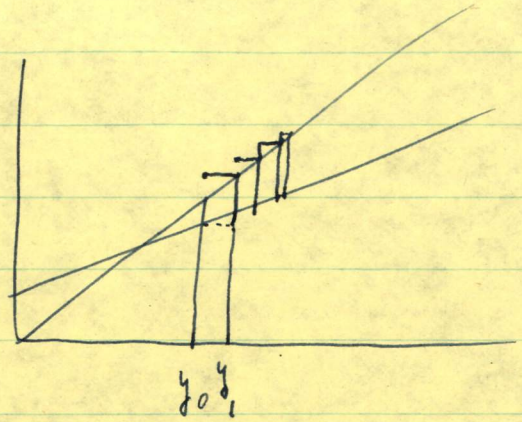
e

Relate this to p. 39. "Sliding wedge".





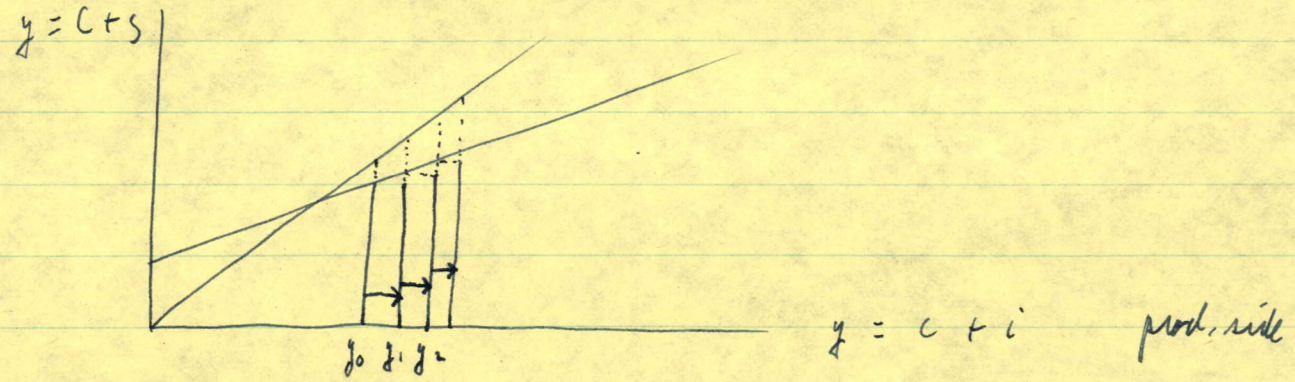
14.



Incr. i has to fit in between 2 curves.

f)

Inc. side



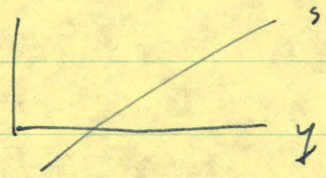
y_0 : $s = i$

y_1 : Something wrong here! The rascals have spent more of the Δy, so $i \rightarrow s$ still, and sc moves $c+i$ to right

y_2 : Same problem again!

y_3 : Etc, until $s = i$.

15.



$\Delta s / \Delta y = \lambda$ of s

16. p. 40 Taxes come first out of inc: then s.
So, income to cons y reduce s. (laying groundwork for saying taxes funtcify idle s.)

81 17. A) $y = \text{alla } C + i$

$C = a + c' \times y$ $\qquad c' \equiv mpc$

$y = a + c'y + i$

$y - c'y = a + i$

$$y = \frac{a+i}{1-c'} = \frac{a+i}{s'} \qquad c' = \frac{\Delta c}{\Delta y} \qquad (1)$$

~~$\frac{\Delta y}{\Delta i} = \frac{a}{1-c'} \cdot \frac{1}{1-c'} = \frac{a+1}{1-c}$~~

~~$\frac{\Delta y}{\Delta i} = 0$~~

17 B)

How about effects of Δi?

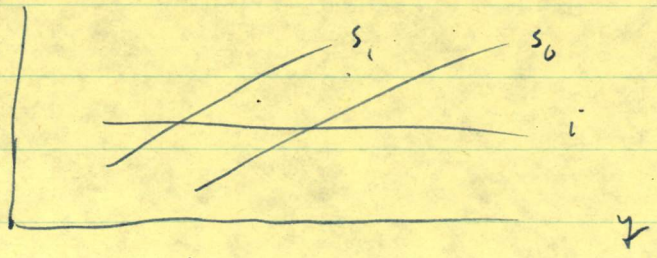
$$y = \frac{a}{s'} + \frac{i}{s'}$$

$$\Delta y = 0 + \frac{\Delta i}{s'} = \frac{\Delta i}{s'} \quad \text{or} \quad \frac{\Delta i}{1-c'}$$

$\frac{\Delta y}{\Delta i} \equiv$ The Mult.

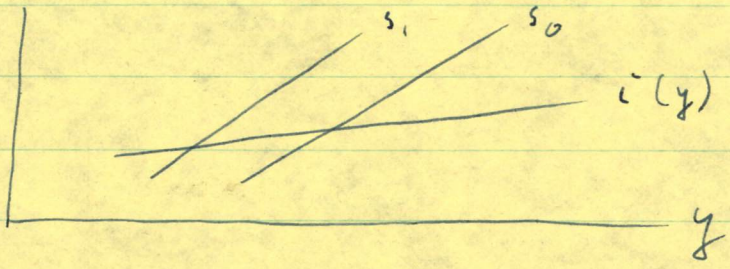
These are the guts of Ch. 3. Summing how B+L add decorations before they do the fdtn. adds obscurity. Get basics first, the structural skeleton. Then can add on rest of decorations.

18. "Paradox of Thrift"

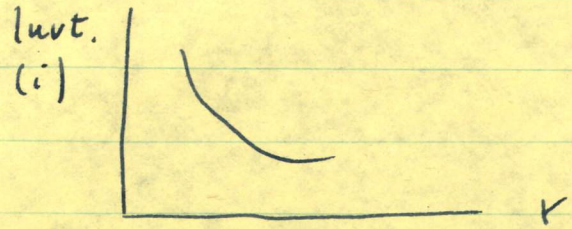


At s_1, save more from given y, reduce y. Result of textbook model-building, cumulative impact of several assms.

The paradox is not just that s_1 reduces income; but reduces i, where $i(y)$.



Ideas, ch. 4



$y = c + i$

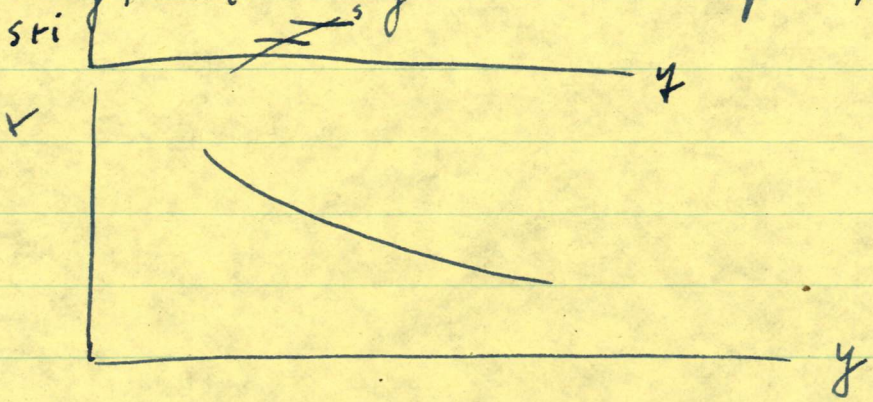
$i = i(r)$

$y = c + i(r)$

Now, r becomes monetary control w. double leverage:

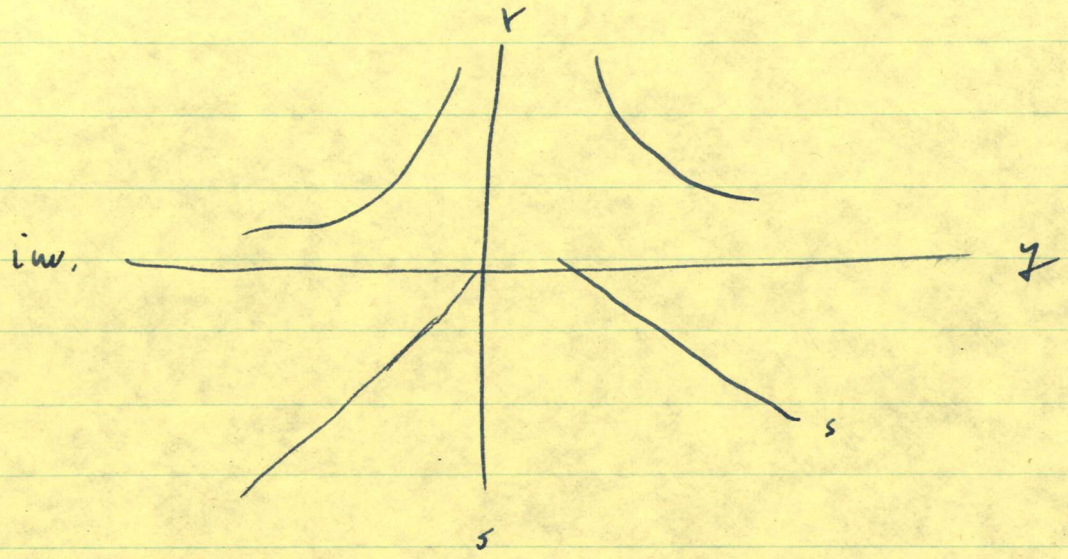
r controls invt; invt. controls y.

(Is this really so? Int. rates bob up & down today, w/o any extreme response)



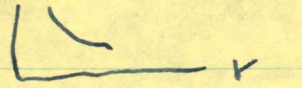
p. 62

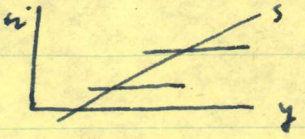
IS quadrant



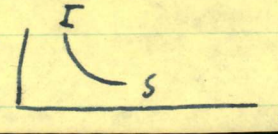
(Why I go slow. O.M. technique is to decorate & elaborate the model from the very first step — thus discouraging any deep insight into its meaning.)

The 4-quad. diagram doesn't seem to add anything to the orig. 3-step demo. so stick w. that.

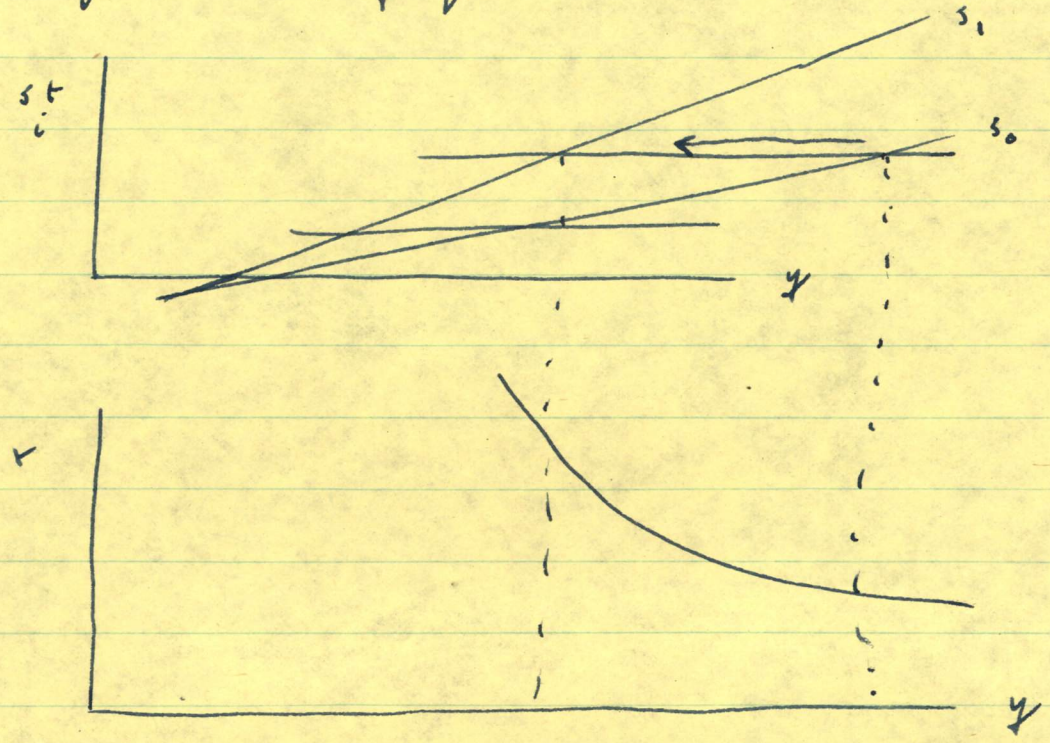
1. $i = i(r)$  decr. fn.

2. $y = f(i) = \frac{a+i}{1-i} = k + \frac{i}{s'}$ 

$\Delta y = \frac{\Delta i}{s'}$

3. $y = f(r) = k + \frac{i(r)}{s'}$ 

If s' rises, y falls



The 4-quad. approach is mind-boggling. Go to algebra.

IS curve reps. eq. "in the product mkt", i.e. $S = I$. (note departure from l.c., in labelling IS curve, which must mean curve of $Im = Sav.$) The other mkt. is "the money mkt."

News Notes. Macro

2/11 Don Regan, Secy Treas., says Fed. is main agent to reduce inflm. Tax + budget cuts are a small part.

But Fed. responds, Govt. must do it by not borrowing.

Energy Secy J. Edwards says energy + jobs are in lockstep.

Realty Barometer

January 18, 1981

✓ **Many commercial banks** are in the market for income property construction loans without takeouts, reports Alan Crittenden in the Crittenden Report on Real Estate Financing (P.O. Box 128, Nevada City, Calif. 95959). Crittenden says this marks a departure from recent practice. Banks have traditionally been reluctant to make construction loans unless developers had previously arranged permanent takeout commitments. These future commitments, usually for fixed rate mortgages, would take effect upon completion of the project. When a developer brought in a permanent commitment, bankers were guaranteed that another lender frequently a life company, would pay off the construction loan. The developer in effect transformed his short term construction debt into long term mortgage debt.

Claremont Team Playing Key Role in Shaping Economic Policy

By WILLIAM J. EATON, *Times Staff Writer*

WASHINGTON—There are no names on the doors of a suite in the Executive Office Building where a small team of economists from Claremont, Calif., is playing a key role in the formation of President Reagan's economic program.

"When we walk in, everyone's quiet," said John Rutledge, president of the Claremont Economics Institute, a six-year-old private research firm, and leader of the group. "We're known as Stockman's guys."

Stockman is David A. Stockman, 34, the former Michigan congressman who appears to be playing the leading role in shaping Reagan's anti-inflation and economic growth package.

"We have a secret handshake and our password is 'Cut 'em deep,' " the 32-year-old Rutledge said in an interview.

He believes Reagan's plan, due to be unveiled with considerable fanfare about Feb. 18, will be a "blockbuster" because of the scope of its tax relief, deregulation and cuts in government spending.

Rutledge, Claremont vice president Jerry St. Dennis, 37, and an associate, Lawrence Kudlow, are working without pay to help assess the impact of various economic proposals and to justify Reagan's sweeping plan to the public. Claremont's contribution is a mathematical forecasting tool that Rutledge says is different from the conventional forecasting tools because it considers the "rational expectations" of consumers and financial markets in developing programs.

"We represent the triumph of common sense over econometrics," Rutledge said. "Getting inflation out of the economy is possible, quickly, and will not be as costly in terms of unemployment as other forecasters think."

Reagan's plan, he implied, is designed to bring the inflation rate, now running about 12.5% a year, down by 3 to 5 percentage points.

Rutledge and his associates have been sitting in on policy meetings with Cabinet members during the period of intensive preparation for Reagan's new economic plan. In addition, the Claremont institute has had a group of computer experts working around the clock in California to supply forecasts and statistics for their work.

"I've been here (in Washington) since Jan. 9 when I came for a one-hour meeting," Rutledge said. "I've had to send back for more shirts and underwear."

U.S. home owners = 55 m.
Value of their "equity" = $1.9 tr.

Equity/owners = $35,000 @

est. by N.A.R., in LA Times, p. 1, 1/31/81.

Cal. has $200b equity in homes, or $\frac{.2}{1.9}$ = 11% of U.S.

Times Board of Economists

Michael K. Evans

Evidence Validates Reagan Tax Plan

The largest desperate ploy of the old-guard liberals who oppose the Roth-Kemp tax cut is their argument that it will decrease savings, thereby lowering investment, reducing productivity, raising inflation and generally harming the economy.

Supply-side economists may be permitted a wry smile at this turn of events. For years Keynesian economists have argued that fiscal policy should be directed at increasing consumption as the proven way to improve economic performance and reach full employment. Tax cuts that merely went into savings were "wasted." Now these same economists are mounting a rear guard attack by claiming that broad-based personal income tax cuts are counterproductive because they do not generate enough savings.

Thus, it is argued, we should restrict the scope and size of personal tax cuts over the next three years until those elusive spending cuts are passed by Congress.

Liberals Were Horrified

The new battle line of the liberal attack recently surfaced in response to Treasury Secretary Donald T. Regan's testimony about the effect of Roth-Kemp on the personal saving rate. Regan claimed that one-half to two-thirds of the Roth-Kemp tax cut would be saved, since most of it would be received by upper-income brackets. Walter Heller went so far as to label this result "crap," and some journalists of similar views called Regan's estimates so "horrendous" that they were an "embarrassment."

Yet far from overstating the case, all the empirical evidence I have been able to muster suggests that Regan's estimates were essentially correct, based on what previously occurred when personal income tax rates were changed.

Furthermore, my estimates show that far from diminishing savings, President Reagan's tax package—a 10% across-the-board tax cut in personal income tax rates for three years and a 40% reduction in depreciation lives—will actually raise total national savings. In other words, private sector savings will increase more than the rise in the public sector deficit.

Before presenting figures to support this assertion, however, let me briefly present the evidence surrounding previous changes in the personal income tax.

The prototype example is clearly the 18% across-the-board cut in personal income tax rates in 1964, the chief architect of which was, somewhat ironically, the same Walter Heller who now denounces the Roth-Kemp tax cut. During that year, the personal savings rate rose to 6.7% from 5.4%; this represented an increase in personal savings of $5.6 billion more than usual. Not so coincidentially, taxes rose $6.0 billion less than would have occurred if the tax rate had remained constant. In other words, the extra increase in savings was almost identical to the decrease in taxes caused by the rate cut.

Taxes Affect Savings

Personal savings responded similarly in 1968, when a 10% surtax was imposed in the middle of the year. The savings rate fell from 8.1% in 1967 to 7.1% in 1968 and declined further to 6.4% in 1969, when the surtax was in effect for the entire year. When the surtax was removed in 1970, the saving rate returned to its previous 8% level.

Thus in the four years that the American consumer has been subjected to significant changes in marginal tax rates, over two-thirds of the change in taxes has been reflected in changes in savings; only one-third of the change has gone into consumption. By comparison, the $8 billion rebate in 1975, which was targeted mainly for lower income groups, was almost all spent, as the savings rate moved only from 8.5% to 8.6%.

These figures clearly suggest that the distribution of the tax cut has a major impact on how much savings will change. While figures for taxes paid by separate income classifications are not available later than 1977, we can extrapolate these figures to 1981 and combine them with sample surveys on savings rates to draw some profile of who will get the tax cut and how much they will save.

Most surveys have shown that on balance consumers earning below the median average income do not save; this figure will be approximately $23,000 in 1981. Consumers with incomes between $23,000 and $45,000 save approximately 5% of their income, while those with incomes over $45,000 save about 25% of their income. (It should be pointed out that these figures are national averages and do not necessarily apply to people living in the Los Angeles area, and certainly not to those in Beverly Hills.)

In any case, under the assumption of a broad-based tax cut, only 16% of the tax cut will go to those with incomes below the median—which may provide the real reason why the liberals oppose Roth-Kemp. Another 40% will go to those who save an average of 5% of their income, while the remaining 44% will go to those upper-income groups which save an average of 25% of their income.

While these figures show that the great majority of the tax cut will accrue to those that save, even the 25% figure does not square with my earlier statement that as much as two-thirds of the tax cut will be saved.

However, that comparison overlooks two important facts. First, the 5% and 25% figures quoted above are average, rather than marginal, savings rates. Empirical research studies on personal saving performed by economists with as widely divergent political views as Lawrence Klein and Milton Friedman have all found that the proportion of income which is saved from unusual changes in income, such as changes in tax rates, is between 40% and 70% in the first year.

Second, the reduction of high marginal tax rates on income will encourage saving because of the sharp increase in the after-tax rate of return. If the top marginal bracket declines from 70% to 50%, and the rate of interest is 12%, then the after-tax rate of return has increased 2.4 percentage points for upper bracket taxpayers.

Compensated by Savings

Because of these factors, I estimate that the rise in personal and corporate savings due to the Reagan tax plan will actually be greater than the increase in the Federal government deficit for every year except 1981, when the decline in total savings will be a minuscle $1.9 billion.

In 1982, for example, the federal deficit will be $48 billion larger than would be the case in the absence of any tax cuts, but personal savings will be $46 billion higher and corporate savings $6 billion higher. In addition, the surplus of state and local governments will rise by $2 billion because of the higher level of economic activity. Hence, total saving will rise by $6 billion.

Thus, far from causing a decline in saving and investment, the Roth-Kemp tax cut and the 40% reduction in depreciation lives will actually stimulate saving enough that it will more than offset the increase in the Federal government deficit.

Michael K. Evans is president of Evans Economics Inc.

Macro

2/13/81

China's "Oil Faction"

They set "targets" (a totalitarian approach — cf. Riverside Energy Comm.)
(cf. U.S. oil leasing policy. Each adm. sets "targets".)

Oil Faction ruled for 10 yrs. 1970s. Then New Ec. Group prevailed. Deng Xiaoping goes w. N.E.G.
1980-81. NEG attacks, gains ascendancy. Chen Yun. They used a dramatic collapse of a faulty drilling rig as cause célèbre. It repd. "crash-ahead, politics in command" leadership. Leftist approach.
NEG pressed for a "national discussion" of the "goals of socialist construction". Opposed old "big scale indl. expansion" ~~drive~~ of ~~the~~ Yu Qiu li, who stopped earlier "nat. discussion".

Oil + gas reserves had been padded, by subordinates seeking to impress their superiors. Pipelines + plants built to use non-existent reserves.
Exports to pay for imported machines, never developed.

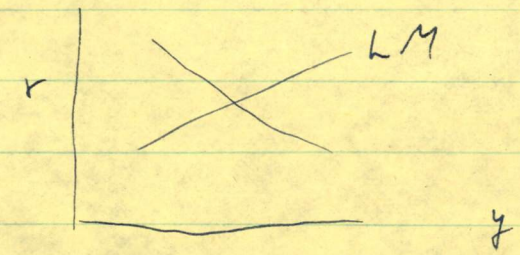
Chen Yun wants to end indl. ministries, is hostile from Soviets, w. indep. plants, decentralized.

Macro Ideas. 2/25/81

1. LM curve says Δy is limited by willingness to spend.

a. What this curve does is to formalize the whole qty. of MV. as T rises, V falls; as r rises, V rises. All other influences are shown as shifts of LM curve.

LM curve is the device by which MV is let back into Macro. It ends the inf. liq. trap.



It ends the presumption that easy money is always better. It argues for higher r, to get people to spend M.

But it neglects other influences on V.
I can give this list anywhere now. Yes.
B+L don't have it.

b. Since $C = F(y)$, the LM effects are all assumed to occur thru i? But IS presumes a fixed i? — no, only at a fixed r. and fixed C.

The trouble w. the devices that springs from Great Sponge model is, invt. comes from a free source. Any demand shd. call forth inf. supply, bec. supply is free, once you divorce invt. from savgs.

So the LM constraint shd. be applied there, by having invt. not be fixed, as in Mult., but an invt det.d in its own mkt. w. S+D, with r being the price.

b. Steep LM curve says, if IS shifts to rt, the resulting higher r reduces invt.

This is by moving up the IS curve. p. 87. You reduce invt. by having higher r shift you up the curve. Are "offset" effect – what is the better word for it? (over)

Why is r forced up? Gt. Sponge is dry. It takes higher r to induce .... Savg! The Δ invt. is coming from cons. Thus, Δi meets resistance, so attempted Δi causes higher Δr instead of higher y.

c. If LM is flat
- No gain from lowering r
- Enormous gain from Δg or i.

Δi comes from demand side alone.

(Here, the free source qu. arises. If source is free, why is there any limit on invt?) A classic model.

Adjustment response

Counteractive "

Reactive "

d. Orig. K-ian dogma involved saying S had no effect on i; and i required no prior S or exog. S, it created its own.

To the pt. that in for i was then free, they answered 2-0% floor, due to liq. pref. [But this is untenable. If liq. pool is already infinite, as required by indep. of S & i, then marg. liq. pref. is zero.]

LM curve modifies this.

✓ In sum, go thru steps from ISLM to putting price on ord.

Review early sum. – was there an LM curve?

Image was of an inc. stream that keeps leaking, & has to be reinjected. Leaks are assumed lost; injections come from elsewhere – that was a hard part to swallow.

e. If you can put resistance in the income stream, by LM curve, ~~to~~ to offset the mult. w. its assumptions, can also put in other resistances.

LM curve is not formally, math. necy. as Bth say. Cd. have fixed r, indep. of y.

another resistance is reinvt. As r falls, structure of K hardens, payback slows. This might mean there is no prodn. response to Si, bcs. there is a bottleneck other than labor.

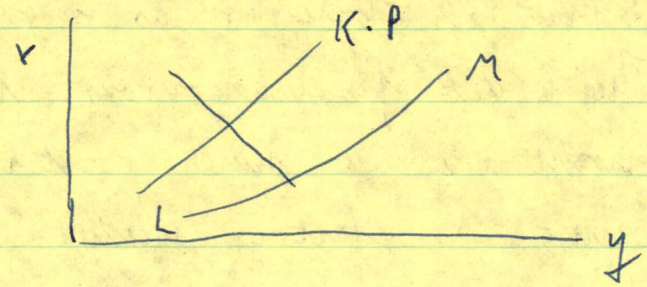
The simple Sam. idea was, shift is until wages rise. This assumed everything else had elast. supply, no mngy., no hard b.o., no energy crunch etc. And no limit to Turnover. But low r reduces T_Δ of K same as V of M. We need another LM curve for that, made the same way. That is, there is, as r rises, a larger (lower)

f. The idea of autonomous invt. was, in an indirect approach to a real truth. Jobs depend on invt., and invt. is elastic, needn't wait for prior s. Can be fd by invt. opps., & this beats lowering r.

Unachieved cons. has a truth, too. Demand for cons. pulls K into softer forms. Releases K from invy., allows reinvt.

They went wrong by sole emphasis on govt. & spending, forgot supply side & incentives.

y possible, and v.v.



K·P is cap.-payback curve, where demand for cap. = K at lower r, K/y rises, y/K falls.

For Wed. class

0. Historical evolution

1. Show other influences on LM curve.

Show M·V approach. This says V has to keep up w. $\frac{y}{s}$

Interpret LM curve in terms of V. This introduces (2).

2. Show A·K curve: demand for K ~~[illegible]~~ = K at lower r, requires more K/y

3. Show LV influence. Demand for K = [demand for Assets − L.V.]

There are more important things than ff. the book slavishly. Book needs to be improved on. Don't let yr. grade anxiety make you lose yourself.

I enters at 2 pts.

1. My new A·K curve.

2. GNP as w. reinv. of CCA.

If CCA is savg, then gross inv. = net inv.

Inv. employs labor, so empl. depends on current flow of i. So misery or prosp. depends dearly on this flow, very sensitive. And the flow is inelastic, in s.r., to

concessions labor might make.

The lessons for Reagan from Kennedy's big tax cut

Ronald Reagan's initial effort as President to sell his controversial economic program got good reviews on television but a skeptical response from economists. "It is an interesting experiment," says Otto Eckstein, president of Data Resources Inc., "but we have only one economy to lose if it doesn't work."

Such skepticism, which seems widespread in the financial and business communities, is damaging to the political prospects of drastic cuts in the federal budget and even more massive cuts in federal income taxes. But more important, as Administration economists admit, this skepticism undermines the Reagan program's public credibility—the factor that will largely determine its impact. An economic "scenario" prepared at the Office of Management & Budget in place of the usual official forecast projects an acceleration of real growth and an amazing halving of the rate of inflation—mainly by assuming a dramatic change in expectations.

Such unquantifiable elements are absent from the econometric models that have become the main arbiters of economic policy over the past decade. But there is historical evidence to support the notion that expectations are indeed decisive variables. The almost legendary success of the great tax cut of 1964, for example, seems to have come more from its galvanizing effect on the business climate than from the expansion of demand that was its major rationale or from the increase in supply that supply-siders now claim it brought about.

Astounding boom. Remembered as the high-water mark of Keynesianism, the 1964 tax cut has lately become something of a symbol for the supply-side movement. Arthur B. Laffer, the inventor of the curve that asserts that taxes can be reduced with no loss in revenue, goes so far as to say that Ronald Reagan is about "to duplicate the economics of the Kennedy Administration."

There are indeed interesting parallels that provide some clues to the conditions for success of the Reagan plan. Elected on a promise to "get the country moving again," Kennedy gathered around himself a group of advisers who called themselves the New Economists and offered a controversial theory with a dramatically simple solution to the problem of economic stagnation. Despite a rising deficit and a commitment to increased defense spending, Kennedy proposed the largest tax cut in the nation's history, assuring Congress that "within a few years of the enactment of this program, federal revenues will be larger than if present tax rates continue to prevail." Passed after his death, the tax cut was followed by an astounding boom that brought full employment for the first time in a decade with no discernible increase in inflation. Moreover, for a brief period before the war in Vietnam, there was even a balanced budget—attained partly because federal spending in fiscal 1965 declined by a symbolic $150 million and partly because revenues actually did rise strongly after an initial one-year drop.

The aging group of New Economists do not like to be reminded of their own



UPI

Reagan: Like John F. Kennedy, he must raise hopes without losing credibility.

Laffer-like claims, and Walter W. Heller, generally considered to be the intellectual father of the 1964 measure, says that "there is no scientific evidence that it paid for itself." This disclaimer makes it rather difficult for Keynesian economists to take full credit for the boom that added enormously to their public reputations.

It is rather striking how blandly Congress accepted the notion that the tax cut would, as the preamble to the final version of the bill puts it, "raise (rather than lower) revenues." Yet in that era, there was no nay-saying from the economics profession, which was united on the need to cut taxes. What was different then was an exaggerated notion of the "multiplier"—the amount by which a tax cut would boost aggregate demand. Many thought it was more than three, which meant that the $12 billion tax cut would raise gross national product by at least $36 billion. Since the government—including state and local units—took in about 30¢ for each additional dollar of national income, the Keynesian equivalent of the Laffer curve seemed to be on a sound footing.

But calculations employed by the current crop of econometric models typically have the multiplier build up gradually to a peak of around two and then diminish. In a retrospective analysis for Congress' Joint Economic Committee, for example, Data Resources found that the tax cut added only about $12 billion to GNP in 1965. It estimated, moreover, that the great tax cut increased the federal deficit in that year by nearly $9 billion. If similar econometric models had been in existence and as influential then as now, the tax cut would probably never have gotten out of committee.

Little statistical evidence. It is true, however, that federal receipts were $20 billion higher in 1965 than they had been two years before. And this is one basis for the argument by supply-siders that the tax cut did much more than simply boost demand. Like Kemp-Roth, it included an across-the-board cut in personal tax rates that averaged nearly 25% when fully effective. The supply-siders argue that this increased incentives and was responsibile for the boom.

Supply-siders tend to shy away from numbers, and there is no authoritative estimate from that camp of the effect of the Kennedy tax cut on GNP. But there is little statistical evidence to support anything like the 3-for-1 gain in productive effort that would be required to validate the Laffer curve on this basis. There was, for instance, no change in labor force behavior to indicate any notable tilting in the work-leisure choice that supply-siders insist is highly sensitive to changes in marginal tax rates. And while there was some improvement in the aggregate productivity performance, it was not particularly impressive.

There was, however, a Laffer effect for upper-income groups. Although the top rate was cut from 91% to 70%, taxes

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By Lewis Beman

paid by those earning more than $50,000 (equivalent to about $135,000 today) rose by nearly 40% between 1963 and 1965. This suggests that work-effort responses are greatest where taxes are highest and also indicates the reduced incentive to shelter income from taxes.

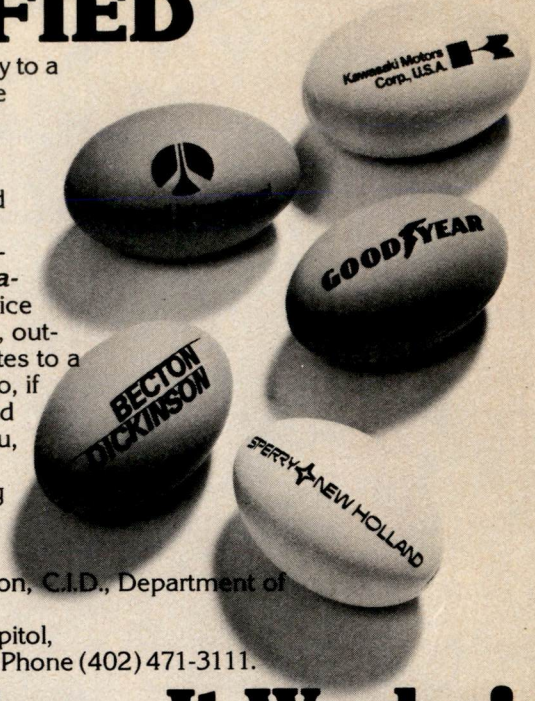
Hot market. The strongest evidence is that the main channel through which the Kennedy tax cut affected the economy was the one concept of John Maynard Keynes that supply-siders most enthusiastically embrace—that of the importance of "animal spirits" in determining the rate of investment. For the most remarkable thing about the boom that followed the tax cut was the one-third increase in capital spending between 1963 and 1965. This astounding surge, which came close to matching in two years the investment growth of the previous decade, was partly a delayed response to the 1962 changes in depreciation and the enactment of the 7% investment credit. But it was also a result of the climate of business confidence that the Kennedy program produced—an ebullience reflected in the nearly 30% increase in stock prices.

The jump in investment was financed partly by a rise of more than 50% in personal savings in the two years following the tax cut. To the extent that the tax cut was responsible for this $12 billion increase, it provided the means to finance any deficit it might have created. From the supply-side point of view, of course, the federal deficit has no direct impact on inflation but does force the Federal Reserve either to monetize the debt through an inflationary increase in the money supply or to allow the government's financial needs to "crowd out" private borrowers. Thus, supply-siders may be expected to argue that a large increase in savings, even if it is only temporary, would considerably ease monetary pressures, pending reduction of the deficit through cuts.

The major question about the Reagan program is how it will affect inflationary expectations. If it continues to be greeted with skepticism, it could be counterproductive, even if its underlying theories are correct. Hence, there also is a lesson from the 1960s in the importance of consensus-building for a program that started with far more academic respectability than the supply-side arguments are currently accorded. John F. Kennedy found the secret of raising hopes without losing credibility. And that is what Ronald Reagan will have to accomplish from his "bully pulpit."

NATURALLY FORTIFIED

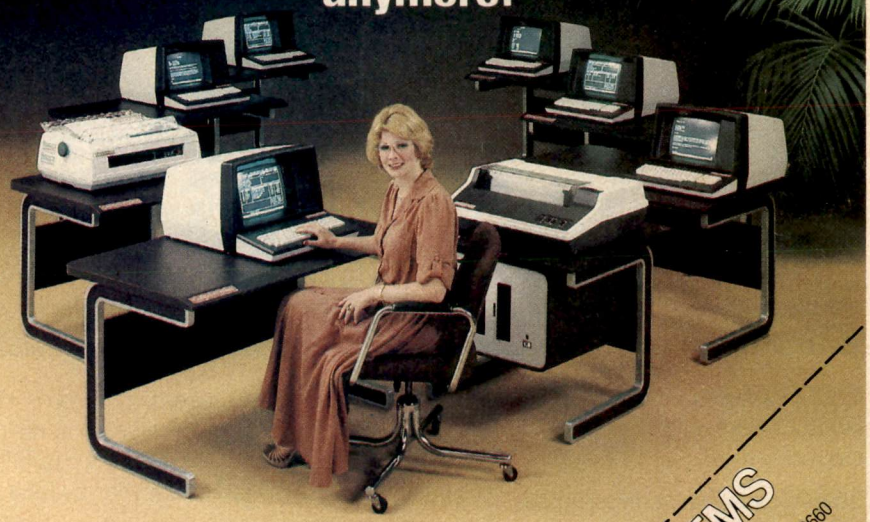
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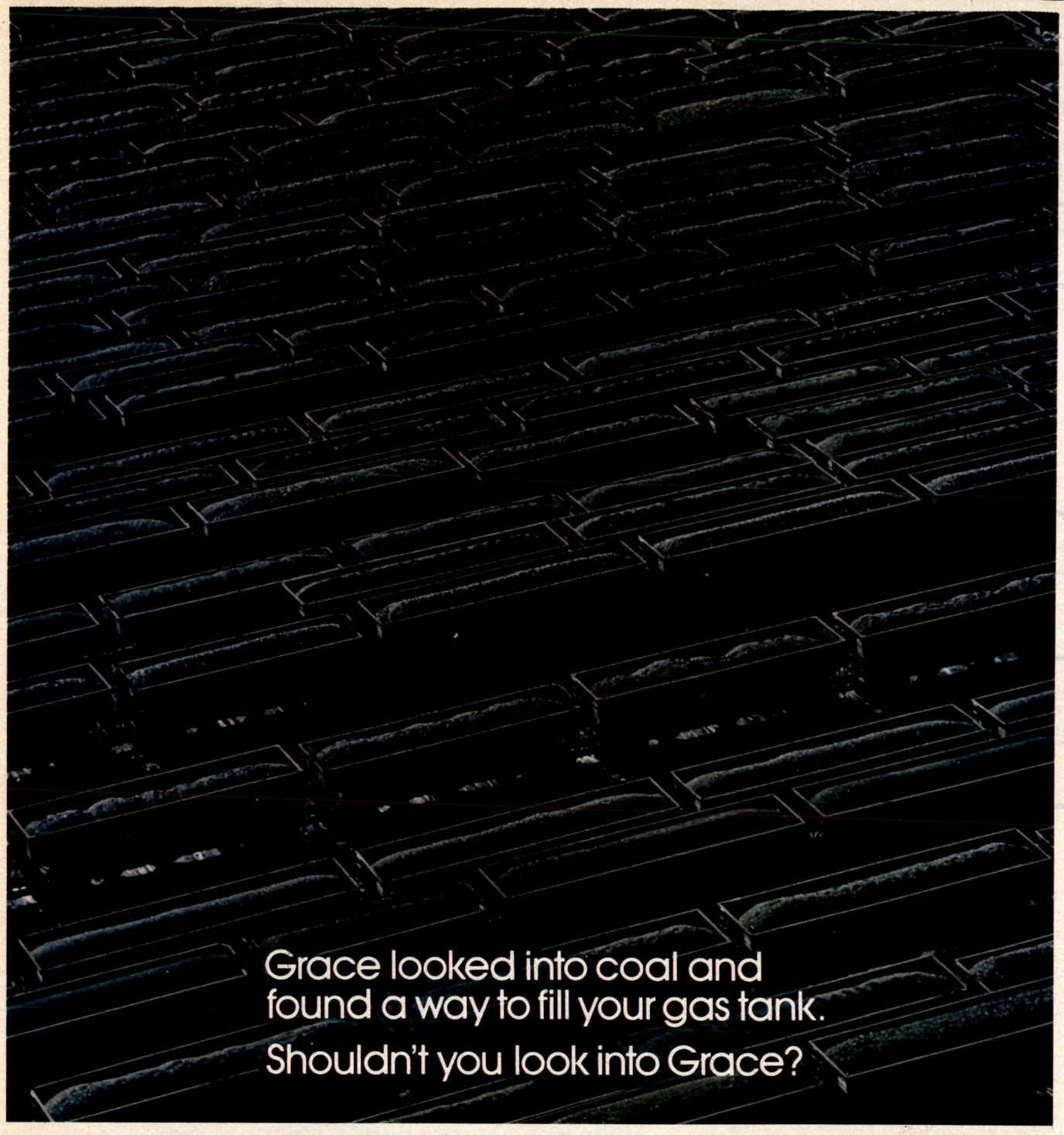
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Idem. Ch. 5 "Mon. & Fiscal Pol."

1. They begin to let P vary, end of Ch. 4

$$y = \frac{a + i}{1 - c'}$$

$$\frac{dy}{di} = \frac{1}{1 - c'}$$

$$i = i(r)$$

$$y = \frac{a + i(r)}{1 - c}$$

2 things interfere w. Δy caused by $-\Delta r$

1. supply of ~~spending~~ $\rightarrow$ LM curve

~~2. ΔP~~ (this shd. also affect c')

2. ΔP $\rightarrow$ same effect as reducing M

They now plot $y \times P$ P ↑ y. Only they show steep curve.

2. Too bad they don't complete their const. P model

3. Policy instrs.

a) Δg.

b) $-\Delta t$

c) ΔM

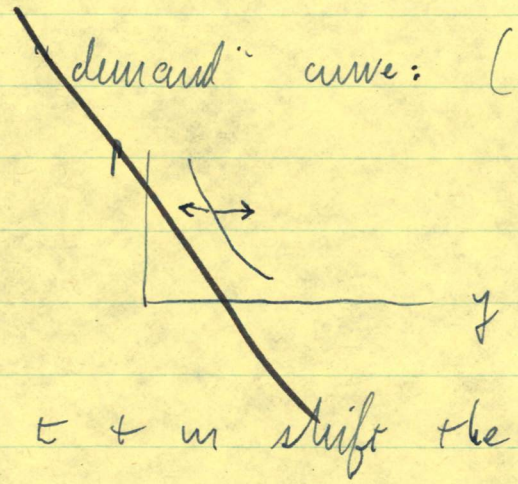
or some combo.

(what happened to r?)

} to discuss $-\Delta P$

4. g ↑ ↓ shift IS curve
M shifts LM curve.

5. A "demand" curve: (locus of ISLM intersections)



g, t + m shift the curve.

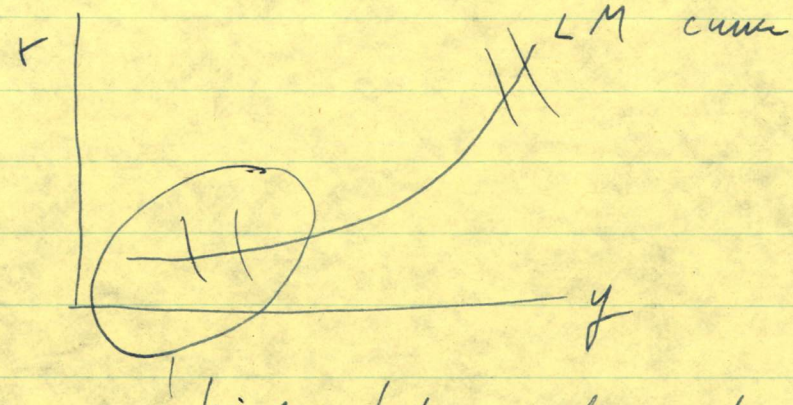
6. re Δg

$$\frac{\Delta y}{\Delta g} = \frac{1}{1-c'} \qquad (\text{where } c' + t' + s' = 1)$$

7. Δg + Δt are seen as indep.
But deficit is allowed to Δr – crowding out.
Δg comes in part from $-\Delta im$.
But as to Δi + Δs, are they equally indep?
Seems as tho the model makes Δi come from inf. prod – there is no penalty, no cost.

8. Deficit from $-\Delta t$ is same as Δg.
a. This abandons original idea of Δg as better
b. Doesn't develop incentive qu. -- even tho model implies that Δi is greatest thing that can happen, + i responds to incentive:

9.



bi spec. balances; large liq. pref.

10. effectiveness of Δg varies over bus. cycle.

Conflict among true believers

THE NEW ECONOMIC FAITH

BY ROBERT B. ZEVIN

THE CONTINUING GAINS OF conservative thought in economics are impressive by any measure. It is difficult to find an economist who still refers to himself as a "Keynesian." Economists are now likely to describe themselves as "neo-" or "post-" or "eclectic but mostly" Keynesian. The intent of these prefixes, simple or compound, is to apologize.

Only a decade ago the conservatives' doctrine was characterized as "neoclassical economics." Where are the neoclassical economists now that theirs is a majority view of the world? They have become supply-side economists, believers in rational expectations, monetarists. They are unashamed to cling to the doctrinal purity of the economic theories propounded 100 years ago by Alfred Marshall and 200 years ago by Adam Smith. Victorious, they are classicists without prefix.

The successful conservative advance on our minds has been reflected in an equally successful capture of political power. The consequences of victory are abundant and plainly visible.

• In February of 1979 the Joint Economic Committee of the Congress of the United States completed its thirty-third annual report, as required by the Full Employment Act of 1946. For the first time in two decades the report was unanimously endorsed by representatives and senators from both the Republican minority and the Democratic majority. Its forty-two recommendations can be fairly summarized as nearly replicating the economic platform adopted at the Republican convention in the summer of 1980: the report denounced wage and price controls, excessive regulation, and government inefficiency; emphasized the primary importance of fighting inflation rather than unemployment; advocated monetary restraint, tax restraint, and spending restraint; endorsed special incentives for savers and investors.

• In the summer of 1979 the Carter Administration passed through a prophetic political and economic crisis. The Cabinet was reshuffled in a distinctly conservative direction, and Paul Volcker was appointed chairman of the board of governors of the Federal Reserve System. Volcker is an impressively articulate, skillful, and thoughtful man who has a natural preference for pragmatic solutions over ideological dogma. Nevertheless, he has been clearly identified with the economic ideology of the right. He led the temperate monetarists of the policy-making Open Market Committee of the Federal Reserve System while serving as president of the Federal Reserve Bank of New York.

• In a dramatic announcement in the late evening of October 6, 1979, the central bank of the United States committed itself without mitigation to the doctrine of monetarism, a doctrine that is the nexus of the new conservative movement.

• The final ratification of conservative victory came on November 4, 1980, when Ronald Reagan won a margin unusually decisive for recent elections and led the Republicans to control of the Senate and to strong gains in the House. In addition, the electorate demonstrated an ideological consistency that had not been seen for decades.

This record covers only the past two years of conservative ascendance in the United States; in fact, it has encompassed most of the past fifteen years and most of the world.

As the conservatives' ranks have swelled and their conquests multiplied, internal divisions among them have grown apace. In particular, established theorists have been subjected to increasingly harsh attacks from newer, younger, more militant converts to the faith. On December 30, 1980, in the pages of the *Wall Street Journal*, Herbert Stein, chairman of the Council of Economic Advisers under Nixon and Ford, and one of the most pragmatic members of the beseiged Old Guard, acknowledged the state of affairs and held out an olive branch of sorts: "We are all conservatives now—since November 4. And now it is necessary, of course, to have two or more schools of conservatism, since universal agreement would be intolerable."

Just as it was advisable for the nineteenth-century inhabitants of most of Asia and Africa to understand the complex beliefs and divisions in the faith of their Christian colonizers, so it behooves all of us, whether we consider ourselves conquered or converted, to understand the doctrines that unite and divide the now dominant conservative economic faith.

THE CONSERVATIVE GARDEN OF EDEN

The first credo among all conservatives has always been that freely competitive markets, in which individuals compete without unfair advantage to maximize their own well-being, are optimally efficient. This principle holds not only for practical problems—the production of goods and services—but for the social and ethical ques-

Robert B. Zevin, an economic historian who has taught at Harvard, Columbia, and the University of California at Berkeley, is senior vice president of the United States Trust Company of Boston.

tions of how justice and liberty can best be ensured.

There is an impressive and elegant collection of theories produced over the past two centuries that presents optimal results as logical consequences of the rational pursuit of self-interest, if there is competition. Direct assaults on the internal logic of this theory have been infrequent and usually unsuccessful. It is now generally agreed that competition is imperfect in most markets; but the conclusions of the theory of perfect competition are left reasonably intact after allowing for some degree of imperfection. It is also understood that, for instance, a profit-maximizing steel mill may rationally choose to pollute the air all of us breathe, thereby requiring some non-market form of social intervention.

What separates the faithful from the detractors is not so much the logical structure of the conservative dogma as the prime postulate. The exposition, after all, is about what happens in an economy *if* there is a reasonable degree of competition in most sectors. Those who deduce from the theory of competition policy recommendations for less interference and management of the economy are implicitly asserting that there is competition in most of the economy, or that there would be in the absence of a smothering government presence. The non-believers have always been united in the conviction that competition was lacking entirely, or weakened beyond use, in significant parts of the economy.

Whatever might have been the objective innocence of the economists who developed the pure theory of perfect competition, its fundamental postulate tended naturally to attract support from those who saw their immediate interests enhanced. In the beginning, its supporters were a new class of capitalists bent on simultaneous revolutions in the existing political and economic structures.

A century later, the same faith naturally tended to attract a different set of adherents. The assertion that an adequate degree of competition does in fact exist, and that this objective circumstance assures just and efficient solutions to social and economic problems if governments do not intervene unnecessarily, appeals to those already enjoying the most favorable circumstances. Those who receive the most from the present system are the most pleased to be told how optimally it functions and how tampering with it would be as dangerous to the general welfare as it could be to their own well-being. No one is happier to hear the virtues of competition extolled than the monopolist, no one more anxious to join the assault on granting further government privilege than the present recipient.

By the twentieth century, the free market was no longer a standard against which its believers measured the velocity of progress. It had become a way of describing—and defending—the status quo. In today's atmosphere of despair and decay, the free market has become a version of the golden-age past that would be restored if only we pruned away the social and economic programs of the last half-century. As free-market ideology has become more closely associated with the defense of established private wealth and power, its advocates have shown an increasingly strong aversion to perfecting a public policy consistent with their theory, i.e. a policy that would maximize fair competition. Rarely are they heard advocating the public provision or regulation of natural-monopoly goods and services. Still less do they press for confiscatory estate taxes, high minimum standards of public health and education, or other policies that would countervene the present mechanisms through which the earned rewards of one generation become the unequal opportunities available to the next. While Alfred Marshall and Adam Smith were known in their day as liberals, there is good reason to call their descendants conservatives.

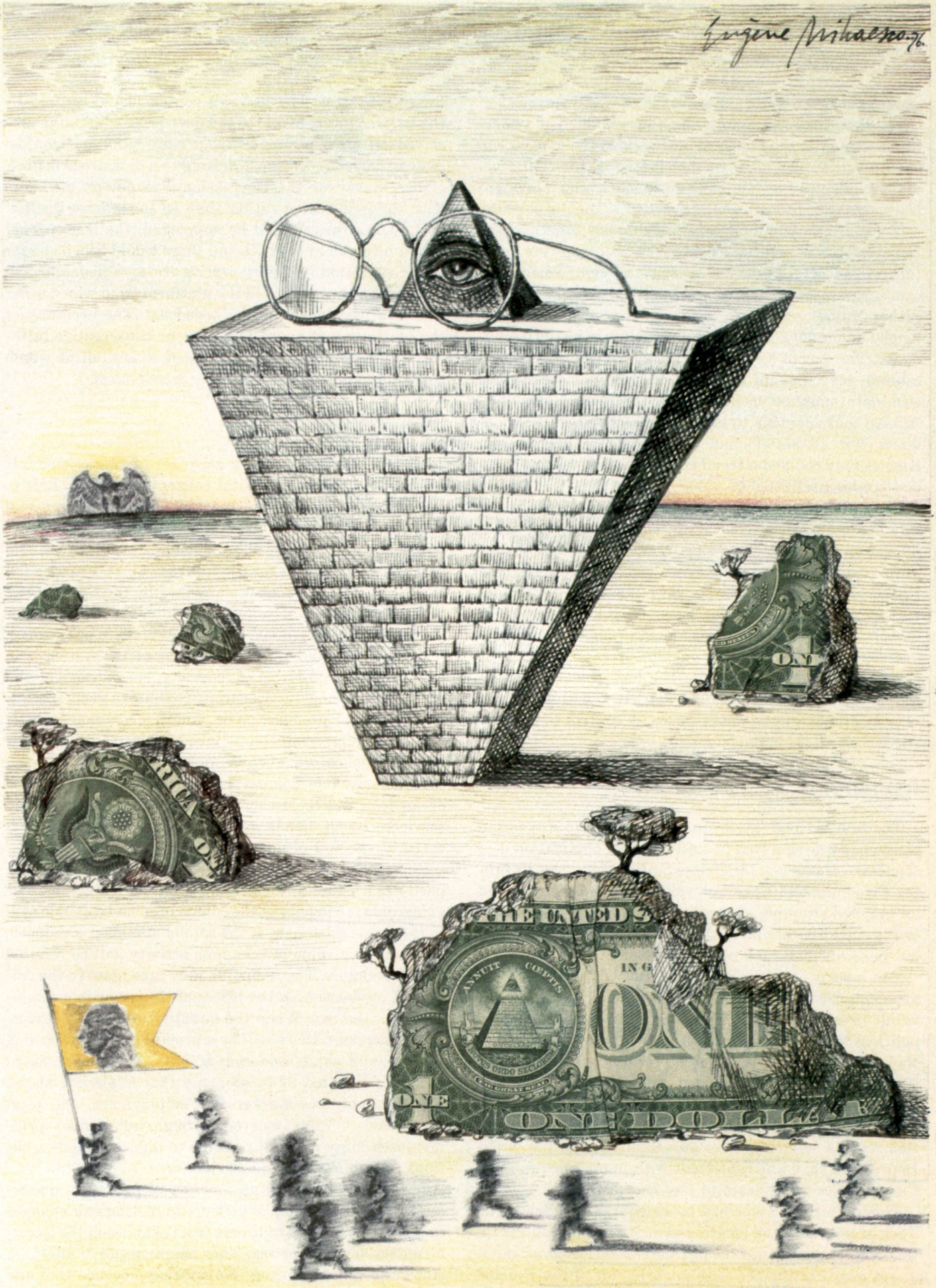
THE APPLE

The initial heyday of conservative conviction and practice lasted for a century and a half. It was decisively terminated by the ubiquitous Great Depression, which began around 1929 and failed to end as promptly and meekly as everyone anticipated. The Depression affected conservatives like a thunderbolt hurled by a wronged god. Here were apparently free and competitive markets, in which desperate producers and workers continually reduced the prices at which they offered their goods and labor, and yet goods could not be sold nor labor employed. To all appearances, governments had done relatively little to intrude on economic activity before or after the Depression's onset. Where were the technical efficiency, the moral justice, the elementary common sense of such a hopelessly fouled system?

Conservatives were routed by these events. Into the abandoned field stepped John Maynard Keynes to expose the fallacies of the orthodox and expound the validity of what had been heresy. There was some confusion in Keynes, as well as among his followers and critics, about whether he had disproved the logic of the conservative argument that showed how free markets led to full employment or whether he had simply revealed that the emperor had no clothes by remarking on the absence of perfect competition to begin with. Keynes's view is expressed in *The General Theory of Employment, Interest and Money*: "Our criticism of the accepted classical theory of economics has consisted not so much in finding logical flaws in its analysis as in pointing out that its tacit assumptions are seldom or never satisfied, with the result that it cannot solve the economic problems of the actual world."

For better or worse, Keynes occupied himself with observed economic behavior more than with the axioms from which behavior could be deduced. *The General Theory*'s message is something like this: Relatively small departures from perfect competition make it possible and probable that modern industrial economies will

ILLUSTRATIONS BY EUGÈNE MIHAESCO


Eugene Mihaesco
ONE
ONE DOLLAR

experience some unemployment, as they did for most of their histories even before the Depression. The operational sequel is that modern states have the capacity to ensure full employment by generating a sufficient level of demand, and they ought to do so since unemployment is a waste that serves no valid social or economic purpose.

Most people did not care very much whether the Depression was proof of the absence of competition or of the failure of economists' theories to comprehend the consequences of competition. What it did prove, as Keynes rather unnecessarily argued, was that deep and prolonged unemployment was quite possible in modern economies. The Age of Keynes was the age of commitment by central governments of the industrial democracies to eliminate unemployment, using techniques that had seemed more obvious to laymen than they had to economists. For all his eloquence, acumen, and compassion, Keynes only codified a trend that had been growing longer than his lifetime.

For a long time the Depression loomed over economics. The hapless conservatives could not get out from under its shadow. No matter how many errors of thought they uncovered in the works of Keynes and his followers—and there were plenty of them—the plain truth for economists, plainer still for those less troubled with logical complexities, was that governments had the ability to overcome the Depression's unemployment by acting as employers of ultimate resort. The idea that there were limits to the efficiency of free markets—and that their very existence was in doubt—became central to the new wisdom in all the industrial democracies.

REDEMPTION

The first serious intellectual breach of the Keynesian consensus was achieved in 1963 with the publication of *A Monetary History of the United States, 1867–1960,* by Milton Friedman and Anna Schwartz. Milton Friedman had already led stunning charges of conservative Rough Riders against liberal barricades, and he has led more since, but none has had such penetrating effect as this one.

For nearly three decades conservatives had been attacking the usurpers with little reward, elegantly but vainly presenting the virtues of freedom in economic and political life. A number of theoretically impeccable dissections were performed on the structure of Keynesian thought. These were accorded due respect in graduate economics courses, but had little impact on political economy. The essential weakness of the conservative opposition was its failure to offer an explanation of the Great Depression that was consistent with unqualified faith in the existence and efficacy of free markets.

This defect was remedied by Friedman and Schwartz. They argued that the length and depth of the Depression was not a natural outcome of free-market behavior but a direct result of the perverse misbehavior of the Federal Reserve System. The nation's central bank, created by the federal government for the purpose of overriding perceived defects in a competitive private-bank market, had instead compounded those defects to a disastrous degree. Hence blame for the Depression was put on meddlers with the free market rather than on the market itself.

If such a thesis could be supported, the free market would be restored to grace and there would be a basis for the restoration of conservative rule. Friedman and Schwartz had constructed the platform from which other conservative ideas could be broadcast. The necessity of the platform was appreciated by the conservative faithful, all of whom promptly adopted it and all of whom continue to pay their respects to *monetarism.*

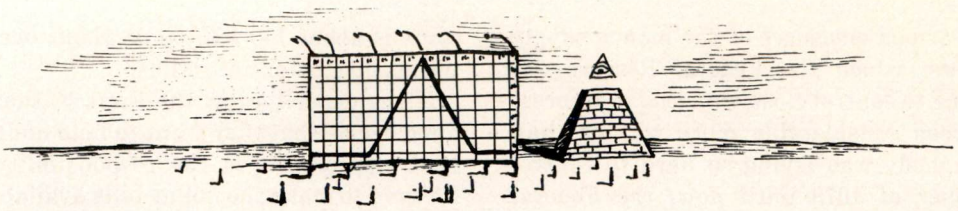
MONEY MATTERS

Modern monetarism is a crisp set of propositions. It begins with the fundamental conservative faith: Left to its own devices, the free market will provide optimal solutions to the problems of achieving full employment, deciding what to produce, producing it at least cost, and balancing investment for the future against consumption for the present. This is accomplished by the singly insignificant responses of selfish individuals to a system of prices that is determined by their aggregate behavior.

As everyone understands, if an economic system is to achieve advanced levels of diversity, specialization, and abundance, money is essential. It enables each specialized worker or producer to be paid in a common form. It reduces a staggering complexity of relative prices (how many bushels of wheat equal an hour of a welder's time?) to a manageable comparison of money prices ($11.00 divided by $4.50). Money changes hands as goods and services change hands and productive activity is measured by the flow of money.

For some time political institutions have had the capacity to produce or destroy what passes for money. The abuse of this capacity is the source of most economic evil, in the monetarist view. If the supply of money is reduced, the monetary value of economic activity will be reduced proportionately. The reduction may take place in the volume of production, in the prices of things, or in a combination of the two. When the quantity of money is excessively increased there will be a proportionate increase in the value of total economic activity. As the increased money is supplied to an economy that is already at the perfection of free-market full employment, the total increment in value will be through inflationary price increases, since it is not possible to induce further additions to employment and production.

If prices rise or fall as a result of monetary disturbances, it becomes more difficult to distinguish changes in the relative prices of things from changes in the general money level of prices. This has a negative effect on efficiency and well-being. Monetarists concede that the



Keynesian remedies for depression work. They believe monetary stimulus also works, and that proper monetary policy would prevent depressions from occurring.

A proper policy, in the view of most monetarists, would be to keep a steady hand at the monetary throttle. A strong minority among monetarists would eliminate direct control of money as a government function. They would have the government merely enunciate and uphold a gold-for-money exchange standard and permit an otherwise unregulated, competitive, private banking system to determine the supply of money.

The monetarist hypothesis is a good deal flashier than the evidence warrants. Friedman and Schwartz in 1963 had shown a general tendency for the supply of money to fluctuate in the same direction as the dollar value of economic activity and for the monetary movements to occur before the changes in output and prices. At the same time, the relationship was imprecise, the division of movements between prices and employment was uncertain, and the observable measures of these relationships changed in inexplicable ways. Friedman and his followers argued that there was a cause-and-effect mechanism between changes in the money supplied and changes in prices and employment. But neither they nor anyone else has been able to provide a convincing description during the past eighteen years.

Nevertheless, during this time, the liberals came to admit that money did matter in our economy, that monetary policy could abet or abate depression and inflation under many circumstances. A compromise interpretation of the Great Depression has emerged in academic circles. The initial sharp decline from 1929 to 1931 was caused by an unusual confluence of ill winds of the sort that are always breezing about in our economy. Neither unwarranted changes in money nor other types of inept government meddling were significant among them. The further collapse from 1931 to 1933 is largely attributable to the failure of the Federal Reserve to perform the basic function for which it was created: preserving the integrity of banks and money.

While monetarism has made modest progress among academic economists on the strength of modestly appealing arguments and evidence, it has achieved overwhelming dominance in the realm of public policy on a record of repeated failures. Obviously, the source of its success must be elsewhere. Monetarism enables conservatives to escape the Depression bogey. The rise of monetarism is thus in part ancillary to the rise of conservatism. Indeed, recent conservative strength springs from many phenomena of a noneconomic or tangentially economic character, phenomena that have been skillfully described by Christopher Lasch in *The Culture of Narcissism.*

Three years after Friedman and Schwartz revived monetarism, economic developments began to make the thesis look better still. The economic difficulties of the past fifteen years, without exception, have readily been perceived as causes or consequences of an ever-present and widely resented inflation. Inflation is a surefire prescription for a conservative resurgence. It proves they were right, since they are always predicting it as the consequence of liberal excesses. It seems intuitively obvious that almost any schemes to ensure full employment and transfer income to the disadvantaged will contribute to inflation. Inflation also adds directly to the popularity of monetarism. It appears only tautological to assert that inflation is the consequence of a disregard for sound money. Too many dollars are being created to "chase" the finite quantity of goods we can produce. The solution, obviously, is to stop "printing" so many of those troublesome dollars. The technique that conservatives choose out of necessity becomes the technique that easily generates popular conviction.

In the English-speaking Atlantic triangle, monetarism has been a major element of economic policy in Canada for about five years, in Britain since May of 1979, and in the United States since October of 1979. Not surprisingly, the Canadians have found that their interest rates, unemployment, and inflation tend to move in concert with counterpart statistics for the United States. For the roughly three years that Canadians observed monetarist canons of good behavior and Americans did not, the Canadian dollar became perversely more abundant relative to ours, at least as measured by its rapidly falling exchange rate during this period.

Britain was next under Mrs. Thatcher. A front-page headline in a recent New York *Times* charitably described the results: BRITISH UNEMPLOYMENT INCREASES DESPITE MRS. THATCHER'S POLICIES. The same story notes that "Inflation, which stood at 8 percent when the Conservatives came to power in May, 1979, is now nearly double that—15½ percent on an annual basis in 1980."

Finally came Mr. Volcker's triumphant introduction of orthodox monetarism to the United States. In the year and a half since, interest rates have been higher and more volatile than ever before in our history. But that, after all, was an anticipated consequence of the new poli-

cy direction. The various measures of the money supply and its components, which the Federal Reserve announced it was going to control closely *instead* of interest rates, have also been considerably more volatile than they were when nobody was trying so hard to control them. From October of 1979 until now, the Federal Reserve has succeeded in making most of the money measures grow at rates approximately equal to its policy targets. Even though this accomplishment means that all the versions of money have been growing at rates below their averages for the past ten years, the rate of inflation is the second or third highest for a comparable period since 1920. And, as a diabolic bonus, our national income is down and an additional 2 million people are unemployed. The conservative doctor has powerful medicine; but workers who lose their jobs and politicians who run for re-election cannot survive the side effects long enough to enjoy the promised cure.

MONEY MUDDLES

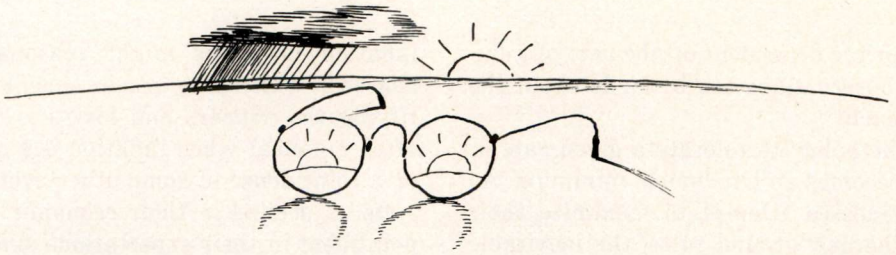
Why doesn't monetarism work? Or, better yet, how does it work? When the Federal Reserve, or any central bank, endeavors to reduce the growth of money, it utilizes a handful of well-known standard techniques. It can sell securities it owns (U.S. government bonds and bills) for money that then "disappears" from the private economy. It can be more parsimonious about money it lends to banks, or it can charge more interest for such loans. If it wants to move more forcefully, it can alter for member banks the maximum permissible ratio of deposits to reserves. Finally, with presidential authorization, it can move precipitously by directly regulating the quantity of new loans made by banks, through which the banks create money (credit controls).

It doesn't take a Ph.D. in economics to see that the common effect of these techniques is to make it more difficult and more expensive for individuals and businesses to borrow money from banks. It is a little less obvious that this is the *only* channel through which monetary policy affects the economy. Our system of money and credit has ramified into an enormous, tenuously balanced structure. Its stability depends on our confidence in its stability. The maintenance of this confidence and stability is the primary task of the Federal Reserve. It used to be that the holders of bank notes (paper money) and bank deposits (bookkeeping money) worried about whether or not they would be able, as promised, to convert these into gold (real money). That problem has now been solved by declaring that paper money *is* real money. But an identical problem remains. Can the holders of bank deposits, savings accounts, dollar deposits in London, money-market funds, and Treasury bills convert them with confidence into each other or into currency? The total of such claims on dollars in the world exceeds 3 trillion, while the total of actual U.S. paper money and coins is about 130 *billion*, or about one dollar for every twenty-five potential claims.

If the depositors at the First National Bank of Anytown decide that they want to hold dollar bills instead of bank deposits, it is the responsibility of the Federal Reserve to make the dollar bills available. It will convert into currency the deposits the First of Anytown has at the Federal Reserve. Then it will lend the Anytown bank additional currency against the collateral of loans made and securities purchased by Anytown with its depositors' money. This is precisely what was *not* done during the chaotic slide into the depths of the Great Depression. This mistake is not likely to be repeated.

Now consider an example from the other end of the economic spectrum. The great multinational corporations, such as IBM, hold huge deposits denominated in dollars in banks outside the United States. The banks may be German or British or overseas subsidiaries of American banks. The deposits may have been created by borrowing dollars abroad, by earning dollars abroad, or by converting some other currency into dollars. Collectively these deposits are referred to as "Eurodollars"—a somewhat misleading name since the deposits may reside in Hong Kong or in Nassau. The Federal Reserve does not count Eurodollars in the money supply that it is now trying to control. Suppose that IBM decides to move $10 million from Chase Manhattan in London to Chase Manhattan in New York. This appears to have been a frequent enough occurrence over the past five years, as the American economy has grown faster than the economies of many major countries, and multinationals have found more needs to use money in the United States. As far as IBM is concerned, one account has been debited and another credited by the same amount. However, as far as the Federal Reserve is concerned, a net $10 million has been added to U.S. bank deposits and therefore to the money supply. Under the rules that maintain the system's stability, a new deposit must be secured by new reserves. Only the Federal Reserve can create the assets necessary to support the new deposit. If it fails to do so, it may provoke a crisis by creating a situation in which its own rules are not satisfied, thus forcing a sudden liquidation of bank credits, a loss of confidence in banks, or both. Thus, one way or another, the Federal Reserve supplies the cash and reserves necessary to support fully whatever liquidity has been created. It doesn't matter if the claim on dollars was created years ago or yesterday, in New York or in the Bahamas. These claims are so extensively fungible that the integrity of all depends on the integrity of each.

Most students are taught that the Federal Reserve can directly expand or contract the currency and deposit reserves that it supplies to the economy and thus determine the total supply of money. This proposition is correct from a legal or an algebraic point of view; but it is a woeful guide to policy in the world today. If Mr. Volcker



and his colleagues, in a fit of anti-inflation zeal, were to supply less currency and reserves than are demanded by the people and required by the banks, they would cause banks to fail. This is the cardinal sin committed by their predecessors fifty years ago. Monetarism is built on the exposure of this transgression. Hence, its fundamental fallacy is apparent. A central bank that is true to its primary responsibility cannot control the supply of money. Rather, it can only influence the demand for money by changing the level of interest rates.

This may seem like a small distinction until we return to the question of how the application of monetarist principles actually affects the economy. If the Federal Reserve attacks price inflation and a ballooning money supply with monetarist policies, the immediate effect will be to make borrowing more difficult and expensive. Obviously, the proximate effect will be to curtail the quantity of borrowing. If banks lend less money, they will create fewer new deposits for the accounts of borrowers. Thus the growth of money will be successfully curtailed.

To see the next link in the chain, we must ask what most people and businesses borrow money for. The answer is usually to buy things that cost a lot of money and last a long time: automobiles and factories, machines and television sets, college educations and airplanes, houses and inventories. If less is borrowed to finance these sorts of purchases, less will be purchased. If less is purchased, less will be produced. Unemployment will increase. For reasons that were extensively analyzed by the Keynesians and are disputed by no one, the original drop in purchases and the increase in unemployment will be multiplied into further declines in economic activity.

It is time to pause and count up the victories of orthodox monetarism against the inflationary dragon. Thus far, monetarism has increased interest rates while also increasing unemployment and decreasing national income. What about inflation? Higher interest rates will make a modest but perceptible contribution to increasing the cost of everything from houses to asparagus, and thus to increasing the rate of inflation. For some considerable period of time, higher unemployment and lower production will also increase the rate of inflation. If General Motors makes fewer Chevrolets, it can lay off production workers and some supervisors. But it will still have the same complement of executives, research-and-development personnel, and administrative employees; the same interest on its debt; the same property taxes to pay; the same rent; the same pensions for retired employees; and so on. Hence, many fixed costs will be spread over fewer units, increasing the cost per unit. Also, because total employment will not be cut back as fast as production, the number of automobiles produced for each hour worked will also decline. Both effects will increase the cost of each car. The pressure on General Motors to increase the price of its cars will thus be intensified, and inflation will again be exacerbated by the application of orthodox monetarism.

This is essentially what has happened in Britain under Mrs. Thatcher and in the United States under Paul Volcker. Proponents of this approach can still argue that persistence will ultimately produce rewarding results. If unemployment is increased and production reduced far enough and long enough, workers will accept lower wages in order to keep or obtain employment, while corporations might cut prices in order to keep or expand their market share. Something like this did happen as a result of the deep recession from 1973 to 1975, during which the rate of inflation was finally cut in half, from about 10 percent to about 5 percent. Implicitly, a reliance on monetarism is a reliance on prolonged unemployment and decreased profits to beat inflation out of the economy.

Again, the central issue is the degree to which the actual economy satisfies the assumptions of perfect competition inherent in all conservative economics. Because the United Auto Workers and other unions benefit from closed shops, three-year contracts, and quasi-monopoly power; because General Motors and other large corporations also possess some amount of monopoly power in their markets; because the government administers or supports the prices of everything from wheat to telephone calls, minimum wages to fighter planes; because of all such protections against the effects of inflation, it takes a longer, deeper, more nearly lethal dose of economic decline to have any impact *on* inflation.

GOOD INTENTIONS

At this point you may well ask, If the cost of vanquishing inflation is so terrible, what is the cost of simply tolerating it? From time to time in recent years, many conservatives and liberals alike have suggested that we adopt the techniques for accommodating inflation that have been developed by our Latin American neighbors. We have already moved far in that direction by making Social Security, many private pensions, wages, interest

rates, and contract prices dependent on the rate of inflation. Three general observations can be made about the pitfalls of this approach.

First, if it is public policy to tolerate a given rate of inflation, that rate becomes an irreducible minimum. As individuals and businesses attempt to maximize their own wealth under the new ground rules, the inevitable momentum of inflation is toward still higher levels, which must be tolerated in turn. This is the story of economic policy during most of the Carter Administration.

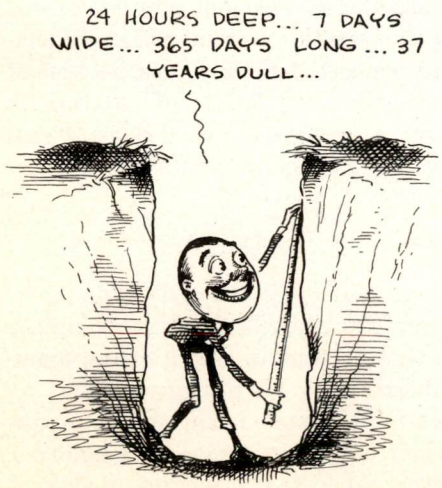
Second, the more frequently and substantially prices change, the more expensive and inefficient it becomes to operate a system such as ours, in which decisions about the deployment of resources are governed by prices. The social-cultural obverse of this phenomenon is the disaffection and dissolution that are already so widely apparent. The quintessential example is the Weimar Republic.

Third, inflation is as addictive and dangerous as heroin. Consider the family that buys a house that, by conventional standards, it cannot afford and pays 15 percent interest on a mortgage. That family is gambling its future on continued inflation, in the wages it receives and in the value of the newly purchased house. When a corporation goes deeper into debt at high interest rates to finance new plant and equipment, it is making a similar wager. As more and more of us make such wagers, our continued economic equanimity and survival depend on continued inflation. More bluntly, if inflation eases or reverses, many families and businesses will be hard-pressed or bankrupted, which will lead in turn to foreclosures and distress sales and ultimately to deflation and depression.

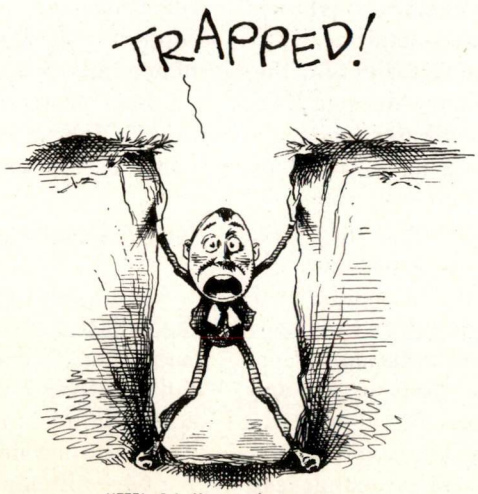
These are reasons enough, perhaps, for all interest groups to support measures to contain inflation. The enthusiasm with which particular groups support anti-inflation measures might reasonably depend on the degree to which they lose or benefit from inflation. Identifying the winners and losers is a difficult task. It is often not clear when inflation is a cause, a consequence, or a coincidence of some other event. Most groups have suffered decline in their economic well-being or disappointment in their expectations since the onset of rapid inflation in the early 1970s. Unionized workers who have kept their jobs seem to have maintained or improved their relative position. Oil companies and certain other producers of natural resources have benefited enormously. Nonunion workers have fallen somewhat behind. Those who depend on welfare and Social Security have done reasonably well, contrary to conventional liberal mythology and perhaps only because of the humane determination of the previous administration. It is easy to show that the largest corporations have done rather poorly, as a group and individually, compared with others in their various industries. Relatively small companies, especially those committed to new products and processes, have been strong winners.

This is a mixed bag. Most of the winners and losers are only marginally to one side or the other of center. Few have a strong motive to risk the immediate, high costs of fighting inflation in order to avoid the abstract and long-term costs of continuing it. Each individual or group wants to assess its particular, private share of the total burden imposed by acting against inflation. Our asocial, ahistorical culture of narcissism intensifies these self-interested, short-sighted responses to policy alternatives.

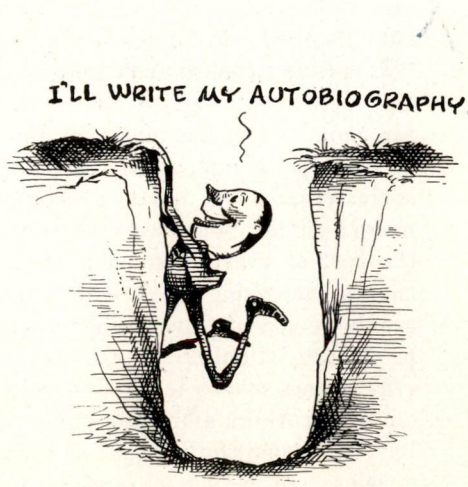
At its best, the new political strength of conservatism offers an alternative to this process of political-economic atomization and attendant cultural disintegration. It appeals with some renewed inspiration to beliefs in moral right and wrong that transcend personal relativism; beliefs in society, country, and civilization that transcend



On January 1, 1981, Winthrop T. Blinkman took measure of his life.



"Winkie" was in a rut.



Desperately, he sought escape . . .

special interest groups; gratitude to our ancestors and a willingness to sacrifice in hope for our children that transcend hedonism. Yet it seems probable that as much of Ronald Reagan's support came from the electorate's base desire to be left alone as it did from these more elevated aspirations.

WAYS OUT

It is false to assert, as is commonly done today, that inflation is a problem of such technical intricacy that economists simply do not know how to end it. One surefire method that has ended every previous inflation in the Western world over the past 500 years is a precipitous, deflationary depression. This is the natural method of a free-market system for correcting excesses. To the extent that governments seriously pursue the restrictive fiscal and monetary policies advocated in different combinations by various conservatives, they make a repeat of this historical outcome more likely. The more long-lived and virulent the present inflation becomes, the more ominously inevitable the ensuing crash appears to be. Hence the urgency of the search for other solutions and the delicacy required in their implementation.

There are other solutions. There is no insurmountable technical obstacle to the operation of wage and price controls. If they are administered in conjunction with policies on government spending, taxation, and money creation that are consistent with reducing total demand for goods and services to the level of total income, they can succeed. However, they cannot be administered without totalitarian government enforcement and/or a patriotic spirit of voluntary compliance. The former is a high price to pay. It may also prove irreversible after the crisis is controlled. The latter is simply a missing bond in the body politic. The weakness of the Carter Administration was its inability to command any degree of self-restraint and support from its own constituencies for an anti-inflation program. There is some basis for hoping that Reagan has the charisma and the mandate to command more cohesive loyalty than Carter could. But it is not yet clear that he means to direct this potential in support of a collective effort against inflation.

There are a number of solutions that fall short of the immediate imposition of controls but have similar prerequisites. To end inflation without the ruptures of depression or an imposed freeze requires that price increases be brought down slowly enough over a number of years that numerous businesses and families with contractual commitments based on the presumption of continued inflation are not forced to default on their contracts by going bankrupt. It is also necessary that prices in different sectors come down at roughly comparable and coincident rates in order to avoid equally severe embarrassments. Obviously, such a process of decompression is not likely to happen without a great deal of planning and control.

HAVING AND GETTING

Let us now turn our attention to the two main conservative factions within the Reagan Administration—the Old Guard and the Young Turks. Members of the Old Guard place primary reliance on orthodox monetarism rather than on reductions in the size of government to fight inflation. They care about balanced budgets. They are not enthusiastic about general tax cuts and would prefer specific reductions in taxes on business profits and on the gains of investors. Their enthusiasm for deregulation is equally selective, varying in direct proportion to the extent that regulation is seen as inhibiting or protecting the profitability of leading corporations. They



but Chapter One was boring. *Suddenly, he saw the answer:* *redecorate the rut.*

tend to be pragmatic, managerial, concerned about an equitable maintenance of the status-quo distribution of economic benefits, pro-big business, concerned about a depression, and unideological. They tend to be middle-aged or older and to come from entrenched institutions and to have impressive vitae. They include the secretaries of the treasury, defense, and commerce; the chairman of the Federal Reserve board of governors; Arthur Burns, a former chairman; Milton Friedman, the Nobel prizewinning economist; Paul McCracken and Herbert Stein, former chairmen of the Council of Economic Advisers.

The Young Turks endorse monetary restraint, for reasons already explained. But the thrust of their argument is that we should remove the inhibition of government from an economy that would otherwise flourish. The centerpiece of their program is the Kemp-Roth proposal to reduce drastically *all* federal income tax rates over a three-year period. They pay lip service to a balanced budget. Their major contention is that removing the burden of prohibitive taxation will unleash the creative energies of a competitive, return-motivated economy. People will work harder and more intelligently, invest more and better. The result will be an explosion in the supply of goods and services. The explosion will vanquish both inflation (money will have more goods to chase) and the initial government deficit (more activity will produce more tax revenue, even at lower rates). This is the meaning of supply-side economics.

The Young Turks would deregulate and decontrol almost everything. They would have the federal government refrain from saving the New York Citys, the Chryslers, and the Hunt brothers in order to restore the necessary element of risk to the competitive system and to accelerate the pace of technological improvement through the death of the outmoded, making room for the growth of the new. They do not worry very much about a depression, perhaps because they are younger people, very ideological, and often supported by newer and more successful economic interests. They believe in fighting inflation with expansion rather than contraction.

The Young Turks refer to their Old Guard opponents as contractionists, economic fine-tuners, crypto-Keynesians. The most uncompromising Young Turks with high positions inside the administration are David Stockman, director of the Office of Management and Budget, who distinguished himself as the only congressman from Michigan to vote against the Chrysler rescue plan, and Paul Craig Roberts, assistant secretary for economic policy and formerly associate editor of the *Wall Street Journal*. The best known Young Turk economist is Arthur Laffer, whose famous curve purports to illustrate the increased activity and tax revenue that would result from lower tax rates.

The Old Guard has power and influence in this administration because it represents money and power in the world. That money and power contributed directly to the President's successful pursuit of the nomination and to his election. They bolstered the campaigns of many new and old conservatives in the Congress. Finally, through the large-scale increase in public-issue corporate advertising, they helped to shift opinion in a conservative direction. Because the locus of private wealth and influence shifts slowly, we have seen the Old Guard in Washington before. Many of its members were present in the Nixon and Ford administrations. Their generic antecedents have been in the cabinets and inner circles of every President since Lincoln.

The Old Guard is not notable for strict obedience to constant principles. I remember an afternoon at Columbia University in 1967 when Arthur Burns berated an official from the Agency for International Development for the continued provision of American food and other aid to India at a time when that country had chosen to proceed with the development of publicly owned steel mills and fertilizer plants. Yet, so far as I know, Burns has never advocated expelling Britain from NATO, despite that country's grave lapses into socialism.

Like the President himself, these men have endorsed and implemented the policies of the Keynesian welfare state in various roles at various times in the past three decades. The present chairman of the Council of Economic Advisers, Murray Weidenbaum, now forcefully proclaims the virtues of decontrolling everything; but the same man was the earliest, strongest advocate of wage and price controls in the Nixon Administration. I do not wish to denigrate the extent to which continued experience and contemplation have revealed a higher truth to these intelligent gentlemen. Nevertheless, one must be forgiven for imagining that still higher truths await future revelation.

Things fall into a more comprehensible mental order if one supposes that the members of the Old Guard have had a constant purpose for 120 years of American experience. Often unconsciously or accidentally, they have gone about the truly conservative business of preserving the interests of those individuals and institutions that are already best served by our political economy. Their shifting doctrines make more sense if viewed as a succession of different techniques that are sequentially appropriate to achieving the same objective, like the series of tools employed by a dentist at work on a single cavity.

Of course Old Guard purposes are always well served by the first conservative postulate: efficacious free markets. It is also generally in the interest of those who already have the most money to advocate that it be supplied sparingly and expensively.

For now, the specific policy issues have to do with inflation. There is no question that inflation has been a cause and a symptom of decline in the relative domestic and international positions of most of America's largest corporations, banks, and private fortunes. Truly, the Old

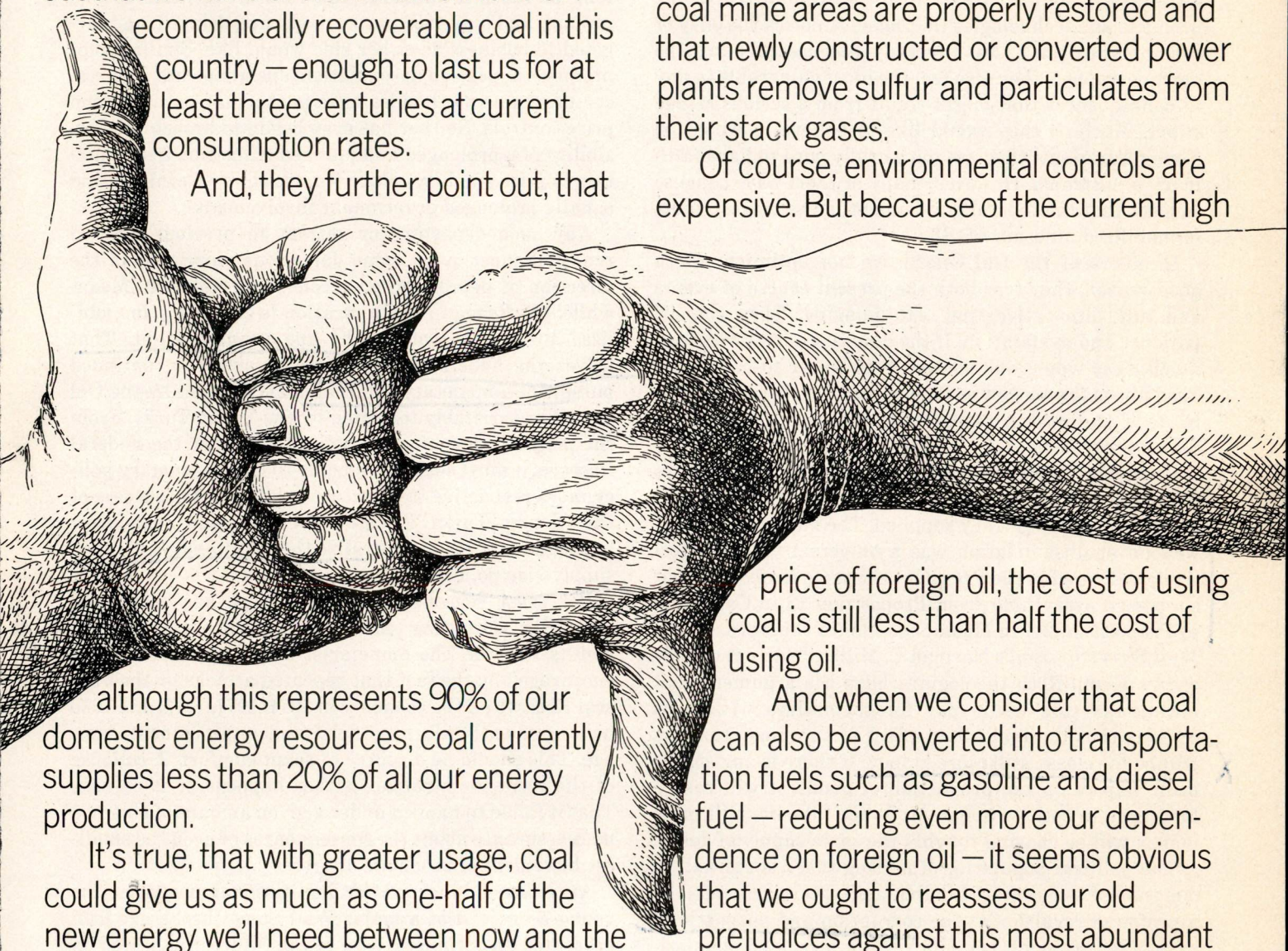
Some insist coal is good. Some insist coal is bad.
We insist it's not that black or white.

Those who insist that coal is good point out that we have over 200 billion tons of economically recoverable coal in this country—enough to last us for at least three centuries at current consumption rates.

And, they further point out, that although this represents 90% of our domestic energy resources, coal currently supplies less than 20% of all our energy production.

It's true, that with greater usage, coal could give us as much as one-half of the new energy we'll need between now and the year 2000—enough to help loosen the dangerous ties that bind us to expensive and insecure foreign oil.

But those who insist that coal is bad point to abandoned mines which scar the landscape and allow acid water to seep into streams.



And to the fact that coal contains ash and sulfur which, if not removed, can pollute the air when burned.

Still, we believe that these days the advantages of coal outweigh its disadvantages.

Because these days we have extremely tough environmental laws.

Laws that require the restoration of mined lands and the protection of air and water resources. Laws that ensure that coal mine areas are properly restored and that newly constructed or converted power plants remove sulfur and particulates from their stack gases.

Of course, environmental controls are expensive. But because of the current high price of foreign oil, the cost of using coal is still less than half the cost of using oil.

And when we consider that coal can also be converted into transportation fuels such as gasoline and diesel fuel—reducing even more our dependence on foreign oil—it seems obvious that we ought to reassess our old prejudices against this most abundant of all fossil fuels.

At least Atlantic Richfield thinks so.

There are no easy answers.

ARCO

Atlantic Richfield Company

Guard would like to end inflation. At the same time, its ranks seem almost as frightened of the potential for a precipitous and damaging deflation as the most liberal of Carter's advisers. Perhaps this is natural for those who have the most to lose. It is natural as well for those with the closest view of the pinnacles of private power to appreciate best what a delicate equilibrium we presently enjoy. In any case, the oldest, biggest corporations, which find voice in the Old Guard, are like dinosaurs trapped in a morass. They are often still firmly committed to the products and technologies that made America the envy of the world in the 1920s. Precisely because they are the most entrapped, they also feel the most vulnerable to any ill consequences that might result from a serious rescue effort. Much as they would like to believe in what the Young Turks say, they are too worldly wise to have faith in such nostrums. However, many of them have come to suspect that the federal government is the biggest, most immobilized dinosaur of all.

Members of the Old Guard are not optimists. With good reason, they fear both the present course of events and any alternative they can imagine. They counsel patience and moderation. If the dinosaurs don't wiggle so much, they won't sink so fast. It is better to have one's head above the surface as long as possible, both as an end in itself and on the chance that workable answers will develop with time.

If the Old Guard has influence because of the resources it provided, the Young Turks are represented primarily because of the votes they supplied. The idea that the best weapon against inflation was a universal tax cut effectively delivered to the President the same majorities that supported everything from Proposition 13 in California to Proposition 2½ in Massachusetts. In the words of the *Wall Street Journal*'s Norman C. Miller, "Almost nobody except Kemp-Roth theologians buys the argument that income-tax cuts would pay for themselves." It seems obvious that the immediate effect of enormous tax cuts will be to release still more money. If there is any significant impact on the production of goods, it will take a long time to become apparent. In the interim, still more money will be chasing roughly the same supply of goods.

The political popularity of cutting taxes is eternal. In our time of self-centered individuality, complemented by a profound revulsion at the corruption and purposelessness of government, tax cuts acquire increased popularity. It is particularly natural for the Young Turks' program to attract the support of those who have done relatively well under inflation and thus have little reason to care whether tax cuts and deregulation prove effective against rising prices. Of some significance in this group are the owners and managers of successful smaller firms with newer products and technologies—the "high-tech" companies. These can easily envision an acceleration in the rate at which they elbow aside the older corporations as a consequence of a withdrawal of the federal government from its various activities. The improvement in their relative position could be all the greater if a federal withdrawal were followed by continued inflation.

TUG OF WAR WITH A FRAGILE ROPE

The Young Turks haven't much reason to favor a hard-money policy, and in fact they do not. But on most other issues, the two factions of the conservative controversy tend to reach a standoff. Tax cuts are neither as big, prompt, and universal nor as moderate, delayed, and targeted to business as either side would like. Similar compromises appear on deregulation, spending cuts, and rescue programs. Both sides have anathematized wage and price controls. Neither has even begun to broach the possibility of a prolonged and planned transition from inflation to price stability, which would require a complex and equally prolonged government involvement.

Any such departure or retreat to previously failed remedies must await some dangerous movement in the direction of depression or accelerating inflation. Meanwhile, the Reagan Administration is effectively immobilized by the pull of weight and counterweight. That leaves the Federal Reserve free to act. The continued pursuit of a monetary solution is encouraged by the Old Guard and irritably tolerated by the Young Turks. From the point of view of most policy-makers at the Federal Reserve, it must seem reasonable to make monetary policy more restrictive in direct proportion to the success of the Young Turks in the executive and legislative branches in order to neutralize the inflationary effects of supply-side policies.

For these reasons our central bank has been coldbloodedly assaulting our economy since the election results were in. The monetarist hard-liners are further encouraged by the fact that repeated attacks by the Federal Reserve on the economy in 1974, 1978, 1979, and 1980 have produced only superficial and impermanent damage. This should be a source of scant comfort. A collapse of the economic structure either happens or it doesn't. That it failed to happen under a given amount of strain is no reassurance about the consequences of even the smallest increment of economic distress.

At a recent luncheon for institutional investors, the young economist of a major Wall Street brokerage firm presented an optimistic view of the future, predicated on a strong dominance of Young Turks in the formulation of administration policy coupled with monetary restraint. The audience was less sanguine, and there were a number of questions about the danger of a major economic collapse because of, or in spite of, the pursuit of conservative policies. The young economist was unperturbed. Keynes may not have known beans about inflation, but he certainly understood depressions. "We know how to prevent depressions," he said. "Keynes taught us that."

We may be well on the way to re-inventing them. □

Macro, Mtrls.

CFTC-Ginnie Mae futures regulation, he says, "is not a sensible way to run a railroad."

The stickiest problem in the jurisdictional overlap is that the SEC staunchly monitors sales practices, enforcing a strict standard requiring brokers to ensure that certain investments are "suitable" for a given customer. The CFTC has no such standard. The securities agency also enforces tougher rules on trading. Investor confidence could be endangered if exchanges, in their zeal to create volume in the new instruments, take the path of least resistance and shop for the easiest regulatory terms.

The SEC's Friedman and others believe that the conflicts cannot be resolved by the regulators and that they eventually will have to be settled in Congress. For now, however, the legislators are paying little attention to what seems to them to be an arcane fight.

"Congress has created a situation of ambiguous jurisdiction with respect to options," says CFTC Chairman James M. Stone, who will soon step down but remain on the commission. "Congress and only Congress can settle that. I take the SEC's action as a statement about its own jurisdiction and not about ours. . . . The result is going to be that both agencies will be supervising options in similar instruments." ■

MONEY & BANKING

A new source of mortgage money

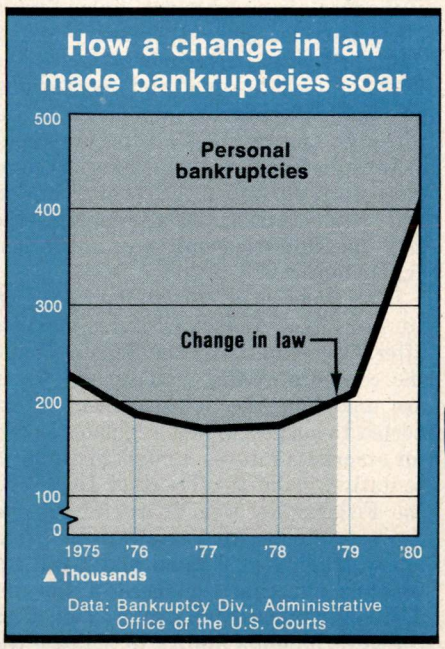
The nation's thrift institutions hope to bolster sagging earnings by doing less mortgage lending, where profits have been pitiful, and more lending of other kinds to consumers, where they hope profits will be better. Ironically, as they make the shift, the savings and loan associations and savings banks will bump head-on into the consumer finance companies—with giant Commercial Credit Co. in the lead—that hope to beef up their own sagging earnings by doing more lending to finance housing.

The thrifts are caught between paying sky-high rates for deposits while relying for earnings on portfolios filled with older, lower-yielding mortgages. The thrifts got legislative authority to use more of their assets in consumer installment loans, and many intend to do just that. The finance companies, meanwhile, have long been hampered by state usury ceilings, which cut into profit margins.

More recently, the finance companies have also been stung by the leniency of the 1979 rewrite of the federal bankruptcy law, with the resulting flood of personal bankruptcies (chart) boosting their loan losses. So they are forsaking their traditional car and appliance loans and are going after residential first mortgages.

A market edge. Finance companies think they can succeed where savings institutions have failed, through greater financial muscle, an ability to move quickly to offer new forms of variable-rate mortgages, and freedom from the constraints of banking regulators. And Commercial Credit, the Baltimore-based subsidiary of Control Data Corp., will be the first finance company to make the move.

Over the next five years, Commercial Credit, with $5.1 billion in assets, plans to convert about 500 of its more than 800 offices nationwide into "homeowner centers" that will offer an array of services aimed at the American home buyer. Explains Joseph D. Minutilli, Commercial Credit president: "We are transforming our consumer business into providing services for the real estate industry and its customers."



Steve Hart—BW

About one-third of Commercial Credit's $1 billion in revenues now comes from consumer loans and services, including a growing volume of second-mortgage personal loans (BW—Mar. 16), down from a 70% share in the early 1970s. Commercial lending for receivables, aircraft and computer leasing, and insurance provides most of its revenues and profits. And there is greater focus on small business services.

Consumer business nevertheless is expected to return to as much as half of Commercial Credit's total under the new strategy, with up to 70% of that coming from real estate lending and services, says Minutilli. By the end of this year, the company hopes to have worked out a deal with a major national real estate brokerage chain. Already, Commercial Credit has an employee relocation company, a mortgage insurance subsidiary, and an Ohio S&L, and it has begun packaging second mortgages for sale in the secondary market. As the homeowner centers proliferate—the goal is to open at least six this year—the company will begin writing first mortgages and promptly packaging them for secondary market sale. "Our strategy is not to look just at the first mortgage," notes Minutilli, "but at an integrated set of services for the homeowner."

Commercial Credit is not alone. Sears, Roebuck & Co. and Merrill Lynch & Co. are also positioning themselves for this homeowner market with real estate and financial services. And other consumer finance companies already active in second-mortgage lending indicate that it may be just a matter of time before they offer first mortgages as well.

The main reason finance companies have shunned first-mortgage lending in the past has been their higher cost of funds. The S&Ls, with low-cost consumer deposits, have been far and away the price setters on mortgage rates. But that advantage is eroding, with thrifts already paying near-market rates of interest on a large chunk of deposits, and it will disappear as all consumer deposits begin to yield money market rates. The cost advantage will shift to the bigger financial organizations—those able to raise funds with commercial paper and long-term debt sales. "When those differences are resolved," says Finn M. W. Caspersen, chairman and chief executive officer at Beneficial Corp., first-mortgage lending "will be sound business."

More consumer deposits. In addition to its use of money market resources, Commercial Credit is moving to bolster its

Investment figures of the week

Short-term interest rates took a big drop during the week, and long-term rates crept a little lower in response to slack demand for credit and some apparent easing by the Federal Reserve. Stock prices showed little change.

Money market rates	Latest week	Previous week	Previous month	Year ago
Federal funds	**15.15%**	16.51%	16.72%	15.65%
New three-month Treasury bills	**13.96%**	14.34%	15.35%	15.38%
New six-month Treasury bills	**13.30%**	13.91%	14.55%	14.96%
Three-month commercial paper*	**15.00%**	14.75%	15.63%	17.25%
Stocks				
Price/earnings ratio* (avg. 1,500 stocks)	**9.73**	9.71	9.45	8.00
Dividend yield* (avg. 1,500 stocks)	**4.97%**	4.99%	4.95%	5.65%
Dow Jones industrial average	**972.66**	966.02	948.63	826.45
Standard & Poor's 500 stock index	**130.46**	130.56	129.24	107.78
Value Line composite index	**145.32**	144.19	143.14	116.03
Lipper growth mutual fund index	**155.75**	156.26	154.14	119.03
Average daily NYSE volume (millions)	**47.9**	51.1	43.2	47.0
Average daily NYSE blocks (10,000 shares and over)	**692**	759	625	588
Bonds				
New Aaa utilities*	**14.88%**	15.00%	14.63%	14.00%
New Baa utilities*	**16.75%**	16.88%	16.88%	16.00%
New Aa industrials*	**14.00%**	14.13%	13.75%	13.63%
U. S. governments (8½% issue of 1994-99)	**12.40%**	12.83%	12.92%	12.17%
Bond Buyer municipals (20-bond index)	**10.40%**	10.27%	9.90%	8.94%

All figures are as of Tuesday, Mar. 10 except those marked*, which are from Friday, Mar. 6 and the Bond Buyer index from Thursday, Mar. 5.

Data: Federal Reserve Bank of New York, Salomon Bros., Arnold Bernhard & Co., Lipper Analytical Distributors Inc., Standard & Poor's Compustat Services Inc.

pressure to liquidate a position, options also afford the hedger a better opportunity to hold the contract longer to ensure against sudden swings in price in the underlying security.

The SEC move broke a four-year bottleneck in financial industry efforts to win approval for nonstock options. The commodities industry, led by the Chicago Board of Trade, is charging the SEC with unseemly haste in an effort to undercut the Commodity Futures Trading Commission, which regulates Ginnie Mae futures and has congressional authorization to develop a system for trading commodity options. Arguably, a Ginnie Mae certificate is a "commodity" under the CFTC's enabling legislation because a futures market exists for it.

The Chicago Board of Trade fears that it will be left behind in its plans to trade an option on Ginnie Mae futures—literally, the derivative of a derivative, which would give holders the right to buy or sell futures. Board of Trade President Robert K. Wilmouth indicates that the exchange will probably file a suit against either the CBOE or the SEC to block trading, which otherwise should begin this fall.

The new regulators. Some experts in securities and commodities law, however, say that while the CFTC is free to create an options-on-futures market, options on physical securities are well within the purview of the SEC. Thus, the commodities agency's only alternative to losing regulatory turf will be to mimic the SEC and uncork a freewheeling options program of its own. This is thought to be likely under Chairman-designate Philip Johnson, now the Board of Trade's counsel.

At the same time, the SEC also will get a new leader with an industry background—E. F. Hutton & Co. Vice-Chairman John S. R. Shad. With two industry men at the regulators' helms, analysts predict a no-holds-barred race by the exchanges to win the hearts, minds, and money of investors.

"It's an unbelievable situation, but how you come out on the issues depends on your point of view," says Steven E. Levy, outgoing head of the SEC's economic directorate. "Either, to paraphrase Yeats, all anarchy is being loosed on the world, or we're on the verge of one of the freest financial markets in the history of the U. S."

The jurisdictional issue is further complicated by the SEC's six-year refusal to relinquish claims of authority over the various security-based futures contracts that already trade on commodity exchanges, including not only Ginnie Maes but also several Treasury issues. After last year's silver market scare, the CFTC imposed an unofficial moratorium on itself in approving new financial futures. Of the 29 financial futures applications pending—on such things as common-stock portfolios, Eurodollar issues, and bank certificates of deposit—the CFTC has approved only one in the last eight months.

Both agencies are preparing their own studies of the financial futures markets after two requests by the Senate. While the contents of the CFTC's white paper are unknown, the SEC document is expected to suggest a new regulatory body for securities futures, composed of representatives from the Treasury Dept. and the Federal Reserve Board. Fiscal and monetary regulators are worried that heavy trading in T-bond and T-bill futures is affecting the price of the underlying securities and interfering with the government's ability to manage the national debt.

Stock-index trading. Perhaps the most imaginative—and divisive—contract proposal splitting the two regulators is a plan by at least six exchanges to trade an option or future on stock indexes. If approved, the plan would forever put to rest the old investment saw that "you can't buy the market."

If a contract were held to delivery, holders would receive actual shares prorated as they are weighted in the indexes, the cash equivalent, or shares in a mutual fund created to reflect the index holdings.

For portfolio managers, the concept would be a revolutionary way to hedge against losses by selling the options or futures. Losses in a down market would be offset by the profits reaped in the contract. Far ahead of its competition, the Chicago Board of Trade has created contracts for stocks in each of 10 industries, in addition to a contract covering a broad stock index, which gives investment managers a specialized form of insurance.

'Not sensible.' While the SEC has declined to challenge the CFTC openly on Treasury futures, it has usually protested loudly when the commodities regulator has taken up stock-index plans. Futures industry officials have contended that SEC approval of the CBOE Ginnie Mae contract was the opening salvo of an even more aggressive stance on the jurisdictional issue, a charge that the SEC has heatedly denied.

The SEC's move, says Commissioner Stephen J. Friedman, "stands for the proposition that in our judgment we have jurisdiction over Ginnie Mae securities traded on an options exchange. It doesn't go beyond that." But Friedman adds that "this is an area that desperately needs rationalization." Separate SEC-Ginnie Mae options regulation and

Inside Wall Street

David G. Santry/March 23, 1981

The takeover muddle that has Orion jumpy

In Greek mythology, Orion was a hunter. On Wall Street, Orion Capital Corp. is the hunted.

Since emerging in 1976 from the wreckage of the Equity Funding Corp. of America scandal, Orion has repeatedly been pursued by someone bent on acquisition. In Orion's early days, Shearson Loeb Rhoades Inc. (then Shearson Hayden Stone), Charter Co., and USLIFE Corp. were all interested in some kind of deal with the New York-based insurance holding company. Last May, Shearson came back. When nothing developed from Shearson's second overture, one shareholder, Martin J. Whitman, started a proxy fight (BW—Oct. 20) but then backed off.

The feverish activity in Orion's stock between Feb. 23 and Mar. 6, when more than 1.1 million of its 7.4 million shares changed hands and the price spurted by $4.50, to $18.63 a share, has again focused Wall Street's attention on Orion as an acquisition target.

Damsel in distress. Orion's chairman and president, Alan R. Gruber, insists, however, "There is nothing pending as far as I know." But, he adds, investment bankers have approached him asking if he wanted a "white knight"—Wall Street parlance for a company that comes in to rescue the victim of a hostile takeover attempt. Gruber says he is willing to listen to any acquisition proposal. At the same time, Orion is still paying a retainer to the New York law firm of Skadden, Arps, Slate, Meagher & Flom, the takeover specialists who represented Orion in the fight against Whitman last fall.

"Gruber has chief executive-itis," charges shareholder Whitman, meaning that Gruber enjoys the trappings and privileges of a CEO and does not want to surrender them. "Management, left to its own devices, will resist any deal," Whitman adds.

But some Wall Street investment bankers see a way to make a profit and are plotting to sell Orion. To be sure, Orion has many attractive features. For one thing, it is one of the few existing independent, medium-size life, property, and casualty insurers. Orion's earnings per share have grown to $1.75 in 1980 from 64¢ in 1977 and could hit $2.50 this year. What is more, Orion still has a tax-loss carryforward of $45 million.

Orion's stock ownership makes it vulnerable to a takeover. Management owns only 1%, while the 10 largest holders together own about 40%, according to one source.

Possible suitors. Attractive as Orion is, many Wall Street observers agree with Whitman that Gruber is not really interested in selling out. What could change his mind, they say, is for someone unacceptable to Gruber to make a proposal—Carl H. Lindner's American Financial Corp. and Raymond K. Mason's Charter Co. are two names that come up. If that happens—the theory goes—Gruber may opt for a friendly deal with a white knight.

So far, no one has come forth with a proposal. But just because a canny investor, Associated Madison Cos., sold some of its stock in the company on Mar. 9, a day when Orion's shares dropped by $1.25, to $17.38, does not mean a proposal may not come. Associated Madison was taking profits on stock it had owned for a while—and it did retain some Orion stock.

At any rate, if someone does make an offer for Orion that is substantially above its book value of $18 a share, Gruber and the other directors will have to take a long, serious look. "They'd be under tremendous pressure from big shareholders to accept a deal in the $26-to-$30 range," says one investment banker.

own consumer deposits—now totaling about $400 million. It owns a bank in Texas and a loan and investment company in Rhode Island, along with the Ohio S&L, and also takes deposits at branch offices in 11 other states, where they are registered as industrial banks. Asserts Minutilli: "No longer will the S&Ls dominate the mortgage lending field."

To a large extent, Commercial Credit and other finance companies are being prodded into the mortgage business to compensate for a near-disastrous performance in more basic consumer markets. Car loans—long a finance company staple—have largely been preempted by the captive automotive finance companies, which subsidize car loan rates to spur sales. The market for smaller consumer loans has also dried up, with the market for those loans shifting to credit cards.

Meanwhile, the portfolios of unsecured loans at consumer finance companies have been left extremely vulnerable to write-offs because of the new bankruptcy law, which went into effect on Oct. 1, 1979. Higher exemptions, easier filing rules, and lawyer advertising are sending personal bankruptcies soaring—up 82% in the first 12 months under the new act. The result: "Loan losses are double or triple what they had been," laments Walter R. Kurth, president of the National Consumer Finance Assn. That means that instead of net losses of less than 2% of consumer loans outstanding from 1977 to 1979, the losses for 1980 are expected to come in at 3% to 4%.

The primary way finance companies have insulated themselves has been to take second mortgages as loan collateral at rates usually three percentage points over the going first-mortgage rate—now more than 15%. Indeed, of the $32 billion in non-auto consumer loans made by finance companies last year, a hefty 45% were backed by real estate liens—up from 16% in 1976. Commercial Credit has followed that trend and now has 35% of its consumer loans backed by second mortgages, and last year slashed its outstanding fixed-rate loans by $226 million. "Our lending for cars and consumer durables," says Minutilli, "has been all but phased out." ■

CORPORATE FINANCE

Faster write-offs may spur leasing

The speedier depreciation allowances expected out of Congress this spring could provide a bonanza for the leasing business. That seems a rather curious outcome, since the faster write-offs are aimed at spurring purchases of new plant and equipment by industrial companies. However, companies in such capital-intensive industries as autos, steel, utilities, and airlines already have more write-offs and investment tax credits than they need to shelter what in some cases are meager, or even nonexistent, profits—and do not need more. And many are out of cash to spend on new capital goods, the accelerated depreciation notwithstanding.

But these companies can trade off un-

usable credits to leasing companies in exchange for lower financing charges on leased assets. Leasing companies, by using the tax benefits of the faster depreciation themselves, will be able to offer rates as much as 200 basis points lower than current levels, according to a study by U. S. Leasing Corp., an industry leader. As it is now, using existing depreciation allowances and the 10% investment tax credit on the assets they buy to lease out, leasing companies are offering rates of 500 to 600 basis points under conventional loan rates. That works out as a good deal for lessees who cannot use the tax breaks themselves.

Because of this cost advantage, the use of leasing has been growing at companies that formerly snubbed it as the poor man's way to acquire assets. U. S. Steel Corp. is currently negotiating to lease the $200 million coke battery it is building near Pittsburgh—one of the biggest leasing deals on record. Chrysler Corp. also has been shopping for plant-scale leasing arrangements. Ford Motor Co. has stepped up its equipment leasing over the past year, and even General Motors Corp. is looking at leasing as one financing method for its $40 billion, five-year investment program.

"The auto companies were so profitable for so long that they didn't need this kind of financing," observes Bernard A. Roth, executive vice-president for finance at Greyhound Leasing & Financial Corp. But with the persistence of their profit slump, "I think leasing could become very large in that business now," he says.

Fleeting value. Companies unable to use up their tax credits right away can, of course, carry them back three years or forward seven (or perhaps longer, if Congress approves). But high inflation and interest rates cause the value of such credits to dwindle the longer a company with profit problems waits to use them. "Those investment tax credits are more valuable now than several years out," explains W. Bruce Thomas, U. S. Steel's vice-president for accounting and finance. "So it makes sense to sell them to someone who can use them now."

Moreover, with long-term loans scarce and costly, a 10-year lease may offer the longest fixed-rate financing available to some companies. Lessors are willing to lock in a rate because their inflation risk is hedged by the residual value of the asset they lease out. They figure the value of that plant or equipment appreciates with inflation.

Even without the lure of faster depreciation benefits, the leasing business has been growing fast. Last year the American Association of Equipment Lessors signed up 100 new members for a total of 600. That membership accounted for 95% of the $37 billion worth of equipment leased in 1980—double the volume of 1975. The trade group expects 100 new members this year as more banks set up leasing subsidiaries—both as a customer service and as a tax shelter.

Cash-rich industrial companies also have been getting in on the act. They see it as a way to help sell their products, diversify their business, and shelter their income. AAmco Industries Inc., for example, a privately held franchiser of aftermarket auto parts, is about to launch or buy a leasing outfit. Abraham Bernstein, executive vice-president, says that in looking to diversify into manufacturing, the company could not find profit opportunities that compare with the return on leasing. For every dollar invested in leasing, Bernstein says, he thinks the company could shelter anywhere from $5 to $9 of taxable income.

Margin erosion. To be sure, volatile interest rates have squeezed leasing company profits during the past two years. In 1980 the average return on equity was 12.9%, down from 15.9% in 1978, and return on assets averaged 1.6% vs. 2.4% in 1978. But those margins are still respectable, and industry officials are confident that better money management and new leasing deals allowing some pass-through of higher interest costs will stem further margin erosion.

There is a question as to "whether the leasing industry has the appetite for all the business it may be getting," says John A. Blessing Jr., senior vice-president with Commercial Credit Co., a subsidiary of Control Data Corp. There are fears that even the leasing industry could run out of ways to use all the tax credits—partly because faster depreciation will require lessors to put up one-third more equity in each lease to meet tax and accounting rules. The threat that tax breaks might thus go to waste could rekindle business demands for refundable tax credits—an idea opposed by the Reagan Administration, which thinks it is an inefficient tax subsidy. But the proliferation of new leasing companies could fill the gap. Paul M. Finfer, president of Beneficial Leasing Group Inc., declares that "there will be no shortfall of ability to absorb these benefits." ■

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Where the big econometric models go wrong

When Budget Director David A. Stockman spurned the conventional econometric models and instead brought to Washington the little-known Claremont Economics Institute forecasting model, the battle lines were clearly drawn between the Reagan Administration and the econometric establishment that for years has provided much of the analysis that the federal government used to make economic policy. The dispute goes much deeper than the obvious disagreement over economic forecasts. The supply-side revolution in which the new President has enlisted challenges the basic framework of conventional Keynesian models. Many of the supply siders now ensconced in the executive offices believe that the success of their revolution depends to some extent on lessening the influence of the model builders. "We have decided to break away from the traditional econometric models," says Treasury Secretary Donald T. Regan.

Those traditional models have been enormously successful. Over the past decade a small group of entrepreneurial academics has turned econometrics into one of the nation's fastest growth industries. Offering a convenient package of data bases, macroeconomic models, and computer software, they have held out the hope that anyone willing to pay the price could obtain reliable economic forecasts. It was a powerful message in an age of economic uncertainty, and on it was built a market that now produces more than $100 million a year in revenues from a customer list that includes most major corporations as well as the principal departments of government.

Yet these are trying days for the econometrics establishment. Not only is its forecasting record under attack, but the Reagan supply-side revolution also means that the Washington connections that have played an important role in the econometricians' commercial success have begun to unravel. Acceptance in Washington has always been a strong selling point, and eager competitors hope that official disapproval may shake the dominance of the big three econometric firms—Data Resources (owned by McGraw-Hill Inc.), Chase Econometrics (Chase Manhattan Bank), and Wharton Econometric Forecasting Associates (Ziff-Davis Publishing Co.).

The political problems come at a very inconvenient time for the econometrics profession because the business community was already becoming skeptical about computer-based forecasting. "Corporate executives have always been suspicious of black boxes that they don't understand, and the poor track record of econometric forecasts seems to be reinforcing this natural bias," says Thomas H. Naylor, a Duke University economist who recently completed an extensive survey of the corporate use of econometrics. "I think a lot of companies are reappraising their reliance on the large-scale models and are looking for something that is more manageable and less mysterious," he says.

Credibility gap. The underlying problem is that the demands of the marketplace have pushed econometric models beyond their inherent limits. And by offering an illusion of certainty that sharply conflicts with reality, they have built themselves a virtually automatic credibility problem. Critics, particularly those in the Administration, believe that these problems have been mounting for the following reasons:

- The econometricians are too reliant on historical information and can do no more than make judgments about the future based on past statistical relationships. Over the last decade the explosion of oil prices and inflation and the growing interdependence of the world economy have caused changes that the model builders have been unable to fit effectively into their mathematical formulas.
- They have oversold their ability to forecast. Because of their claims to "scientific procedures," econometricians more than other economists have, like it or not, locked themselves into precise predictions that have proved increasingly difficult to defend.
- They have danced too fast to the tune of rapidly changing economic numbers. In recent years the big model builders have changed their forecasts quarterly or even monthly as the data appeared to prove them wrong. Even with those all-too-frequent changes, their forecasts were off badly in the last two years.

By overselling their ability, they have virtually built an automatic credibility gap

The big econometric models began signaling a downturn early in 1979 and construed the second-quarter dip as the onset of a potentially serious recession. After the third-quarter recovery, they kept betting that the next quarter would turn negative. Then, when last spring's drop was already under way, they turned briefly optimistic until the worsening statistics convinced them that their initial pessimism had been correct. They were wrong once again, because the economy picked up during the summer and was still running strong at the end of the year (table). "They were not only consistently wrong, they constantly changed their forecasts in the wrong direction," notes Stephen K. McNees, an economist at the Federal Reserve Bank of Boston whom the econometricians themselves rely on as an arbiter.

The model builders point out, of course, that they were in good company, since their forecasts were no worse at any time than was the consensus reading of most business economists. Yet that in itself is an admission that the enormous technological resources that they draw on have not given them much of a leg up on forecasters who scratch out their hunches on the back of an envelope. "I have never been able to discover any real differences between econometric and judgmental forecasts," says Victor Zarnowitz, professor of economics at the University of Chicago, who has been following the track record of various groups for more than 20 years.

Judicious manipulation. The fact is that the model builders produce forecasts that also are largely judgmental. In theory, they are based on a series of mathematical equations that accurately reflect the underlying structure of the economy and require only the addition of estimates of such "uncontrollable factors" as monetary and fiscal policy to grind out reasonable forecasts. In practice, a model that is run mechanically generally produces poor forecasts and is brought back to reality largely by the judicious manipulation of equations.

"There is no way of telling where the Wharton model leaves off and Larry Klein takes over," says James B. Ramsey, professor of economics at New York University, referring to Wharton's Nobel laureate Lawrence R. Klein. To be sure, the model builders do not deny that they tinker. All forecasts come with long lists of special changes that have been made to the original equations, and DRI's package includes a run of the model in its pure form. "The Wharton forecast is an interaction between the model, the staff, and sophisticated users who always tell us more about the economy than we know," says Klein, who argues that the final version of the forecast is generally the best. He sees the model itself as essentially a tool that imposes consistency and allows forecasters to organize their thoughts about the behavioral characteristics of the economy.

To some academics, this attitude chal-

Haig will make a last-ditch fight when faced with the mounting opposition from congressmen seeing their own pet domestic projects slashed and from Haig's own State Dept. requesting a $140 million bilateral aid package for El Salvador alone.

Congress may deal more gently with the World Bank request to double its capital. The cost to the U. S. would be $650 million over six years. Along with other donors, this would double the bank's present capital from $40 billion to $80 billion. But it is only a stopgap solution to the bank's overall financial problem, since the additional capital will be quickly outpaced by the bank's present lending rate of about $8.5 billion per year. The articles of the bank require it to be leveraged on a one-for-one basis, meaning that the new capital base increase would be eaten up in four years.

Nix on oil projects. McNamara had hoped to solve the bank's financial problems with major borrowings from OPEC surpluses by organizing a new bank "facility" to develop oil around the world. The argument was that it would help in two ways: by developing new oil sources for the poorer countries in severe difficulty because of their rising imported-energy costs, and by enlarging its lending facilities. But the Reagan Administration has rejected the proposal. And, in fact, the highest working echelons in the bank doubt their competence to enter the sophisticated international oil business on such a huge scale. Nor, for that matter, is it certain that the OPEC surplus countries are interested in funding such a program. Still, there is a silver lining to most clouds, and Clausen's problems may return the bank to its old, pre-McNamara ways. It will now have to abandon such massive new plans as "structural lending"—in fact, balance-of-payments loans to hard-up countries (BW—Feb. 23)—and attempts to remake the social environment of the less developed countries. It should return, some old aid hands argue, to the bank's original concepts of building economic infrastructures on which private and government enterprises could grow.

To do even that, Clausen must greatly expand co-lending with commercial banks and aggressively attack problems of the bank's long-neglected "free enterprise window"—the International Finance Corp.—possibly by permitting it to float its own paper in the capital markets.

There is an urgent reason to redefine the bank's role, however. In October the West will meet the less developed countries in Mexico for the long-awaited North-South summit conference. The Canadians, one sponsor of the meeting, got a green light from Reagan while he was in Ottawa in March for U. S. participation and, possibly, Presidential attendance. Any new World Bank strategy has to be in place before the Mexico meeting if it is to meet the new demands any program worked out there will place on it. ■

The surprise election hurdle facing Giscard

Valéry Giscard d'Estaing may be facing a photo finish rather than the shoo-in conventionally forecast in the elections in late April, when he seeks a second seven-year term as French President. Giscard is publicly concentrating on Socialist leader François Mitterrand as the man to beat. But his first major challenge is to win the first round of the two-tiered contest against feisty Jacques Chirac, mayor of Paris, his chief rival for the support of the center-right coalition that now governs.



Vioujard/Gamma/Liaison

Challenger Chirac: A Reaganesque appeal to middle-rank businessmen.

Public opinion polls—which have an even worse record for predicting the winner than those in the U. S.—say that either Giscard or Mitterrand will be sworn in as President. But they ignore an increasing possibility that Chirac might make a strong enough showing in the first round to force Giscard to abandon the race.

What makes all this interesting to Washington is that Chirac has launched an unabashedly Reaganesque campaign—courting middle-rank businessmen by promising to cut $6 billion in taxes and to slash public spending.

The challenges. Chirac does not have it all his own way, though. Despite his leadership of the Rassemblement Pour la Republique (RPR), the party that is the chief claimant to the mantle of General Charles de Gaulle, he is being challenged by two other candidates: Michel Debré, once Prime Minister under De Gaulle, and Marie-France Garaud, a former braintruster for Chirac. The split could produce a huge plurality for Mitterrand in the first runoff. And that could so damage the center-right front-runner that he could not recoup before the second round two weeks later.

Fortunately for Giscard and for the center-right allies, Communist leader Georges Marchais appears more interested in following Moscow—the Soviets have just endorsed Giscard—than in producing a victory for a united left with the Socialists. Even without Marchais' sabotage of any Socialist-Communist alliance, Mitterrand has trouble inside his own party. Giscard's nightmare is that Socialist bickering could destroy Mitterrand's chances. That would leave Chirac to channel dissatisfaction with the government in the first round—precisely the way Giscard beat out the Gaullist favorite, Jacques Chaban-Delmas, in 1974.

—John Templeman

Past mistakes of econometric forecasters...

1980
Forecast as of December, 1979
Percent change in real GNP growth (annual rate)

	I	II	III	IV
Chase Econometrics	−6.1	−1.7	1.1	3.4
Data Resources	−4.6	−2.4	1.7	1.9
Wharton EFA	−2.1	−1.8	0.5	2.8
Actual	3.1	−9.9	2.4	4.0

Data: Data Resources Inc., Chase Econometrics, Wharton EFA Inc., Commerce Dept.

...cast doubt on their current pessimism...



Chase's Chimerine



DRI's Eckstein



Wharton's Klein

		Percent change 1981	1982	1983	1984
Chase Econometrics	Real GNP	1.3	3.6	3.9	3.1
	Inflation	10.2	9.1	7.7	7.7
Data Resources Inc.	Real GNP	2.7	2.4	3.2	3.8
	Inflation	10.4	9.6	9.0	8.1
Wharton EFA	Real GNP	2.2	2.1	3.4	3.4
	Inflation	10.3	9.6	8.3	8.0

...opening the door for some new optimists



Claremont's Rutledge



Evans Economics' Evans



Merrill Lynch's Cox



CEA's Weidenbaum

		Percent change 1981	1982	1983	1984
Claremont Economics Institute	Real GNP	0.3	3.2	5.4	4.0
	Inflation	9.9	7.2	5.5	5.5
Evans Econometrics	Real GNP	2.5	4.7	4.6	4.2
	Inflation	10.0	8.8	8.4	8.4
Merrill Lynch	Real GNP	0.6	4.9	6.0	4.3
	Inflation	9.5	7.1	6.0	6.2
Reagan Administration	Real GNP	1.1	4.2	5.0	4.5
	Inflation	9.9	8.3	7.0	6.0

Data: Chase Econometrics, Data Resources Inc., Claremont Economics Institute, Evans Economics, Wharton EFA Inc., Council of Economic Advisers, Commerce Dept., Merrill Lynch Economics

Keith Meyers; Christopher Morrow; Brian Payne; Newsweek/Ficara; Gwendolyn Stewart; Andrew Popper; UPI

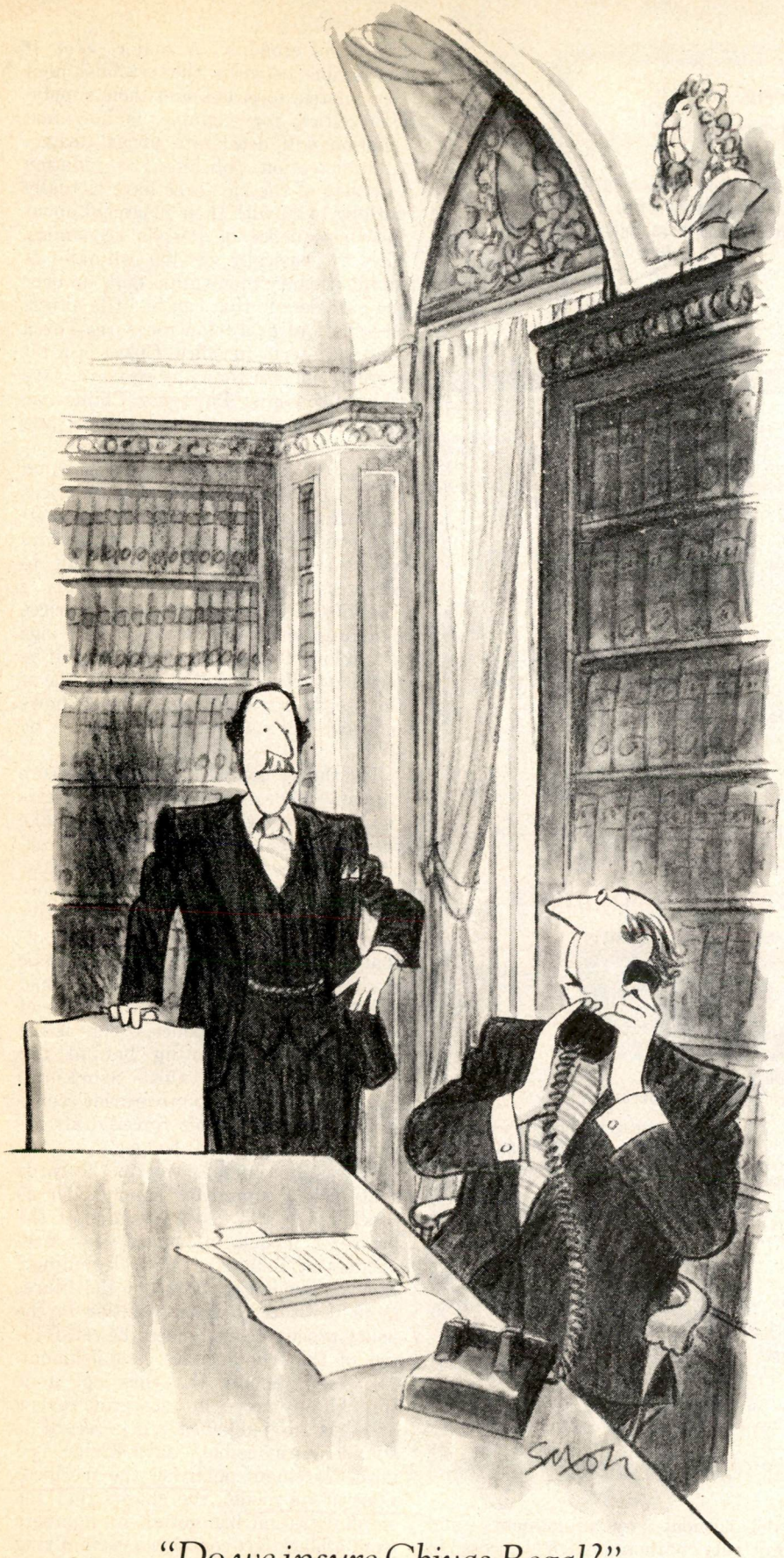
lenges the notion that the large commercial models have scientific validity. "To the extent that the forecasts are the result of adjustment, they provide no test for competing theories about how the economy behaves," says Ray C. Fair of Yale University, who runs his own model without any adjustments—and admittedly without much success in forecasting. This is a crucial point because the current battle over econometrics is also over which theories provide the best guide to how tax and budget cuts, as well as monetary policy, will affect the economy. A major point of contention between the establishment econometric forecasts and their supply-side critics, for example, is how fast inflation will decelerate under Reagan Administration policies. The inflation forecasts of the big three have virtually nothing to do with their judgment about the consequence of Reagan economics. They are basically varying estimates of an inflationary momentum built up over the past decade that can be little affected—short of draconian measures—by a four-year term in office. Chase is a bit more optimistic than the rest are, says Chief Economist Lawrence Chimerine, because it assumes that OPEC is settling down to a moderate pricing policy.

Wharton shows a modest deceleration in 1983 because only 60% of past prices increases get built into wages, and sluggish growth in the preceding two years lowers capacity utilization enough to compress markups. For DRI, not only is 85% of the increase in consumer prices built into wage equations, but the lags are so long that current inflation will be pushing up wages well past the middle of the decade. Its long-term forecast shows inflation still stuck at more than 7% by 1990.

The theory behind DRI's stubborn core rate of inflation is "adaptive expectations"—the notion that people make their judgment about the future direction of prices from the slow accumulation of experience at the grocery store and the gas station. The alternative theory—"rational expectations"—holds that individual price forecasts tend to be made on the basis of a relatively rapid judgment about the future direction of monetary and fiscal policies. That is the fundamental reasoning behind the Claremont model that Stockman brought to Washington to provide econometric support for his forced-draft reworking of the federal budget.

It was, of course, never in the cards that such a committed supply-sider as Stockman would depend on one of the big three models to predict the consequences of Reagan's "New Beginning." But the sudden elevation of the Claremont institute to a key position in the policy process has offended the sensibilities of the econometrics establishment. "To use a model that has not gone through any process of academic review and has no published track record is simply irresponsible," says Klein. And until Claremont publishes the specifications of its model, the charge that the Administration has gotten its numbers from a black box contains a certain ring of truth.

A preliminary version of the institute's forthcoming report does, however, give some notion of the model's basic characteristics. It is, first of all, a mone-



"Do we insure Chivas Regal?"

Chivas Regal • 12 Years Old Worldwide • Blended Scotch Whisky • 86 Proof. General Wine & Spirits Co., N.Y.

tarist model in which the main determinant of the course of the economy is the rate of growth of the money supply. But unlike old-fashioned monetarism, it draws a distinction—based on the rational expectations theory—between what the impact of a change in the growth of the money supply will be when it is or is not expected by the public. "Essentially what we are trying to do is divide the monetary influence into an expected component, which affects only prices, and a shock component, which affects only output, says CEI President John Rutledge. There is a similar treatment of fiscal policy, in which only an affects only output," says CEI President the real economy. Finally, interest rates

In fact, the models are based on judgment as well as on mathematics

are determined by the same process that generates inflation, and the two always move together.

Political appeal. Rutledge claims that his is "the first model that accurately reflects the consequences of the highly volatile monetary and fiscal policies which we have been experiencing." Its obvious political appeal to the Administration is that, while conventional models portray a world in which Washington can have relatively little effect on inflation without sharply increasing unemployment, the Claremont model shows that a gradual reduction in the rate of money growth, if expected, will reduce inflation without the cost of a severe recession.

Rutledge expresses indifference about politics and does not particularly like the public's identifying him now with the supply-side camp. "I'm a businessman, not a politician," he says. "I think we have found a better way to forecast, and that is the basis on which we intend to sell our model." On the surface, there is no evidence that the track record of the Claremont model is superior to that of its more conventional competitors. Like them, for example, it made a premature call on the 1979 recession, and it was as confused as they were about the course of the real economy last year. Its major success story is that it was quick to pick up the acceleration of inflation in 1977, and its sales pitch to its customers, which were mostly financial institutions, is that it has been better than most in tracking volatile interest rate movements.

Rutledge makes no secret of his ambition to replace DRI as the principal source of policy analysis in Washington. But he has no thought of competing to provide the data bases and computer services that account for most of DRI's revenues. Indeed, he says, "I am a customer and I think their software is

b." As much as DRI President Otto Eckstein appreciates that business, however, he thinks that his model is flexible enough to be adjusted to new evidence on the workings of the economy. "We have been able to incorporate the lessons of the monetarists on the importance of financial variables, and we have taken into account what to us seem like the valid parts of the supply-side argument about the effects of fiscal policy," he says. He believes that progress in econometrics comes from the slow improvement of existing models rather than from the adoption of totally new approaches.

Doubters. It is too early to tell whether the Reagan Administration will eventually learn to accept this type of cheerful eclecticism. One likely holdout is Norman B. Ture, Treasury Under Secretary for tax and economic affairs, who has strong views on supply-side economics. "The incentive effects built into the DRI model are almost nonexistent and are completely outweighed by an invalid Keynesian multiplier," he says. His argument is that a tax cut affects the economy only by changing relative prices in a way that increases the supply of labor and capital. In a model that he constructed several years ago with support from the National Association of Manufacturers, the demand-side effect, in which a tax cut affects the economy by increasing disposable income and hence consumer demand, was totally absent. Not surprisingly, this meant that there was no way for a tax cut to be inflationary under any circumstances, a conclusion that most economists would not buy.

The supply-siders' choice: A monetarist model that stresses expectations

Ture hopes that his model, which he sold to the accounting firm of Coopers & Lybrand before he took office, will serve as the basis for a new model that will be used in all of the government's economic policy analysis. "Perhaps it can be married to the Claremont model, which does not really handle fiscal policy in a detailed way," he says.

In the end, however, the main result of the current debate over econometrics will probably be a healthy skepticism about what comes out of the computers. The enormous differences between the various models underscore the risks of policymakers' accepting the conclusions of the one that happens to be wrong. "We have been asking the models to do our thinking for us," says Senator Pete V. Domenici (R.-N.M.), chairman of the Senate Budget Committee. "We have to realize that they just won't be able to come up with the answers." ■

ENERGY

The gasohol boom dries up

Last year's widespread predictions of a prolonged boom in demand for gasohol are quickly evaporating, killing any hopes for a rapid increase in alcohol distilling capacity by 1982. Because of a surplus in gasoline supplies and a drop in auto usage, gasohol sales have stopped growing. Moreover, the prospect of sharply reduced financial support from Washington threatens to curtail further the industry's ambitious expansion plans. "The excitement about gasohol has turned out to be premature," says K. Laurence Patton, manager of economic analysis for Cities Service Co., a big oil company that has scrapped plans to enter gasohol production. "The demand for gasohol will remain very localized. I don't see a nationwide program for us or any company."

The 6.6% drop in gasoline sales in 1980, coupled with historically high stockpiles, has dampened the eagerness of oil companies to extend their gasoline supplies by blending unleaded gasoline with alcohol to produce gasohol. The problem is exacerbated by the Reagan Administration's effort to slash some $1 billion in loan guarantees for alcohol commercialization projects. Thus, it now appears that alcohol capacity will increase from 100 million gal. in 1980 to no more than 350 million gal. by 1982, far below the 700 million gal. that Carter Administration officials were predicting just last year.

A new ball game. Among the largest projects vulnerable to budget cutbacks is a $52 million joint effort among Ashland Oil Inc.; Publicker Industries Inc., a major industrial alcohol producer; and the Ohio Farm Bureau Federation to produce 60 million gal. of alcohol. Virtually the entire project is dependent on federal money. Says Publicker Chief Executive Joseph C. Minio: "If it's pulled out from under us, it's a whole new ball game."

The Cities Service project with American Maize-Products Co. on a proposed 25 million-gal.-a-year plant fell through in January because of a change in the companies' business plans, brought on in part by the dismal outlook for gasohol. "All of us," says Patton, "were surprised at the decline in gasoline consumption from a year ago when there was a shortage of high-octane product. The situation has changed completely."

With gasoline demand and pricing pressures easing, Amoco Oil Co., the marketing arm of Standard Oil Co. (Indiana), will restrict its future efforts to areas with substantial state subsidies (22 states provide tax reductions of 1¢ to 6.5¢ per gal. to encourage gasohol use). "Gasohol has not achieved the point where it can be sold on its own merits," points out Joe L. Gibbs, Amoco's general manager of marketing.

Crucial months. The sharply reduced demand forecast for gasohol is leading a number of major alcohol producers to trim output drastically. Typical is Midwest Solvents Co. in Atchison, Kan., whose production has slid to 300,000 gal. a month from a peak 500,000 gal. six months ago. Moreover, the company no longer plans to use a plant it bought in Pekin, Ill., last June to boost capacity to 1 million gal. a month for alcohol production. "The industry is not going to mushroom like we anticipated a year ago," says President Ladd M. Seaberg.

Predictably less pessimistic is alcohol industry giant Archer-Daniels-Midland Co. (ADM), which is boosting production capacity from 6 million gal. a month to 19.5 million by the end of the year, even though current capacity is not fully utilized. ADM is also eying a site near Des Moines for construction of an 18 million-gal.-a-month plant, though industry sources doubt that construction will begin any time soon. ADM's Richard E. Burket, assistant to the chairman, insists that those who are writing off the industry are wrong, but he concedes, "this is still a longer-range program than most people realize."

Sales are plummeting as gasoline surpluses rise and auto usage drops

Texaco Inc., the largest gasohol marketer, insists it will stick with its expansion plans even though gasohol sales at its 1,700 stations offering the product have fallen to only half what they were last summer. "These cycles will appear and reappear," says Samuel P. Dickens, vice-president for planning and finance for Texaco USA. "But as the price of crude oil rises and as the amount of lead-free gas sold increases, over the long-term the sheer economic forces are positive."

Others suggest, however, that the fate of gasohol may be determined in short order. "The next six months could be crucial," says James M. Childress, former director of the National Alcohol Fuels Commission, a congressional group now being disbanded. "If gasoline demand doesn't rebound, you could see a lot of companies put off their plans to get into the business." ■

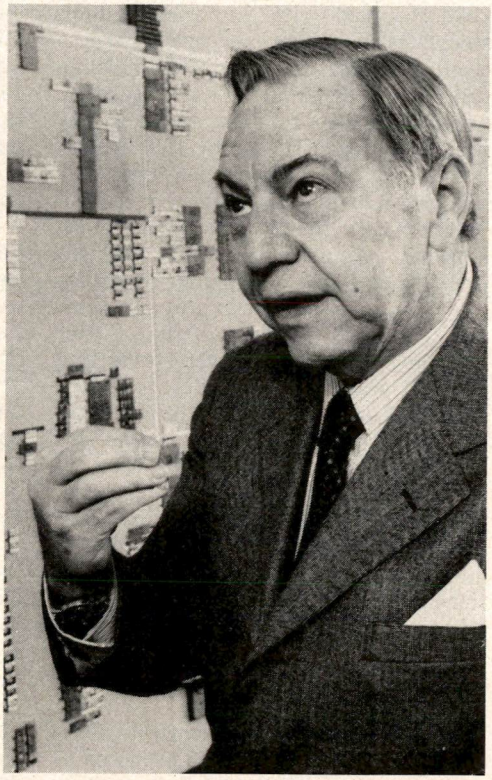
More trouble down the track for Conrail

Observers have long agreed that if the federally supported Consolidated Rail Corp. (Conrail) is ever to become financially self-sufficient, it must shrink its 34,000-mi. system and drastically reduce its labor costs, the highest in the railroad industry. Now, under severe pressure from the Reagan Administration, Conrail is fast approaching its day of reckoning. It must make those cuts soon.

In its Feb. 18 budget proposals, the Administration said that after 1982 it plans to shut off all federal aid to the giant railroad, which blankets the Northeast and Midwest. Conrail's new chairman and chief executive, L. Stanley Crane, has discussed the railroad's future with Transportation Secretary Drew Lewis and Federal Railroad Administrator Robert W. Blanchette. "Mr. Lewis' and Mr. Blanchette's words to me are perfectly clear," says Crane. "Conrail will have to operate without a continuing federal subsidy."



Gwendolyn Stewart



Steven Goldblatt

FRA's Blanchette and Conrail's Crane agree that the day is near when Conrail must operate without benefit of federal subsidies.

Since it was formed in 1976 from the remains of six bankrupt railroads, Conrail has been kept going with $3.3 billion in federal aid. The Administration proposes to give Conrail $285 million this year and $150 million in 1982—but no more. "We have to get the federal government out of the railroad business," says Blanchette. "The Administration is not going to throw public money on a losing venture."

Faced with a cutoff in federal funds, Crane, who retired on Oct. 1 as chairman of the highly profitable Southern Ry., is readying a report to Congress on Conrail due Apr. 1. It will outline a package of tough measures Crane feels are necessary if Conrail is to survive on its own, including:

- Reducing the work force handling freight traffic by 10,000, or about 15%.
- Gaining substantial concessions in wages, benefits, and work rules from labor unions.
- Abandoning some 3,100 mi. of little-used branch lines.
- Getting out of the passenger-carrying business, which would remove another 11,000 workers from the payroll.

Clearly, the most critical part of the package is the one involving labor. "We want to keep Conrail viable and are willing to talk about increases in productivity and sacrifice. But don't come at us with a meat ax or we will come back with a hammer and claw," warns Fred J. Kroll, president of the Brotherhood of Railway & Airline Clerks (BRAC), which represents some 11,800 workers.

Since starting up in 1976, Conrail has pared its work force from about 94,000 to 76,000. But despite these cuts, Conrail's labor costs still eat up 56% of revenues, the highest ratio in the industry. Crane wants to reduce labor costs to roughly the industry average of 50% of revenues through additional layoffs.

Protected workers. However, under the law that established Conrail, anyone who worked for any of the predecessor railroads for five years prior to 1974 was guaranteed his or her 1974 salary until the age of 65 if he or she were furloughed. This provision—called Title V—covers some 60% of Conrail's work force and makes significant reductions enormously expensive. So far, Congress has authorized $485 million beyond the $3.3 billion in direct aid to compensate furloughed employees. Crane fears that this burden is about to be put on Conrail's shoulders and that if it is, the end of Conrail will follow. However, the Administration is likely to seek relief for Conrail from Title V when new Conrail legislation is introduced in late spring. But if the federal government were to stop payments for Title V, the cost to the railroad would be $4 million a month.

If Conrail fails to shape up, only one course remains—dissolution

In addition to trimming the payroll, Crane is seeking major concessions from rail labor in the current round of contract talks. Conrail wants an "envelope" of wages, benefits, and changes in work rules amounting to about $200 million a year less than whatever the rest of the railroad industry settles for. Sources say the breaks Conrail is seeking could include: a cap on cost-of-living adjustments (COLA); a wage freeze for part of the next five years; fewer paid holidays; and smaller crews on trains in switching yards.

Willing to listen. There is, in fact, some sentiment in Congress that Conrail's plight is similar to that of the Chrysler Corp. Representative James J. Florio (D-N. J.), for example, favors giving Conrail more aid than that proposed by the Administration, but he thinks the funds should be granted "on a Chrysler loan basis"—tied to productivity.

Conrail's labor unions are certainly aware of the crisis and would prefer a

Deposit Turnover, All Comm. banks. Annual rates

74	98 (est.)
75	105
6	116
7	129
8	142
9	

Macro

1. More stress on how K flees from hi w.r.
   - by emigrating, (as now from Eg.)
   - by preferring long terms.
   - by moving to sunbelt, USA.

Note. I have soft-pedalled this message.
Time to hit it harder.

Macro – orgn.

After the going concern model, then you show how a going concern avoids over committing itself beyond its capital.

Macro

reading recommend

humanities ROBERT B. HEILMA
FREDERICK J. CROS
social sciences EARL W. COUNT, R
LEONARD W. DOOB
MADELINE R. ROBI
JAMES C. STONE, E
natural sciences RUSSELL B. STEVEN

ELLIOT ZUPNICK

Rational Expectations and Economic Policy. Ed., Stanley Fischer. Univ. Chicago. 1980. $22.
The theory of rational expectations is the most revolutionary development in economics in recent years. The essence of this theory is that economic agents react to all the information available to them at any particular point of time. One important implication is that since *anticipated* events are fully and instantaneously discounted, the scope of stabilization policies is severely limited. *Rational Expectations and Economic Policy* is a collection of papers presented at a conference organized by the National Bureau of Economic Research. These papers, written by scholars who have made important contributions to the theory, are indispensable for anyone interested in the present state of economics.

Asset Accumulation and Economic Activity. James Tobin. Univ. Chicago. 1980. $13.
This volume should be read in conjunction with *Rational Expectations and Economic Policy*. It is the most brilliant, cogent, and incisive critique of the theory of rational expectations that has yet appeared. Tobin, Sterling Professor of Economics at Yale University, carefully reviews the theory and argues that it is a defective guide to policy.

New Developments in Productivity Measurement and Analysis. J. W. Kendrick and B. N. Vaccara. Univ. Chicago. 1980. $52.
Productivity has become a buzz word. By now everyone is aware that productivity has declined in the United States in recent years and that this has had serious consequences for the American economy. The reasons for this decline, however, are not well-known. The papers in this volume, delivered at a conference organized by the National Bureau of Economic Research, may not tell us all we would like to know about this important area. They do, however, tell us as much as economists presently know, and, surprisingly, this is a good deal.

The Collected Papers of Franco Modigliani. Vols. 1, 2, and 3. Ed., A. Abel. MIT. 1980. $25.
There are few economists whose papers warrant being collected. Franco Modigliani is one of them. Over a long and fruitful career, Modigliani has made seminal contributions to the areas of

Way of showing greater sensitivity of durables to Δi.

$$f = \frac{1 - e^{-in}}{i}$$

$$\frac{d\,\frac{u}{v}}{dx} = \frac{\frac{du}{dx}\,v - \frac{dv}{dx}\,u}{v^2}$$

$$\frac{du}{di} = -(-n e^{-in}) = n e^{-in}$$

$$\frac{dv}{di} = 1$$

$$\frac{df}{di} = \frac{n e^{-in} \cdot i - 1 \cdot (1 - e^{-in})}{i^2}$$

$$= \frac{n e^{-in}}{i} - \frac{1 - e^{-in}}{i^2}$$

$$= \frac{(ni + 1)}{e^{in}} - 1 \Big/ i^2$$

$\frac{df}{di}$ is always neg., but $e^{in} > in + 1$ or

$$e^{in} - 1 > in$$

$\frac{df}{di}$ grows more neg. for larger n.

"Organic Comp. of Capital"

$$\frac{\text{Const. Cap.}}{\text{Variable Cap}} \equiv \text{Org. comp.} \equiv \frac{\text{Fixed}}{\text{Circ. Cap.}}$$

~~Circ. Cap~~

"Variable Cap.", V, is of labor, so K/L is meant or implied. K/O is also involved, or related.

Macro items.

1. "Weakness in the economy". Transl: low rate of inv. spending forecast.

2. It requires ~~gross~~ "savings to finc. a recovery". Read as gross savings, this makes sense.

3. 2d half of '80, credit controls were removed. So? Specifics needed.

4. "Low capacity utilizn. holds down cap. spending." Transl, Too high a ratio of fixed K / circ. K.
Cap. spending is low, not bcs. there is no outlet, as easily inferred; but bcs. too little gross savings comes in to finc it. Also observed decline in Inv. is higher than actual, bcs. they observe only long. hand invts.

5. Re Say's law, critic notes that incomes aren't all spent. Then, however, ~~reporters~~ makes leap out of neg. mult. where non-spending generates downward spiral.

6. Re 4, numbers are needed.

7. Low circ. K creates problems.] need to dramatize.
- Low food reserves. (Global reserves est. 36 days, ~~#~~ "lowest on record."

7 (cont.)

Examine, b/c big price changes, cd. result.
also, big seasonal swings.

- Stores out of stock. Hunting costs.
- Low gas reserves. Lines, rationing
- Higher cap. needs in trunk lines, bcs. greater peaking problem, w/o local storage near consumers.

8. Cos. in "cash bind." Result of ~~K/O > K~~
K/O * O > K, or required K > available K.

Palmetto Federal Savings & Loan Assn. and California's First Charter Financial Corp., enjoy growing asset bases and heavy demand for lending to finance housing.

If inflation eases. Insurance companies are traditional rate plays that can be expected to do marginally better if inflation slows. Two companies whose earnings are not attached to the depressed life and property-casualty underwritings are MGIC Investment Corp., a major mortgage insurer, and First American Financial Corp., a title guarantee organization with a dominant share of the Los Angeles market.

Well-established industries that are sensitive to interest rates may not do as well in a major market run as newer companies that can be identified with outstanding growth potential, according to Raymond F. DeVoe, an analyst with the New York-based brokerage house of Bruns, Nordeman, Rea & Co. DeVoe favors Prime Computer, General Instruments, and Measurex—all in the high-technology group that has recently fallen from market favor. He predicts that they will double in a "growth market," which could take the Dow average 15% higher this year. Although bearish as recently as December, DeVoe changed his tune with others on Wall Street, as the Reagan Administration's budget-trimming and tax plans have stood up without major congressional changes. The prospect of both less government and falling rates has had a powerful effect in the investment industry. Says DeVoe, "I've never been more bullish."■

MONEY & BANKING

The NOW factor in money growth

If the U. S. economy avoids recession this year (page 26), it ironically may be because the Federal Reserve erred in calculating the nation's money supply. Put simply, the Fed may be creating a lot more money than it thinks it is. If so, the cost of avoiding a slump could be a higher-than-expected inflation rate.

At issue is the negotiable order of withdrawal, or NOW account—the interest-bearing checking account that went nationwide on Jan. 1. While checking accounts pay no interest, NOW accounts pay 5¼%, and consumers have poured $24 billion into NOW accounts in the first two months of 1981.

The Fed thinks much of the NOW account money is coming from passbook savings accounts, and that about one-third of it will still be treated as savings by depositors. Thus, the Fed claims two or three percentage points of growth in M1-B (the basic money supply measure, consisting of cash, checking accounts, and NOW accounts) should be disregarded for policy purposes.

Discounting growth. The Fed says it expects M1-B to grow by 6% to 8.5% this year and argues that the economic impact will be as though M1-B had grown by only 3.5% to 6%—or slightly less than in 1980. If the Fed is right, and it can hold growth in M1-B to 6% to 8.5%, it will be creating less fuel for inflation—and less thrust for the economy. If the Fed is wrong—and some economists say it is—the Fed is providing more stimulus to the economy than it intends, and more zip to inflation as well.

The issue is hot right now because some think—though the Fed does not—that most of the shift into NOW accounts has occurred. If that is correct, the Fed is wrong to ignore any element of money growth since all growth in M1-B from here on would be real.

"We're beginning to lean toward the view that most of the shift into NOW accounts has taken place, and we don't need to adjust M1-B," says Scott E. Hein, an economist at the St. Louis Federal Reserve Bank. Economist Robert H. Rasche of Michigan State University goes even further. He maintains that the money that has shifted into NOW accounts represents checking account money and should not be discounted.

Fed officials admit that the money supply numbers—which show an annual rate of growth in M1-B of 5.5% over the first two months of 1981—are not infallible indicators. But they think the shift of "savings" money into NOW accounts is only half over. The Fed figures M1-B growth in the first two months was overstated by $5.3 billion, meaning the money supply would have shown no change without that $5.3 billion inflow.

What the Fed calls its working assumption on the NOW accounts—that $12 billion to $15 billion of the money flowing into them this year either will come from savings accounts or would have gone into savings accounts—is based on experience in New England, where NOW accounts have been legal since 1976.

But tracking dollars and designating

Investment figures of the week

Heavy Treasury financings and the prospect of heavy corporate borrowing kept long-term interest rates high despite further declines in most short-term rates. Stock prices edged higher in heavy trading.

Money market rates	Latest week	Previous week	Previous month	Year ago
Federal funds	13.69%	14.27%	15.03%	17.72%
New three-month Treasury bills	12.82%	12.90%	14.22%	16.53%
New six-month Treasury bills	12.44%	12.16%	13.74%	15.70%
Three-month commercial paper*	12.50%	13.88%	14.25%	16.75%
Stocks				
Price/earnings ratio* (avg. 1,500 stocks)	10.26	9.94	9.34	7.50
Dividend yield* (avg. 1,500 stocks)	4.75%	4.86%	5.05%	5.87%
Dow Jones industrial average	996.13	992.53	946.10	767.83
Standard & Poor's 500 stock index	134.67	133.92	127.39	99.19
Value Line composite index	152.28	149.40	140.92	105.96
Lipper growth mutual fund index	162.16	159.58	151.73	109.29
Average daily NYSE volume (millions)	60.9	57.2	41.5	36.9
Average daily NYSE blocks (10,000 shares and over)	880	838	584	464
Bonds				
New Aaa utilities*	14.25%	14.38%	14.63%	13.88%
New Baa utilities*	16.00%	16.25%	16.50%	16.25%
New Aa industrials*	13.50%	13.63%	13.75%	13.50%
U. S. governments (8½% issue of 1994-99)	12.61%	12.19%	12.88%	12.87%
Bond Buyer municipals (20-bond index)	9.81%	10.34%	10.22%	9.20%

All figures are as of Tuesday, Mar. 24 except those marked*, which are from Friday, Mar. 20, and the Bond Buyer Index from Thursday, Mar. 19.

Data: Federal Reserve Bank of New York, Salomon Bros., Arnold Bernhard & Co., Lipper Analytical Distributors Inc., Standard & Poor's Compustat Services Inc.

Inside Wall Street

David G. Santry/April 6, 1981

A 'hope rally' for cars may soon be dashed

The stocks of the three major automobile companies have all jumped more than 20% since their nadir in February. But this is nothing more than a "hope rally," according to analyst Arthur G. Davis of the brokerage firm of Prescott, Ball & Turben. The stocks have performed well because of news reports of higher auto sales brought about by price cuts and rebates. But Davis, possibly Wall Street's gloomiest auto analyst, says the stocks are overpriced and predicts "new shocks for investors."

Reluctant consumers, excess small-car manufacturing capacity, and price wars mean Detroit is in for rough times in the next 6 to 12 months, Davis says. "Given our outlook for flat disposable income in 1981, we believe that Detroit faces an anemic market for the remainder of 1981," he says. In fact, Davis says, the recent auto sales increases induced by rebates will be only temporary and total U. S. sales will be only about 9.5 million in 1981. In 1980, total U. S. sales were 9 million cars.

Price competition. Davis says there are several reasons consumers may not be in a mood to buy cars. For one thing, consumers are still illiquid. Installment debt is high, about 17% of disposable income, while savings are low, 4.6%. In the last economic decline the savings rate was close to 8%. "At the same time we believe that gasoline prices at $1.50 a gal. offer little incentive to purchase a new small car in the $9,000 to $10,000 range," says Davis. Furthermore, the cost of operating a car increased 25% in the last year to an average 42.1¢ a mile. "Car operating costs are advancing at twice the rate of inflation, a strong negative for car sales."

Davis says that consumers who buy cars are now much more conscious of price. "The auto industry is rapidly moving to low-priced, high-mileage small cars," he says, noting the brisk sales of Ford and Chrysler cars selling for less than $7,000. "The market has become fragmented with no high-priced, high-margin car line in a high-volume position."

Davis says that small-car production capacity already exceeds demand by more than 1 million units and will grow to 2 million by late 1981. "New products introduced in the next six months will cannibalize sales from established lines, resulting in continuing price pressures on new and old," Davis says. In particular, he says, General Motors will have to cut prices to bolster its market share, which has been slipping slightly.

Intense price competition could mean Chapter 11 for Chrysler as early as the second quarter of 1981, Davis says. But Chrysler has a new labor contract that gives it a 15% cost advantage over its rivals, making it attractive to Japanese and European producers. Chapter 11 might reduce Chrysler's unfunded pension liabilities. "If a consortium of Peugeot, Mitsubishi, or others joins hands with Chrysler, a string of strong competitors for Ford and GM would evolve with a lower labor-cost base," he says.

The result of all these major changes in the automobile industry will be to hurt profit margins in both the long and the short run, Davis says. He estimates that Ford and Chrysler will both lose $7 to $10 a share in 1981, while GM will earn an "anemic" $2. GM will probably cut its dividend in May, Davis says.

Going for the gold

Ranchers Exploration & Development Corp. plans to pay its dividend for the June quarter in gold—that is, if the company isn't acquired first. Whether Ranchers, which produces uranium, copper, and gold and is developing a silver mine, will survive as an independent company is anyone's guess. The recent rush of mining company takeovers has heightened speculation that Ranchers may not. The company's stock price jumped $14 a share, to $48, amid the recent takeover announcements. What is more, First Mississippi Corp. owns 21% of Ranchers' 3.1 million shares outstanding and says it wants to buy more than 25% but less than 50%.

Ranchers has said that any further purchases by First Mississippi would not be in the shareholders' interests, and it has hired Kidder, Peabody & Co. as an adviser. "I don't care to be a vice-president for another company," says Maxie L. Anderson, Ranchers' chairman, who in February tried to circumnavigate the globe in his balloon, the Jules Verne. But Anderson says the oil companies are flush with cash and could easily afford any mining company. "There may not be an independent mining company left in the U. S. by yearend," he says. Still, with the hefty prices the oil companies have been offering, Anderson, his family, and associates, who own 30% of Ranchers, could profit if Ranchers were bought.

Meanwhile, Ranchers plans to go ahead with the gold dividend. The specific details have yet to be resolved, but to be eligible a shareholder will probably have to own 600 to 700 shares. The dividend to the shareholder will be taxable at the market value of the gold on the day it is received. Taxes on any increase in the value of gold will not have to be paid until it is sold.

From Ranchers' point of view, the gold dividend is attractive because there is no double taxation: The gold is a distribution of inventory, rather than a sale. "This factor might enable the company to increase the rate of its dividend," Ranchers says.

them "spending" or "saving" would be hard under settled credit market conditions. And it is even more complicated with massive shifts into money market funds, which also provide both checking and savings characteristics. Fed figures show that traditional checking account deposits and passbook savings at banks and thrifts fell $60.4 billion in the first two months of 1981. But how much went into NOWs, which grew by $23.6 billion and how much into money funds, which grew by $16.6 billion?

Rasche thinks he sees evidence that whatever amount went from savings into NOW accounts is insignificant. He notes that a $33.9 billion hemorrhage in regular checking accounts stabilized in late February—signaling an end to the shifts—and that the outflow was more than big enough to explain the rise in NOW account funds.

Both Rasche and Hein say that 5% or 6% growth in M1-B is more consistent with the 14% or 15% growth in the dollar value of total economic output in the first quarter than is a flat money supply. Most credit market analysts, however, are sticking with the Fed's assumption that some money growth must be discounted. "The adjustment has validity," says Leif H. Olsen, chairman of the economic policy committee at Citibank, who thinks it will be midyear before NOW shifts stop bloating M1-B. Failure of the economy to slow down in the second quarter would be a sign that no adjustment of M1-B is necessary, says Olsen, but he thinks a slowdown has started. ■

POLLY ROBERTS

Faster Write-Offs Will Boomerang on Reagan

President Reagan hopes to spur productivity by cutting taxes. But his kind of tax cut will do just the opposite.

The proposed reductions, notably super-accelerated depreciation and lower taxes for higher brackets, are supposed to encourage business investment. Actually, such cuts just channel investment away from labor and into capital – using more land and machines, but fewer people. This shift will reduce both employment *and* output.

In any society, there is a mix of capital and labor that maximizes productivity. This mix differs from one society to another, depending on circumstances. For example, Japan has one of the densest populations in the world, and relatively little farmland. Japanese farmers therefore cultivate very intensively. They get about ten times U.S. output *per acre*. But in the lightly-populated U.S., farmers get about ten times Japanese output *per manhour*. Each society has high farm productivity, but uses a very different mix of capital and labor to get it.

Yet in all countries, government policies tend to favor the use of capital over labor. In this way they actually reduce output and employment by shifting the mix of capital and labor away from the one which maximizes productivity.

Capital Bias

The U.S. economy today suffers from just such a bias. For example, income and Social Security taxes, the minimum wage, and a variety of regulations all raise the effective cost of labor to employers. This encourages them to automate more than otherwise, or shift to intrinsically more capital-intensive products (e.g., chemicals instead of clothing).

Accelerated depreciation does the same. Accelerated depreciation lets an investor pay taxes as if his assets wore out in an arbitrarily short period – like 10, five and three years for buildings, equipment, and cars. This effectively subsidizes investors to buy very durable, highly-automated plants and equipment, and to shift into more capital-intensive industries.

The federal regulatory and tax codes bulge with government policies that artificially raise the cost of labor and reduce the cost of capital.

Government policies, including tax loopholes, also favor the kind of investors who prefer particularly capital-intensive investments – that is, wealthier individuals and larger corpora

Larger entities find capital cheaper and labor more expensive than smaller ones do. Consequently, a big firm or wealthy individual uses relatively more capital and less labor to accomplish the same thing. When government policies redirect capital from smaller to larger entities, they just increase the economy's bias toward capital intensity.

Treasury Secretary Donald Regan now advocates giving wealthier persons the biggest tax cuts, because the rich invest proportionally more of their income. But the rich choose investments yielding relatively low real output per dollar invested. For example, they buy up appreciating suburban land, instead of building up a small grocery business. So the total productivity of the economy suffers.

Finally, government spending itself often proves astoundingly capital-intensive. I need only mention the interstate highway system, or the many and vast monuments of the Army Corps of Engineers, or help for sick giants like Penn Central and Chrysler. Defense marches off with first prize for capital intensity. And when the government finances deficits by printing money – creating inflation – it makes capital artificially cheap both for itself and for borrowers. This further biases the economy to capital intensity.

How does excessive capital intensity harm the economy? Two ways.

First, by artifically raising the capital required per job, it reduces the number of jobs the capital stock can support. It selectively eliminates "marginal" jobs, or parts of jobs – whatever work adds the least value above the wage. Jobs we can get along without, or easily automate, like an extra salesperson in a crowded department store, or an elevator operator. Little jobs, unskilled jobs. . . .

Second, because it reduces jobs, excessive capital intensity also reduces the economy's output and potential growth rate. The squeeze on output and growth in turn worsens inflation.

But ironically, because it trims off precisely those jobs that add the least to production, excessive capital intensity simultaneously raises output per manhour. I think this explains why Americans so rarely recognize the damage.

We habitually equate "high output per manhour" with "high productivity" and "a high standard of living." But true high productivity means getting the most per dollar of capital as well as per manhour. And a high standard of living requires high output *per capita* – not just per manhour.

For imagine the ultimate automated Utopia: a single operator touches a button and an enormous machine disgorges all the goods and services of the economy. What phenominal output per manhour! But the rest of the population is jobless and starving.

Soviet Textbook

That's not just a figment of a Soviet textbook on the evils of capitalism. Not long ago, a developing country imported modern plastic injection-molding machines. Operated by forty workers, the machines poured forth 1.5 million pairs of plastic shoes and sandals a year. Some 5,000 artisans who made leather shoes went out of business.

The government's bias to excessive capital intensity does not result from the *level* of taxation, regulation and spending, but from the *kind*. Tax systems *can* be redesigned to reduce the capital intensity bias, basically by shifting the burden from active work or investment onto passive wealth-holding. (By this criterion, property taxes, believe it or not, rate better than income or sales taxes).

With more difficulty, given the proclivities of bureaucrats, regulation and spending *can* be redesigned to lower capital intensity – for example, by farming selected functions out to private industry. Such changes require a great deal of careful analysis and political footwork.

The defeated Keynesians lumped all sorts of taxes, regulation, and spending together. Within reason, the more the better. Unlike them, the triumphant "supply side" advisors to the president correctly stress the powerful impact of taxes, reulation, and government spending on incentives to work and invest.

But they then seem to forget their own message. Like the Keynesians before them, they lump everything together, only they say (defense excepted), The less the better. Such a simple-minded drive for "less" won't revive the economy any better than the previous drive for "more."

Polly Roberts, formerly president of the Henry George School in San Francisco, is a doctoral candidate in the Berkeley economics department.

Comment
THE WASHINGTON STAR Friday, March 20, 1981

Cycles

Broilers. LA Times 2-23-81

1960s. 12 wks.

1980 7 wks ± one day.

to make a 4 lb. broiler from 8 lbs of feed.

Free entry, big comps, rapid improvement, exports.

Week

1 M —

Limits + blinders

W ~~Inadequacy~~ of Micro

F What is Macro, 1

2 M What is Macro, 2

W " " , 3

F From Micro to Macro

a. ~~The~~ steel ~~Dismal~~ chain of diismal ideas ✗ in classical p.e.

Diin. rets + the fixed wages fund

b. ~~Hopeful glimmers~~ Cheerful revisions

Tenit. expansion; ~~&~~ land division; aggreg. & rets.

a flexible wages flow ~~thin~~ with a fixed fund

Ricardo; Wicksell; Hofman

3 M Mechanics + models of the flow/fund ratio

a. How factor price flexibility changes the ~~ratio~~ optimal payback time.

b. Payback time + turnover as reciprocals

i. "Normalization"

ii. Calculating payback times.

c. Factor ratios + cap./output ratios

W Examples, applications, + review.

Now you are prepared to cope with ~~the~~ conventional macro, seeing its values, + its errors + omissions, beneath its superficialities to its positive

Macro

Macro ideas from Reagan program, 2/19/81

1. Budget cuts. Be incremental, rather than total.
2. 10 - 5 - 3
3. Tax cuts, across boards, re personal inc. tax rates.
   Those who now pay more one : reduced more.
4. Cutting both taxes & spending do not by themselves cut inflation.
5. Corp. tax rates cut
6. Mass transit subsidies cut.
7. Energy new technologies out. or down: synfuel (out from coal); solar; ~~etc.~~ + conservation.

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1. Another way to create $, is t > g, repay nat. debt, release funds for pvt. inv.
2. Bottlenecks limit flows.
   Ways break bottlenecks, hence release producers from queues.
   Some e.g. of bottlenecks.
   a. Boat-stretcher. There is a queue, bec. stretching takes time.
   b. Bank's capacity to lend. It has $100k, to lend at any one time. Place it all for 30 yrs. + no new

loans are possible for 30 yrs.

✓ B can't use any $ until A is through with it. So there is a queue of borrowers waiting for other borrowers to repay, so they can borrow. The amt available is fixed by terms of prior loans, which regulate flow of repayments.

Flow of repmts responds to higher $ w. a lag.

The pernicious basis of macro is that society can invest w/o having anything to invest. Macro has inst. precede savings, & cause savings. As the aggregating ed. put things backwards.

The ultimate bottleneck is availability of K. K is all accum. ~~surplus~~ fund of real goods, to support life while people produce. To be available, it must be disposable, consumable. The bottleneck is the rate at which it is consumable. We must be able to ~~control it~~ marshal it at command.

Are there bottlenecks in non-ferrous metals? We must add to these indices. Then. This doesn't stop inst., it tells inst. where it is needed. But there must be available disposable marshallable cap. Short cap. is convertible, adaptable, reallocable, under control. Long cap. is out of control.

Macro, Branson + L.

Ch. 6 Ideas

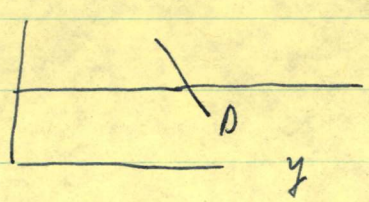
"Output + ~~E~~ level: classic case"

upshot is monetary neutrality.

Classic is neo-classic. They had abandoned w. f. Didn't see that Δ spending ed. mean real T of IE.

ch. 6 develops supply side

6-1



supply in depression

They treat labor as only vble. input.

"K" is fixed

"Mtls" vary w. labor, fixed propn. But then they forget mtls.

(Where are these mtls to come from? " " extra workg IE " " ?

eg shifts DD to rt. They don't say how g gets the w! Great Sponge is assumed.

Problems w. horiz. supply:

a) Rising supply price of labor — pref. for leisure
b) Diff. rets. to labor.

Putting the monkey on back of labor.
Cover their tails nominally by allowing comply. inputs.
But then, only "labor" raises h.o.p.

pp. 106-07. Inflm. is due to Δ demand w/o elastic labor supply. Intervening in one para.

They show dim. rets. as $\frac{\text{output}}{\text{input}}$ -- clumsy.
Then convert to a ~~falling~~ neg. slope demand for labor. This is in the "labor mkt."
[The neg. slope is curve is the "product mkt".
It reflects dim. rets to K! But if there is unempl. the Δ labor will stop the dim. rets. to K
This gets left out of model!]

Mupp. firms has even more neg. demand for labor. They are building case for a demand for labor that is "⌐¬ N

"Fixed-coeffs" produc. fn. is also added. Too many slots for workers — then MP falls near zero.
This adds to the concave effect.

They are building a case for highly inelastic demand for labor in relevant range, so you can't make jobs by lowering w.r.

Labor supply in s.r. depends on W, not $\underline{w}$.
I.e., there is money illusion. p. 116. This is what they think. But in ch. 6 they ~~[illegible]~~ expound the "classical" (neo-classical) view, workers respond to w. ~~(Call it "pre-~~
Then, a demand has no real effect. ~~[illegible]~~

But - Δw does. Empl. is det'd. entirely in the labor mkt. (But real demand for labor ed. rise. a) This is what neo-classicals shd. have stressed, but failed to.

b) Macro ecsts. made it just a matter of w. Instead of real opps. & real flows.

To Δ demand for labor, make land & cap. more comply. to labor. to simple.)

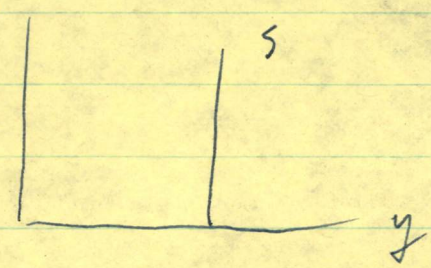
pp. 122 ff. they are torturing the classical model into their model.

Classical model says M is neutral. Eg, (coming from unspecified source), just raises all prices & factor prices in same propn., has no effect except to reallocate. g up, inv. down. & has risen
(but evidently by borrowing, bus. & gov up.

In classical model, reduced t has "same effect" as ↓q? Not quite. Higher c replaces ~~tax~~ inc. Higher t causes this. p. 123.

Sounds like a travesty. They say nothing re incentive effects of lower t.

Upshot is that classic aggreg. supply curve is vertical w.r.t. prices



B + L dispute this, esply. re short run. They cite actual changes in N, empl., + attribute these to changes in ag demand. The classical offsetting effects are only partial, they say.

I.e., they make Tobin concessions, w/o abandoning their position.

Nowhere is mentioned the effects of t on allocn. of K. Or effects of W on same.

Macro

1. ~~Macro~~ K allocn.

Conservatives stress K fmtn., & totally neglect allocn.

My entree — treat allocation of K.

They think mainly of allocn. among alt. goods. They neglect " "
times of ripeness.

But this allocn., intertemp. allocn, converts micro to macro

(to macro does deal w. allocn.)

2. Vessel & pipe -- analogy for fund & flow.

Bladder & meter
Floor space & door capacity
Gas Tank, gas line.
Bottlenecks are guilty. flow chokes
Bathtub, faucet & drain.

Macro idea

Businesses escape union seniority by shifting demand from old businesses to new. E.g. 12/80, small regional airlines are profiting, while old trunks are not, bcs regionals have fewer senior employees, + more productive work rules.

But this is having an effect now only bcs of dereg. from '78 Act.

For other indies, 2 factors slow this termination

1. Land per dumas
2. K turns slowly.

Macro

"Hidden" costs of new devmt. i.e. catchy approach to s.o.c. infrastructure, assoc. costs, etc.

As well as early maint & replmt. costs, e.g. of highways.

Macro

"Fear of goods" has dominated demand side thinking. They have not "neglected" supply, they have suppressed it.

E.g. Samuelson who ~~does~~ expounds LUT case so well. Ask why he never promotes LUT? Oversupply.

Demand side ecsts. are not looking for immediate supply, but invt. opps. Then they worry about remote future demand adequacy!

Macros – To expound.

a) No of ~~people~~ passengers in airport ~~to show~~ is flow x pd. of wait.

Double the wtg. pd. + you double the crowd.

b) But then you need more people
- to expand airport
- to serve the crowd

c) But K in storage adds weight: as the people got bigger or had children at 8%/yr.

Now, shift to cattle in stockyard – they really do gain weight.

War + factor propns.

Wars use labor + K, and certain kinds of land, i.e. extractive ress.

But they surely must Δ shares of labor vs. land.

K is a puzzle. Why was K so cheap in WW II?

Ideas

1. K is the unhired factor. Its income is not generated by inv. spending — but all others are.

2. Micro doesn't see the forest for the trees.
Dismisses aggregates

3. The parts of micro most relevant to macro get downplayed: distribn. & combo. of factors.
∴ they can be upplayed in macro

4. Wages fund approach correctly gave inv. the autonomous role in circular flow. Capl. was advanced.
Macro then came to overemphasize cons. as autonomous more, at least for a while.
But after a while, inv. was returned to the cockpit — but with the stress on net inv.
Cons. remained an inc-creator, directly.

Mainly: a) cons. entics. income
b) Inv. " sales, or liquidn.
to the structure of K dets. inv., & inv. dets. cons.

Macro

1. What is K? Goods produced, but not yet consumed. They are "ripening".

Maybe the corpus (carcass) is consumable, like food.

Maybe a service is rendered as the cap. wears out, like Trucks.

In either case, cap. is constantly ripening until ~~it~~ consumed. (In case of the trucks, you may ask how is it ripening when it is wearing out? Think of it ~~like~~ as (compound annular)

2. Inv. is created when owner of K xfrs it to worker, "I invest". 2 steps — advances M_1 + delivers goods. We collapse into one. Like a co. store. Cap. advances wages to labor. "Faces" produ.

3. Inv. then depends on q. of K: + no of times it is recycled ea. yr. $K \times T$

4. Simple (introductory) case: broilers. 13 weeks, or $\frac{1}{4}$ yr.

P = Period of Invt. = $\frac{1}{4}$ year. "Payback period".

T = Turnover = 4 / year = $\frac{1}{P}$

V = Volume/yield = $4 \cdot K = T \cdot K$

$V/K = T$ = Flow / Fund ratio = 4

K/V = Cap. / output ratio = $P = \frac{1}{4}$

5. The problem with the simple case is that ~~the~~ it does not account for the regular flow of

To be useful, a ring must be on the surface.

of concentric rings): Each year one ring is used up & drops off, exposing the next one. This next one has ripened into a higher value. Sounds strange but this is a perfect image of the way assets are valued by appraisers & valuation engineers. Thus, a depreciating asset is the sum of several annual "rings" of service each one of which is appreciating. The sum depreciates bec. there are fewer rings left each yr.; & ea. one is smaller.

("running costs")
inputs into the broilers, such as feed, shelter, ~~security~~ protection, ~~cleaning~~ waste removal, health care, etc. For example, the ~~the~~ capital invested in feed in week 12 is recovered in just one week, not 13. To account for this, we need a more complex accounting.

Besides the visible running inputs there are invisible ones, especially the regular plowback of interest on unrecovered capital. (If you finance with borrowed money, this becomes visible or "explicit.")

~~There is a~~

Some are prone to declare "impossible" anything which strikes them as difficult, and so the neo-classical micro-economists do with this matter. But we will see it is possible, & more interesting than difficult.

esply. if one doesn't like the results,

Payback Times, to expound.

One approach, which we use, is to normalize.

1. Normalize (going concern)

   Ea. ~~wk~~ you recover one cohort of trailers.

2. Aggregate total K. This is the only hard part.

~~Let startup costs be $1 for ea. cohort.~~

3. ~~Output~~ ~~Apply~~ ~~Rate~~ $\frac{K}{\text{sales/wk}}$ = Payback Time (in weeks)

To apply. K, + get general formula. Let startup costs be $1 per dealer.

4. $K = (1+i) + (1+i)^2 + \dots + (1+i)^{13} = \sum_{n=1}^{13} (1+i)^{13} = \frac{(1+i)^{\frac{13}{1}} - 1}{i}$

i = Weekly interest rate.

$$\text{sales/wk} = (1+i)^{13}$$

$$K/s = \frac{1-(1+i)^{-13}}{i}$$

5. Table

5. Values for $K/s = \frac{1-(1+i)^{-n}}{i}$

n \ $i^{(m)}$	0	.5	1	2	5	10	20
1	1	1	.99	.98	.95	.91	.83
5	5	4.93	4.85	4.71	4.33	3.79	2.99
10	10	9.73 ~~9.23~~	9.47 ~~9.46~~	8.98	7.72	6.14 ~~5.94~~	4.19
15	15	14.42	13.87	12.85	10.38	7.61	4.68
20	20	18.99	18.05	16.35	12.46	8.51 ~~9.23~~	4.87
30	30	27.79	25.81	22.40	15.37	9.43	4.98
40					17.16		
50					18.26		
60					18.93		
70					19.34		
80					19.60		
90	90		59.16		19.75		5.00

6. Now add running costs. (c)
Start up was $1. Running cost be $.10/wk.
This adds to both ~~output~~ sales + K. (Sales must be higher to pay for the running costs, plus interest on them during their respective pds. of time.)

a) Extra sales are:

$$c\,\frac{(1+i)^n - 1}{i}$$

b) Extra cap. is:

~~$c\left[1 + (1+i) + (1+i)^2 + \dots + (1+i)^{n-1}\right]$~~

$$= c\left[\frac{(1+i)^1 - 1}{i} + \frac{(1+i)^2 - 1}{i} + \dots + \frac{(1+i)^n - 1}{i}\right]$$

$$= \frac{c}{i}\left[\sum_1^n (1+i)^i - n\right] = \frac{c}{i}\left[\frac{(1+i)^n - 1}{i} - n\right]$$

c) Extra K/s is: (if considered separately)

$$\frac{\frac{c}{i}\left[\frac{(1+i)^n - 1}{i} - n\right]}{\frac{c}{i}\left[\frac{(1+i)^n - 1}{i}\right]} = \frac{1}{i} - \frac{n}{(1+i)^n - 1}$$

7. ~~Modelling~~ Aggreg. K/S

Orig. sales + new sales are:

$$(1+i)^n + c\frac{(1+i)^n - 1}{i} = (1+i)^n\left(1+\frac{c}{i}\right) - \frac{c}{i}$$

Orig. K + new K is:

$$\frac{(1+i)^n - 1}{i} + \frac{c}{i}\left[\frac{(1+i)^n - 1}{i} - n\right] = \frac{(1+i)^n}{i} - \frac{1}{i}$$

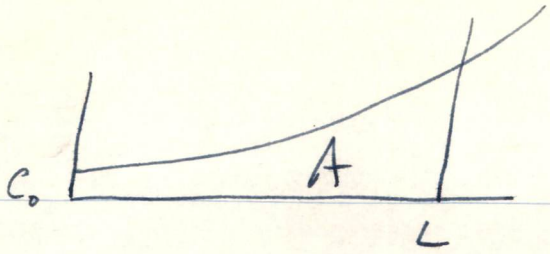
New aggreg. K/S is:

~~$\left[(1+i)^n - 1\right] + 1 +$~~

$$\frac{(1+i)^n + c\frac{(1+i)^n - 1}{i}}{\frac{(1+i)^n - 1}{i} + \frac{c}{i}\left[\frac{(1+i)^n - 1}{i} - n\right]}$$

Algebraically the new agg K/S looks messy, but actually any journeyman programmer could run it off easily and ~~quite~~ tabulate the ~~values~~ ratio for many different values of i, n, + c. Meantime we can get the feel of how the ~~result~~ ratio behaves by tabulating

its components separately. T-1 does this for the case of no running costs; T-2 for the case of no starting costs.



$$A = C_0 \frac{(1+i)^L - 1}{i}$$

$C_0 = H \cdot W$ = Hours × Wage/hr.

A = Total Capital in staggered process

$$H = \frac{A}{W} \cdot \frac{i}{(1+i)^L - 1}$$

1. To ΔH, if unempl.
   a. ΔA
   b. $-\Delta W$
   c. $-\Delta L$
   d. $-\Delta i$ -- weak effect

2. To absorb capl. if big glut of capl.
   a. ΔL
   b. ΔW
   c. ΔH
   d. Δi

3. Meeting the national payroll.

4. Changes in V viewed from 2 standpoints:

a. Trying to get rid of money — means convert money into goods.

b. Trying to add to goods -- counterpart of (a).

Multiplier is a process of frustrated capl. accum.; or money riddance.

But note the implicit assumption that turnover is easily changeable. With money it is believeable. But not with capital.

5. Capl. turnover as bottleneck

a. Chronic aspect

Taxes

Munic. bonds

Govt. invts.

b. Crisis aspect

Bevin - Turner

Keynes Clarified

THE FAILURE OF THE "NEW ECONOMICS" by Henry Hazlitt. D. Van Nostrand Company, Inc., Princeton, New Jersey, 1959, $7.50.

Reviewed by MITCHELL S. LURIO

THE title of this book might more accurately have been "The Monstrous and Demonstrably False Doctrines of John Maynard Keynes." It is a devastating line-by-line dissection of Keynes's pronouncements and predilections in his controversial book *The General Theory of Employment, Interest and Money,* published in 1936 and unsettling the economic and political world since.

The importance of the job undertaken by Mr. Hazlitt is indicated by the following lines from an economist of great stature, Dr. Benjamin M. Anderson, in his notable work *Economics and the Public Welfare—Financial and Economic History of the United States, 1914-1946:*

"Keynes was a dangerously unsound thinker.[1] His influence in the Roosevelt Administration was very great. His influence upon most of the economists in the employ of the government is incredibly great. There has arisen a volume of theoretical literature regarding Keynes almost equal to that which has arisen around Karl Marx."

Despite the enormous upheaval caused in economic circles by Keynes's *General Theory,* no one before Hazlitt has managed to complete a readable, and decisive refutation of his so-called revolutionary discoveries. The interested layman, with rare exceptions, cannot understand Keynes because he is airy, arrogant, blithe, brilliant, diffuse, involved, inconsistent, inverted, imprecise and pretentiously but unhelpfully and speciously mathematical.

Mr. Hazlitt's book explains and demolishes Keynes with remarkable clarity. It is too bad, then, that one who can throw such a powerful and revealing searchlight on the obscurities of Keynes and his followers, relies for his answer so insistently and repeatedly on the doctrine that the real reason for unemployment "is almost invariably the existence of excessive wage-rates in relation to prices." This positiveness boomerangs on the author when he attempts to answer Keynes's statement that higher prices go with higher wage-rates (taking a point on the up side of the business cycle). He retorts that lower prices go with higher wage-rates (taking a point just beyond the peak of the business cycle) and merely asserts that his situation is the more usual one. Certainly a sound theory should do better than that.

The author tries very hard to restrain himself from losing his temper and loosening his tongue, but there are times when he will stretch a statement of Keynes unfairly to make it ludicrous when a more charitable interpretation might have some merit. But Keynes does goad one—and as Hazlitt points out, Keynes flayed his opponents unmercifully and added that no one should be thin-skinned in economic combat.

The positive values in this book may keep the next generation from embracing the society advocated by Keynes, in which experts, statisticians and managers under elected officials may, by expedients, devices and mirrors and by unlimited extensions of central government authority, invade any area of the market-place and try to create illusions that will induce business men to expand their productive activities when they would otherwise contract them. The free enterprise

[1]Lord Keynes was a man of genius. He had great abilities and great personal charm.

system, according to Keynes, needs to be preserved in some degree, so that "dangerous human proclivities can be canalized into comparatively harmless channels by the existence of opportunities for money-making and private wealth, which, if they cannot be satisfied in this way, may find their outlet in cruelty, the reckless pursuit of personal power and authority, and other forms of self-aggrandizement." (*The General Theory* . . . p. 174)

Where it would take years of study for the layman to understand the various interpretations and real significance of Keynes's generalizations and assumptions, the treatment by Hazlitt is so thorough that the cloudiness is largely dispelled. In some cases, Keynes gives considerable space and involved symbols to an unimportant concept. A good example is "user cost," or the "reduction in the value of equipment due to using it as compared with not using it." This quantity is negligible and is so acknowledged by many Keynesians.

Hazlitt's treatment of Keynes's efforts to deny the validity of Say's Law is masterful. Say's Law is the principle that production always generates sufficient purchasing power to pay for what is produced under free conditions of equilibrium, and it should be understood by every economist.

Again, Hazlitt does a very valuable service in pointing out the dubiousness of the concept, and the inaccuracy of the measurement of what is known as national income and its variations and components. These are doubtful and unreliable methods of making comparisons and prognostications. Similarly, he reminds us of the limitations of our various economic averages and indexes.

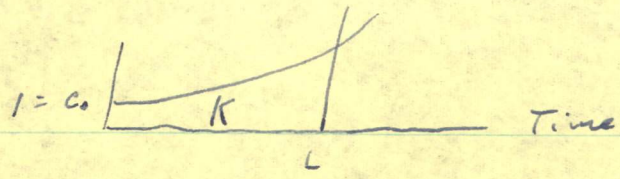
Since Keynes covers the widest range of ideas in the course of his miscellaneous comments, and since Hazlitt pounces upon every one which needs criticism, the reader of *The Failure of the "New Economics"* can get in one book a better over-all picture of economic thinking than he would get from the study of any dozen textbooks. Its value is enhanced by the fact that unlike most academicians, Hazlitt expresses his opinions with vigor, with justifiable lustiness and generally in dissent with the current welfarist trend.

There could be no better college preparation in economics than a second year mandatory course using Hazlitt's book as a text, for regardless of the instructor's bias a student would be able to judge for himself where the alternatives were as clear as they are here. The book is also commended to every business man who would like to know more about the techniques and theories in the academic world.

And to Georgists, who have a much more satisfactory and sounder understanding of the law determining wages, namely that wages for the unskilled tend to existing subsistence standards where practically all land is privately owned—the book is heartily and strongly recommended for its width and depth and clarity despite its failure to mention the most important obstacle to employment—the private tollgates which don't permit access to natural resources except on prohibitive terms.

In the September 11th Christian Science Monitor, in a discussion of Keynesian "cost-push inflation" by John Allan May, we find this economics writer saying: "If it is justice as well as material wealth that we are after we might do worse than to take another look at Henry George and the idea of land value taxation."

T. B.



Labor input = $C_0 = P \cdot W$

$$K = PW \frac{(1+i)^L - 1}{i}$$

$$P = \frac{K}{W} \frac{i}{(1+i)^L - 1}$$

$$P \propto \frac{1}{L}, \frac{1}{W}, K$$

Implications:

1. Capl. funtn. need not depend on future cons. There can be a permanent Δ capl. stock per man
2. Share of capl. depends on $\frac{K}{P}$.

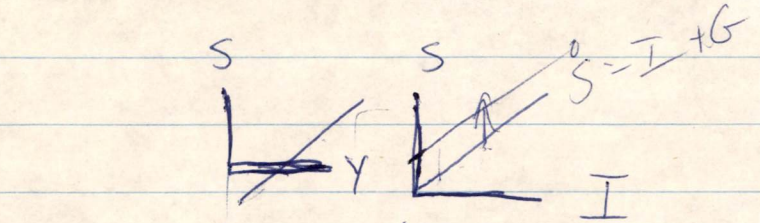
$K \propto L$

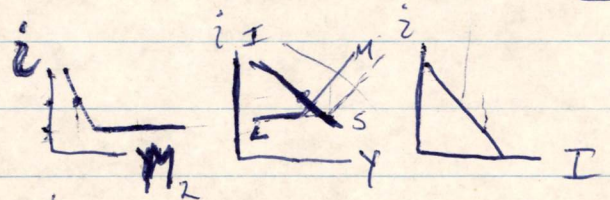
3. There is an automatic adjusting mechanism for full empl. of labor and full absorption of ΔK.
4. Anything artificially lengthening L will reduce PW
5. Etc. -- trace all the relations.

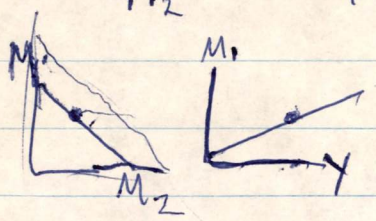
$S = -a + (1-b)Y$

$Y = C + I + G$

$C = a + bY$







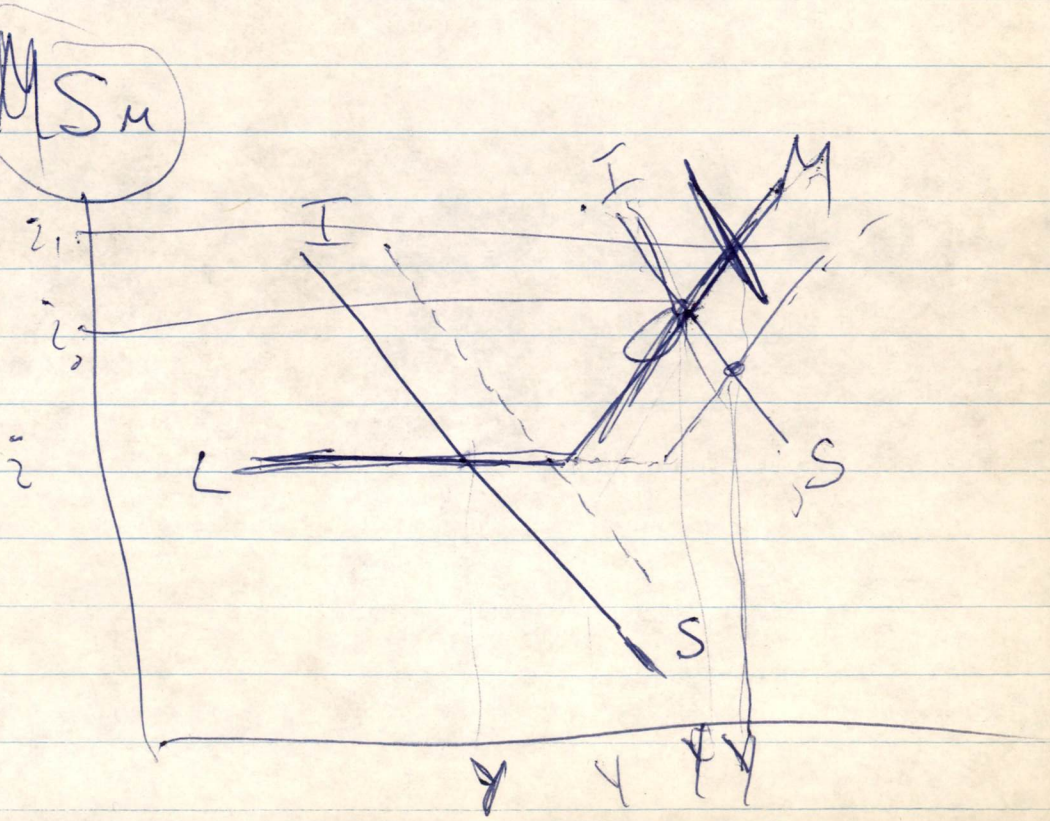
$y = f(i)$

$y = g(i)$

$y = f(x)$

$x = f(y)$

$M_1 + M_2 = M_S$



Michèle Lamy:

Conversation of P.P.

'Dixie Zeckendorf' runs for cover

New Orleans developer Sam J. Recile, battered by winds of tight money, struggles to prevent the collapse of his $100-million real estate empire. He is looking to the courts for shelter



Sam J. Recile's projects pyramided rapidly, but financing stretched thin. Creditors began squeeze this year.

In September, 1965, Hurricane Betsy blew down part of New Orleans' most colorful asset, the French Quarter. Right now, a different sort of hurricane, tight money, is blowing hard at another colorful New Orleans asset, developer Sam J. Recile, often called the "Dixie Zeckendorf." And the debris is being scattered far and wide.

Recile himself faces potential collapse of his $100-million real estate empire, a rapidly built collection of office buildings, hotels, and apartment houses that has contributed mightily to New Orleans' new business vitality [BW Apr.10'65,p160].

He has already sold off $25-million worth of his holdings, and put other property up for sale. His Bourbon Orleans Hotel, opened only last July, may change hands soon. He has filed two petitions for voluntary reorganization under Chapter X of the Bankruptcy Act, and a hearing on one is scheduled Jan. 12.

Creditors' stakes. An undetermined number of creditors have stakes in Recile's future. They include New York's Manufacturers Hanover Trust Co., George E. Fuller Construction Co., Meadow Brook National Bank of Long Island, Exchange National Bank of Chicago, National American Bank of New Orleans, and an estimated 30 or so others. As one New Orleans banker says, "Nobody knows who is holding bags where and for what."

The city of New Orleans itself feels directly involved. Mayor Victor H. Schiro fears that a widely publicized failure would give his city "a black eye." He calls Recile a "prime mover" in the business group responsible for a new spirit in New Orleans. "It would be a tragedy for him to fail," says the mayor.

Few people are counting Recile out yet, though—least of all Recile himself. He claims assets of $60-million to $70-million, against debts of $30-million to $35-million. This asset figure is his own estimate of the fair market value of his remaining properties; what they would actually bring, especially under forced sale, is presently an open question.

Recile is hoping that the courts, by accepting his petitions, will save him from forced liquidation. Several groups, he says, have shown interest in buying the Bourbon Orleans, but are waiting—hoping pressure on Recile will force down the price.

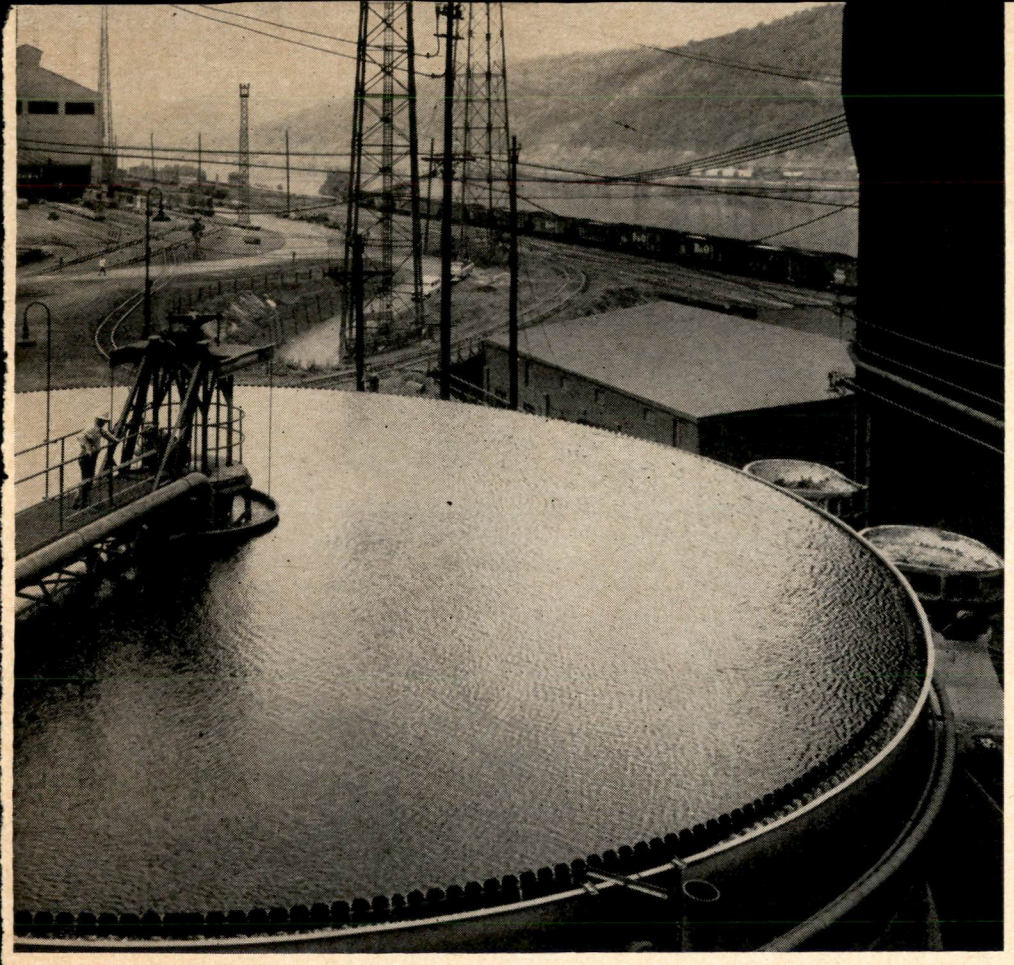
Role of underdog. Many New Orleans citizens are rooting for Recile, who revitalized a large area of the French Quarter and built the state's tallest building. They now see him as an underdog. Joseph W. Simon, Jr., executive vice-president of the Chamber of Commerce, says: "Personally, I'm one of those who think he will make a comeback. He is too smart a man. Already he has left his mark on the city."

On the other hand, New Orleans does not lack businessmen who say they predicted trouble for Recile all along. Some of the older families think of him as an upstart.

Recile, who is now 34 years old, came to the city from an outlying rural parish, and got his start as a French Market watermelon dealer. He began dabbling in real estate as a teen-ager, obtaining a court order at 18 that permitted him to act in his own name, though he was a minor. With help from his moderately well-off parents, he bought and sold modest parcels of land, and even built a two-story office building in a New Orleans suburb.

'Boy wonder' in oil. In Louisiana, it's a short step from land speculation to oil wildcatting, and by the early 1950s, Recile was acquiring a small reputation as a "boy wonder" in the oil business. He says he made and lost $1-million in oil before he was 21.

After that, he returned to real estate, concentrating on buying old buildings in the French Quarter, and turning them into offices and apartments. His first big venture came in 1964 with the purchase of New Orleans' first skyscraper, the 28-story 225 Baronne Building. He built the Bourbon Orleans Hotel; developed a French Quarter project called Le Richelieu, restoring the



installation at U. S. Steel's Duquesne (Pa.) Works, will cut plants' waste discharges.

equipment, although the last Congress exempted pollution-control facilities when it suspended the 7% tax credit on capital investment. The result, says Quigley, is a handicap in FWPCA dealings with industry; in contrast, direct federal aid to municipalities provides a carrot to go along with the stick.

New approach. "We have not had much of a carrot to offer, still don't, and may not get a very large carrot in the future," he says. Some states, including New York, do exempt pollution control installations from some taxes, however.

A new approach advocated by Quigley is for industry to route its waste through municipal sewage treatment plants built to have extra capacity and equipment. The federal government will pay for 30% to 50% of such installations, and industry avoids capital investment, taxes, and some operating costs.

If industry can dispose of waste through municipal facilities, it can do it for a "fraction of the cost it would otherwise take," he contends.

A handful of industry-municipal operations built before federal aid was available are now running. The South Charleston, W. Va., Sewage Treatment Co., for example, is a corporation owned by the city but operated by Union Carbide Corp. The city and industrial users share the cost of operating the $5.3-million plant.

Kalamazoo first. The first joint waste treatment plant with partial federal financing is under construction at Kalamazoo, Mich. Five paper companies and a drug concern, Upjohn Co., will join the city in routing wastes through a $4.4-million plant due to begin operation this spring. FWPCA is giving Kalamazoo $644,000 for the project.

Advantages for both the city and the companies are substantial. The bigger plant will cost less to build than separate, smaller plants. And the companies, though ineligible for federal money, can share the benefits of the grant to the city. The new facility will have a capacity of 35-million gallons a day; the companies will pay a fee for waste treatment.

III. New industry's problems

Makers of control equipment, plant builders, and companies now marketing knowhow gained through their own control progress—Dow Chemical Co. and Container Corp. of America, for example—are foregoing a new industry, but the fledgling has problems.

For one thing, no major technical breakthroughs seem to be in the offing. And the market is fragmented by the diversity of industries to be serviced. No universal off-the-shelf pollution cure will work for all paper-mill problems, for example, and paper-mill equipment won't solve a steelmakers' waste problems.

Tailor-made. Quigley notes that there just isn't a ready market for equipment: "In instance after instance, an abatement facility will have to be tailor-made, or adapted." Equipment profit margins are low, and competition is stiff, he says. The bulk of the cost in many projects is in conventional items, such as pumps, concrete, and pipe.

One marketing strategy combines equipment sales and consulting knowhow. The package can even include operation of the control facility to the point where it can meet federal standards. For example, Calgon Corp., Pittsburgh, has been offering a pollution-abatement service for the past two years through its Hall Laboratories Div.

Variations. Calgon concluded an agreement with Blaw-Knox Co. early in 1965 to work jointly on industrial water processing projects. Some other concerns, including Nalco Chemical Co., Chicago; Eimco Corp., Salt Lake City; and Chemical Construction Co., New York, also have analysis and construction services.

Hall Labs conducts the water surveys, and provides preliminary engineering. If the customer decides to go ahead on Hall's recommendations, Blaw-Knox builds the plant.

Edgar G. Paulson, manager of Hall's process and waste water department, says the number of turnkey or full-service jobs done thus far has not been substantial.

Brisk response. Response on the survey end of the business has been much bigger, he says, and he has had to double his staff of engineers —to 14 from seven—since the service was first offered. Companies surveyed range from rubber producers to auto assembly plants. Surveys take four months to three years, with costs ranging from $2,500 to $20,000 and up.

IV. Area of doubt

Demand for consultation may stem from management's uncertainties over federal requirements. Commented one executive at the NICB conference on pollution: "All this is apple pie and motherhood. What do we have to do?"

Stein says the FWPCA hopes to solve this problem by close cooperation with industry. He has just completed meetings with representatives of 20 or so industries in Massachusetts and a group of 100 companies in Connecticut on standards. **End**

section's Creole charm to a square block of dilapidated buildings; and acquired land in Baton Rouge.

He also announced he would build "the world's tallest hotel," the 72-story Place Vendome, for which pilings were driven. But the brightest ornament of his career was to be the 45-story Plaza Tower, an office-apartment building that now dominates New Orleans' skyline. It also dominates his present straits.

Shaky pyramid. Recile's current predicament is not uncommon among high-stepping real estate speculators. As his projects pyramided, his financing stretched thinner and thinner. By mid-1966, tightening money was beginning to brew a crisis.

In summer of 1964, Recile started putting up the Plaza Tower, scheduled to cost $12-million. Manufacturers Hanover agreed to put up the interim construction money, and New England Mutual Life Insurance Co. signed a commitment for $10.5-million long-term financing, with the stipulation that the building be finished by Oct. 1, 1966.

As construction proceeded, Recile lined up some large tenants. Flush with success, he decided to expand the building, adding $3-million of improvements, including a five-story annex and a garage. Recile says now that he had reason to believe he could raise the additional capital required. But by the middle of 1966 his money-raising drive was running aground.

Troubles. He began missing mortgage payments, and creditors were pressing in. In August, Meadow Brook Bank sued for some $3-million in loans it had made on French Quarter properties. Construction delays on Plaza Tower ran past New England Mutual's time limit, and it let its commitment lapse. This left Recile without any firm long-term financing for the building.

At this point, Manufacturers Hanover moved to protect its $12-million. In early October, the bank brought foreclosure proceedings, joined by National American Bank, which had lent Recile $250,000 on the Tower. Two weeks later, Fuller Construction stopped work on the building, then about 80% complete.

Plaza Tower was due to be sold at public auction on Dec. 1. Recile filed his petition for Chapter X bankruptcy, and literally at the 11th hour, on Nov. 30, a judge issued an order staying the sale pending a decision on the petition.

Counterattack. Recile also brought suit for $96-million against Fuller Construction and two associated concerns. He charges that by stopping work on Plaza Tower, Fuller deprived him of rental revenue he otherwise would have been collecting by now. The $96-million is the amount Recile claims he would lose over a 40-year life span of the building.

In the meantime, Exchange National Bank foreclosed on the Bourbon Orleans Hotel, on which it holds a $584,000 note for fixtures and furniture. Again, the hotel was about to go on the public block when Recile filed his second Chapter X petition. Another stay was issued, and a hearing set for Jan. 12.

Adding to Recile's major headaches, the Internal Revenue Service then filed tax liens for about $1.5-million, which Recile denies he owes. "In my considered judgment, all taxes have been paid, and I've been so advised by my accountants."

Unloadings. To stanch the flood of troubles, Recile started unloading real estate. In September, for example, he sold the 225 Baronne Building to Louis J. Roussel, another self-made New Orleans entrepreneur, whose National American bank has backed a number of Recile ventures. The price was $15.5-million. He has sold half of his French Quarter property, and put his Baton Rouge land up for sale.

His brightest hope at present lies with the courts. They can provide him a storm shelter from creditors and time to refinance. Recile insists that despite his financing problems, his projects are basically sound. The Bourbon Orleans, he argues, is making money. He values Plaza Tower at $20-million, and asserts it would produce $2.5-million a year in rent, more than enough to amortize the debt.

Impact on city. Recile strongly identifies his interests with New Orleans. His assets, he says, "are largely those of the city itself." Their fate "can have a substantial bearing" on its economy, he asserts.

For this reason, most New Orleans businessmen are watching Recile's struggle apprehensively. One businessman warns that what happens to Recile "should not reflect on our city. It's just a case of one man's arrangements going sour."

Most New Orleans businessmen are confident that Plaza Tower, whoever its ultimate owner, will be finished and become, like the Bourbon Orleans and Le Richelieu, an impressive civic asset. Other Recile ambitions, like Place Vendome, apparently have faded away. For the present, what future impact, if any, Sam Recile's drive and enterprise may have on New Orleans is up to the courts. **End**

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Cities briefs

BW

HUD to release eligibility requirements soon for the 'model cities' program

Housing & Urban Development Secretary Robert C. Weaver will soon announce new rules that the nation's cities must follow in applying for federal assistance under the "model cities" (formerly "demonstration cities") program. The rules will spell out in detail how cities can become eligible for some of the $2.5-billion in federal funds on tap for cities that work out coordinated plans for rehabilitating blighted areas [BW Oct.29'66,p141].

Some 200 cities have already expressed interest in the program—and a few have submitted preliminary plans. With the new rules in hand, many will have to take their proposals back to the drawing board.

HUD grappled with some knotty political problems in drafting the rules. For example, **civil rights groups wanted city-wide open occupancy made a prerequisite for any city applying for federal funds.** HUD ruled that it could demand open occupancy only for housing directly affected by the program—such as housing in the demonstration area itself.

Development of new towns continues apace despite restraints of tight money

Despite the restraints of tight money, progress on "new towns," or planned industrial-residential communities, goes on:

▪ **The nation's best known new town, Reston, Va.,** 18 miles outside Washington, has secured a $200,000 federal grant to experiment with housing for moderate-income families. Through a new non-profit corporation, Reston developers will create apartments by stacking factory-made units that contain a kitchen, bath, and two to four bedrooms.

▪ **Construction is under way at developer James Rouse's Columbia,** in Howard County, Md. Ryan Homes of Pittsburgh will be the town's major home-builder.

▪ **Litchfield Park, being developed by Goodyear Tire & Rubber Co. outside Phoenix,** now has a shopping center, professional building, and new 36-hole golf course. Under the town's recently revealed master plan, Litchfield Park will be cut into 12 villages, separated by scenic belts. Each will be grouped around a core area that will contain the major civic and commercial facilities.

▪ Chicago developer Bernard Weissbourd plans a **major new community on the 1000-acre Nun's Island in the St. Lawrence River, near downtown Montreal.** An initial 800 housing units in town houses and apartments are to be followed by commercial and civic facilities for a projected population of 50,000.

▪ Interest grows in the idea of **building new towns far removed from existing cities rather than in the suburbs.** William J. Levitt says his company is working on the idea of developing "primary employment centers," with their own economic base, that are not adjuncts to present cities.

Citibank analyzes New York metropolitan area, feels city has means of curing its ills

New York's First National City Bank has issued an economic analysis of the New York metropolitan area with the hope that it will improve understanding of what the future will require of the nation's largest urban complex. Though the study points out familiar lacks—money, adequate transportation, suitable space for people and industry—it concludes optimistically that New York City, "despite the size of its problems, contains the wealth and resources equal to the challenges."

Another conclusion: **The region is fast switching from a manufacturing to a service-oriented economy.**

The study touched on other hopeful areas—New York's businessmen are taking a more serious interest in the area's welfare, for instance. It also urged some ways by which solutions could be speeded, such as a fuller cooperation by the region's 1,100 governmental units; and **some suggestions for giving state and local government more of the tax money now going to the federal government.**

In the final analysis, the report concludes, progress must rest on the area's considerable strength. "Implicit in what we are saying," says Jac Friedgut, the study's author and senior economist at Citibank's Economics Dept., "is that **if New York can't solve its problems with all its income, what hope is there for any other part of the country?"**

New office-apartment complex on the track

One kind of solution to the overcrowding that has forced industry to desert the cities cropped up recently in New York. Mayor John V. Lindsay, who has taken the lead in searching for ways to hold on to business, announced a $80-million private development designed to help.

The new complex will be built on platforms over the Pennsylvania RR's tracks on New York's West Side, adjacent to the new Madison Square Garden and Penn. Center, and close to the heart of the teeming garment district. **It will include a 14-story office and distribution center, called the Midtown Mart, and a 1,650-unit, middle-income apartment building,** designed by Philip Johnson. The area will have parks, recreation facilities, a large parking garage, and 50,000-sq.-ft. of shopping.

Two companies, Lerner Stores Corp. and Spartans Industries, Inc., will locate their headquarters in the Mart. Lerner abandoned plans to move to New Jersey.

Developer is Westyard Corp., owned by several partners in Lazard Freres & Co., investment bankers.

TIME
INCORPORATED

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ROCKEFELLER CENTER
NEW YORK 10020
JUDSON 6-1212
EXECUTIVE OFFICES

June 30, 1966

Professor Mason Gaffney
Department of Economics
The University of Wisconsin
Milwaukee, Wisconsin 53211

Dear Mase:

Don't worry about any implication of obscurity in my letter to you about poor Mr. Kneese. I'm sure the obscurity was mine.

The reason different effluents take different treatments, I'm told, is that it takes different chemicals to cancel out different wastes. For example, the sulphuric acid in paper mill waste needs a chemical - that is no help at all on sewage. And I'm told - that if the chemicals needed to purify specific industrial wastes are put in the same treatment process they may cancel each other out instead of canceling out the waste each is supposed to cancel.

302

As for Arno Johnson's theory that the first effect of tight money is to raise prices, his argument is that tight money cuts production before it cuts demand, i.e., that producers take cover first. And if production is cut more than demand the far-famed law of supply and demand says prices can be expected to go up, not down. Example: I'm told tight money has already raised the price of new homes 5%!

How did you like the Roundtable draft? And most specifically, did I misrepresent your Milwaukee V.L.I. findings?

Sincerely,

Perry

P.I. Prentice

302 Sequence of Topics.

Semester I, 1966-67

Macro.

1. ~~Various~~ bottlenecks
2. ~~Neo-orthodox~~ Defn. of terms. ~~D&M, Pt. I~~
3. Neo-orthodoxy -- ~~spending determinism~~, spending as the bottleneck. ~~[D&M Pt. II]~~
4. ~~Weak~~ ?inadequacy of neo-orthodoxy
5. Monetary classicism. Keynes

   ?Inadequacy of monetary classicism

6. Real (as opposed to monetary) bottlenecks. a. Resource limits --- natural, capital, technological
   b. Institutional ~~checks~~ limits -- monopoly, taxation, depressive regulation
7. The cyclical nature of macro-economic thinking – a ~~short~~ look at history.

   Which theories fit?

8. Diagnosis

   Reconciliation of inconsistent theories

   Integration of real with monetary-spending theories.

9. Policies toward sustained full use of ~~capacity~~ human and other resources.

Correction Copy

Economics 302
Topics

September, 1965

1. Review of 202; and preview of 302

2. Major macro-economic concerns
   a. Instability
   b. Output below capacity; unemployed resources with especial concern for labor. Poverty. Underemployed or misallocated res.
   c. Growth below capacity; inadequate capital formation and use

3. Factor limits on aggregate output and employment
   a. The natural resource limit
   b. The capital limit
      i. Stock (Capital formation)
      ii. Flow, or turnover
      iii. Allocation
   c. The technological spectre of accelerating displacement of labor by capital

4. Monetary limits on aggregate output

5. Expenditure limits on aggregate output

6. Institutional limits on aggregate output ~~Ackley Ch. 19~~
   a. Market structure and control
   b. Depressive taxes
   c. Depressive government regulation and the law
   d. Limited allocation of capital to R & D; education; s.o.c.
   e. Limited leadership, enterprise and organization

7. Diagnoses: summary and restatement
   a. Criticism of received doctrines. Their contradictions - e.g. cap. shortage vs. cap. glut
   b. Integration of capital theory into macro-economic diagnosis.

8. Policies toward stable growth and sustained full use of capacity
   a. Inadequacy of present policies -- overreliance on control of one possible choke (aggregate spending)
   b. Policy recommendations

9. Review

- Boland

ECONOMICS 202-6

variables:

Y = level of income
C = level of consumption
I = level of business investment
G = level of government investment
T = level of taxes
S = level of savings
R = level of transfer payments

MODEL 1:

$C_d = a + bY$
$C_s = Y - I$
$I = I_o$
$C_d = C_s$

MODEL 2:

$C_d = a + bY$
$C_s = Y - I$
$I = d + eY$
$C_d = C_s$

MODEL 3:

$C_d = a + b(Y - T)$
$C_s = Y - I - G$
$I = I_o$
$G = G_o$
$T = T_o$
$C_d = C_s$

MODEL 4:

$C_d = a + b(Y - T + R)$
$C_s = Y - I - G$
$I = I_o$
$G = G_o$
$T = f + gY$
$C_d = C_s$

MODEL 5:

$C_d = a + b(Y - T + R)$
$C_s = Y - I - G$
$I = d + eY$
$G = G_o$
$T = f + gY$
$C_d = C_s$

MODEL 6:

$C_d = a + b(Y - T - R)$
$C_s = Y - I - G$
$I = d + eY$
$G = T - R$
$T = f + gY$
$C_d = C_s$

ECONOMICS 202-6

A. Elementary macro theory concepts
   1. Equilibrium level of income [chapters 2, 3, & 4]
   2. Multipliers [chap. 3]
      a. investment and government
      b. tax and transfer payments
      c. balanced budget multiplier
   3. Interest rates and demand for investment [chap. 5 & 6]

B. Macro problems
   1. Full employment and inflation [chap. 3, 7 & 9]
      a. labor market
      b. money market
      c. commodity market
   2. Solutions: classical vs. Keynesian [chap. 12]
      a. fiscal policy
      b. monetary policy

C. Other problems:
   1. growth and cycles [chap. 10 & 8]
   2. balance of trade [chap. 11]

D. National income accounting [chap. 1]

[note: chapters from Sirkin: Introduction to Macroeconomic Theory]

Ex. 302



Is the shiny metal's luster only skin deep?

Speculators are buying silver futures and mining stocks, sure that the Treasury soon will remove the ceiling price. But Washington has no such plans for the present

The $1.29 per oz. ceiling on silver maintained by the Treasury Dept. these past few years is headed for extinction. Yet speculators who have been bidding up silver futures and mining stocks, and in some cases hoarding bullion—gambling that Treasury is ready to let the $1.29 ceiling die—seem in line for a dousing.

While Treasury has no intention of keeping the lid on silver indefinitely, it can and will hold the line for at least another year and possibly longer. The first step toward lifting the price ceiling—creating and convening a commission on coinage as specified in the Coinage Act of 1965—won't be taken until early next year. Concludes one Wall Street trader: "There is no chance of anything happening to silver's price for anywhere from 12 to 24 months."

Melting point. Even when the $1.29 ceiling does vanish, silver's price isn't likely to skyrocket. Once the price reaches $1.38 an oz. it would become worthwhile to melt down the 13-billion or so silver coins still in circulation. These coins contain roughly 1.8-billion oz. of silver—enough to meet all the nation's silver needs for about three years.

Many people, of course, disagree. Some influential Wall Street names have been talking up silver shares lately, based on expectations of a markedly higher price for the metal. Says an analyst who follows mining stocks: "There has been a crescendo of brokerage house letters on silver recently, with some talking of as much as $4.00 an oz. In an otherwise dreary market, some silver mining shares such as Hecla, New York & Honduras Rosario, Fresnillo, and Day Mines have been holding near their highs for the year. And investors are eying silverware makers with large inventories.

Market doings. Trading silver futures on the New York Commodity Exchange has picked up, too. While the price of silver for one-year forward delivery was around $1.31 an oz. early last spring, it rose to nearly $1.36 by early June. Even now, the price has slipped back only to $1.34¾.

And while there were only 800 open silver contracts on the exchange last March, there are nearly 2,000 open contracts now. "The whole thing," says an official of the exchange, "is in anticipation of the government being unable to continue selling silver at $1.29 an oz."

It is easy to see why speculators think this way. So far, Treasury has managed to keep the ceiling intact by selling silver from its own stock at the $1.29 price. A look at the supply left in the vaults makes clear that this can't continue much longer.

Currently, there is a 100-million oz. gap between the amount of silver produced in the free world each year and the amount consumed. While silver production has held relatively static, industrial users, especially in photography and electronics, keep buying more of the metal. U. S. industry alone consumed about 150-million oz. last year against only 100-million in 1960, says Handy & Harmon, the New York silver processors. But total U. S. output has stayed under less than 40-million oz. a year. To fill this gap, users turn to the Treasury.

Coinage needs. Beyond this are requirements for U. S. coinage. While last year's shift from 90% silver coins to silverless dimes and quarters and 40% silver half-dollars slashed deeply into the Mint's silver needs, some 30-million oz. will be needed each year to make the 40% silver half-dollars.

Thus, Treasury stocks, down from 2-billion oz. in 1960 to 680-million today, could reach 600-million oz. by yearend—or even lower, if hoarders start buying again as they did in late May and early June.

Treasury officials are convinced that even this dwindling stock will be enough to keep the price lid on for a while longer. "For the next two, three, or even four years, I don't see any great problem," says Assistant Treasury Secretary Robert A. Wallace.

Most professionals in the silver business buy Treasury's argument. Behind their thinking is a conviction the Treasury can't let the price go up, unless it wants to see another severe coin shortage.

Treasury agrees. It says the coin shortage is over, but if it lets silver's price rise, the old silver coins quickly would vanish from circulation. Thus, it wants to hold the price at $1.29 until the transition to the new silverless coins is complete—and that won't be before yearend at the earliest. **End**

Wall St. talks . . .

about trading in Gerber, Dictaphone Corp., Overseas Securities, lending fees

The First National Bank of Chicago denies it has been buying stock in Gerber Products Co. on behalf of any particular investor or group. The bank has been picking up stock in the No. 1 baby food company since last fall, but says that the shares have gone into a number of its trust accounts for investment only. **It's understood that First National has a 700,000-share position**—more than 8% of Gerber's stock.

Despite recurring rumors, Emerson E. Mead, president of SCM Corp., says that **he is "not at the present time" negotiating for the acquisition of Dictaphone Corp.** He also denies that SCM bought any of the block of Dictaphone stock sold by Litton Industries in February.

Shares of most closed-end investment companies sell at a discount. **But tiny Overseas Securities Co. is selling on the Amex at a huge 88.6% premium.** The reason: Over the last three years distributions have averaged $3 a year—14% of the present 21¾ a share price—and are taxable as capital gains. Despite the name, Overseas' holdings at mid-year were mostly domestic: Northwest Airlines, Seaboard World Airlines, Rayonier, oils, steels, banks, and food companies.

New York's Morgan Guaranty Trust Co. is not commenting on reports that it is about to buy control of the Vonwiler Bank, a private Italian bank based in Milan. But sources say **Morgan is negotiating with a group of Swiss stockholders** who own the controlling interest in Vonwiler; the deal should be closed fairly soon.

A large consumer finance company, caught between high money market rates and its inability to push lending rates higher because of state usury laws, thinks it has a way out of its bind—**a $2 service charge on each installment contract it writes for appliance dealers.** A number of states permit such fees; in a number of others, the law is silent on the subject.

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Econ 702
November 1966

Prof. M. Gottlieb

Write one-half hour essays on any four of the following. Respond fully to the issues raised by the questions.

1. Why did the original Keynesian model specify an inverse behavior of real and money wage rates and what presuppositions regarding the production function of the model and market relationships led to this specification? On empirical grounds why was this specification vulnerable and on what grounds?

2. Classical economics may be characterised by three assumptions: (a) that all of income would be spent or invested in produced output, (b) that productive factors would tend to be fully employed, (c) that money values of income would be governed by the quantity of money and by its velocity of circulation. Which assumptions were challenged by Keynes and for what reasons? Which assumptions were accepted by Patinkin? How could the classical model be expressed in terms of formal macro-economic theory?

3. Write out a complete statement or equation for either the consumption or investment function with at least two or more different kinds of explanatory variables or determinants and: - -

a. indicate the validity of the equation or the relationship specified in terms of economic theory or of maximising behavior,

b. indicate the probable form of the relationship (linear, proportional, etc.) and the character of the time-lags involved,

c. outline the approach to the function taken by at least two of the authors studied,

d. indicate gaps in the suitability of the function if known or believed probable,

e. evaluate evidence regarding the stability of the functions during processes of change or disturbance.

4. Define in terms of maximising behavior of households or firms and show the use of any four of the following concepts or terms in macro-economics and indicate their relationship to a relevant equation:

a. "finance" (Keynes)

b. marginal efficiency of capital

c. speculative motive

d. money illusion

e. autonomous expenditures

f. "permanent income"

g. "liquidity trap"

5. "It is an interesting question why a theory in which money is important should have turned into a theory that money is unimportant" (Johnson). Is this statement true? In what ways? Why? Comment freely.

6. If money wage-rates are a non-proportional function of the level of employment and hence intermediately of the level of current output and effective demand, and if the constant term in this function changes to cause a higher level of money wage-rates, what effects will this action have--if no other disturbance and no other parametric changes in the macro-model will be generated--on the equilibrium levels of employment, income and spending (demand)? How do we go about determining what these changes will be? How did Keynes make the corresponding inquiry? What functions and variables would be relevant?

Course Outline
Economics 202

Instructor: Bon Ho Koo
Office : Bol. 518
Office Hours: MWF 11:30 - 12:30

Texts: McKenna, Aggregate Economics Analysis (M)
Samuelson, Economics (S)
Chiang, Exercises in Aggregate Economics (C)

Topics and Reading Assignments:

INTRODUCTION

1. Nature of Macro-economics - Scope of the Course.
2. Review of Elementary Mathematical Tools.
   (C) Introduction and Exercise 1 and (M) 1.
3. Basic Concepts of National Income and Social Accounting
   (M)2, (S)10, & (C)2.

MODERN INCOME AND EMPLOYMENT THEORY

Chapter 1. Theory of Consumption, Saving, and Multiplier.

1. General Determinants of Consumption. (M)10 & (S)11.
2. Consumption Function. (M)3, (S)11, & (C)5 and 7.
3. Saving Function. (M)3, (S)11, & (C)6.
4. A Simple Equilibrium Income Determination. (M)3, (S)12, & (C)8 and 9.
5. The Investment Multiplier.
   A) Comparative Statics: (M)3, (S)12, & (C)11.
   B) Formal Multiplier Process

Chapter 2. The Government and the Economy.

1. General. (S)12-C, (M)4, & (C)12 and 13.
2. Government Expenditure, Tax, and Balanced Budget Multipliers.
   (M)4, (S)p. 244n, & (C)14.
3. Built-in Flexibility. (M)4, (S)18-A, & (C)15.

Chapter 3. Theory of Investment.

1. General Determinants of Investment. (M)9.
2. Marginal Efficiency of Capital. (M)5 & (C)19.
3. Induced Investment. (M)pp. 139-141 and (C)24.

Chapter 4. An Overall View of Commodity Market in a Closed Economy
--Derivation of Commodity Equilibrium Curve.
(M)6 and (C)20-23.

Chapter 5. Theory of Money and Interest.

1. Functions of Money. (M)pp. 91-96 and (S)14.
2. Supply of Money and Monetary Policy. (S)15 and 16 & (C)27.
3. Demand for Money. (M)7.
4. Liquidity Preference Theory of Interest. (M)pp. 98-103 & (C)73.
5. Money Equilibrium Curve. (M)7 and (C)28 and 29.

Chapter 6. Aggregate Demand.

1. Simultaneous Equilibrium in Commodity and Money Markets. (M)8, (S)17, & (C)30.
2. Keynes Effect. (M)11 & (C)31, 33, and 34.
3. Pigou Effect. (M)pp. 180-184, (S)pp. 341-342, & (C)35.

Chapter 7. Theory of Employment and Output.

1. Classical Views on Employment. (S)p. 340, (M)15, & (C)36.
2. Modern Employment Theory.
   A) Demand for Labor.
   B) Supply of Labor--Keynes vs. Classical Assumptions. (M)12 and 13 & (C)36.

Chapter 8. Inflation.
(C)37-39 and further assignments.

Chapter 9. Interaction of Interest, Money, Price, Employment, and Output.
(M)14 and further assignments.

FURTHER TOPICS

1. Introduction to International Economics. (C)16-18 & (S)31-34.
2. Introduction to Economic Growth Theory. (C)40-41 & (S)35-36.