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EXECUTIVE OFFICE OF THE PRESIDENT
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January 24, 1981

MEMO

TO: Murray Weidenbaum

FROM: Steve Brooks

SUBJECT: Model forecast runs

The attached tables summarize the results from recent (within the last week) model simulation exercises using four macro models -- those of Chase, Wharton, DRI and the Federal Reserve Board (labeled as the MPS model).

The forecasts run through 1982. They include our best current guess as to Administration spending and tax proposals. In most cases the models have not been updated for the recent revisions to the National Income and Product Accounts (NIPA). This is not a major failing if the focus is on rates of growth in the key NIPA aggregates.

The major policy assumptions used in all models are these:

- The Carter 1982 budget was revised considerably. Overall spending was lowered by amounts growing to $43 billion or 5 percent by the end of 1982. Nevertheless defense spending was increased. By the end of 1982 defense expenditures are roughly 2.5 percent above the Carter budget. Cuts in non-defense purchases of goods and services, transfer payments, and State and local grants-in-aid bore the brunt of the spending cuts.

- On the tax side, the model simulation assumed the Senate Finance Committee corporate tax cuts (more on these in subsequent memos), which include accelerated depreciation and corporate tax rate and capital gains cuts. The corporate cuts are effective January 1981. The personal cuts were 10 percent in the fourth quarter of 1981 followed by another 10 percent in the fourth quarter of 1981. The timing of the personal cuts would imply late-session passage with no provision for making them retroactive to January. The corporate cuts assume retroactivity.

- There were two sets of monetary policy assumptions used. The first assumed the Fed targets for 1981 and 1982. The results are shown in Table 1. The second assumed those targets were exceeded by a 1.5-percent increase in the growth of M-1B in both 1981 and 1982. These are shown in Table 2. Table 3 is merely the full set of model results which are summarized in Tables 1 and 2.

While the forecasts are quite different in some respects, the general pessimism for the short run is evident in all:

- Under the Fed targets, growth prospects range from 0 to 1.7 percent over the four quarters of 1981. For 1982, four-quarter growth ranges from 2.5 - 4.3 percent. Inflation declines some during 1982 but remains in the 8-10 percent range. The federal deficit (NIPA basis) remains comfortably above $50 billion throughout the interval.

- Under more rapid growth in monetary aggregates the outlook would be somewhat improved, especially so in 1982. Inflation is no worse and the increased incomes raise federal receipts somewhat producing smaller deficits than under the tighter monetary policy embodied in the Federal Reserve targets.

These model runs were done relatively quickly and the budget assumptions are, no doubt, somewhat wide of the mark. Nevertheless, they do underscore two points clearly. First, the budget outlook for the next several years will be dominated by the state of the economy. Second, the state of the economy will be largely determined by the degree of credit tightness that is embodied in the Federal Reserve targets for money growth. While there is too much uncertainty about the latter point to be at all comfortable about any interest rate forecast, it is clear that the monetary targets will be restraining economic activity for the near future.

Attachments

cc: SI
MM
DM
DR
PQ
SN
AW

Table 1

SELECTED ECONOMIC FORECASTS
FEDERAL RESERVE TARGETS

	1981				1982			
	DRI	MPS	Wharton	Chase	DRI	MPS	Wharton	Chase
<u>Percent change, fourth quarter to fourth quarter</u>								
Real GNP	1.0	0.0	1.7	1.2	3.4	2.5	4.3	3.1
GNP Deflator	10.3	10.4	9.9	10.0	9.8	9.4	9.1	7.9
<u>Level in fourth quarter</u>								
Federal surplus or deficit (-) (billions of $; NIA basis)	-56	-81	-90	-62	-57	-99	-79	-67
Unemployment rate (%)	7.9	8.8	7.9	8.2	7.3	9.3	7.5	7.8
3-month bill rate (%)	13.9	13.5	12.4	13.1	17.7	13.4	10.5	11.2

TABLE 3

COMPARISON OF MODEL SIMULATIONS
TARGET M-1B GROWTH

	1981				1982			
	DRI	MPS	Wharton	Chase	DRI	MPS	Wharton	Chase
Percent change, fourth quarter to fourth quarter								
Real GNP	1.0	0.0	1.7	1.2	3.4	2.5	4.3	3.1
PCE	1.1	1.9	1.6	0.8	2.4	2.5	3.4	2.4
BFI	0.1	-7.6	-0.1	1.7	6.8	1.3	7.6	4.5
Residential	4.0	-21.7	8.9	6.2	21.7	-12.2	18.6	21.7
Exports	1.4	4.8	-1.2	1.4	6.4	10.6	7.3	6.0
Imports	3.5	7.1	0.2	1.3	5.6	5.8	4.2	8.7
Federal	0.3	3.0	1.6	0.7	1.3	0.9	0.8	3.4
State and local	-0.9	0.9	-1.0	-0.8	0.1	1.3	-0.7	0.4
GNP deflator	10.3	10.4	9.9	10.0	9.8	9.4	9.1	7.9
C/MII	10.1	11.5	11.1	9.6	10.2	10.8	10.6	8.9
O/MII	0.5	0.9	0.4	-0.4	1.8	2.2	1.9	1.2
M-1B	6.2	7.6	6.0	6.0	6.7	5.9	5.5	5.5
Level at fourth quarter								
Real inv. accum.	6.8	3.5	3.3	4.5	9.2	6.5	10.2	4.8
Real net exports	28.3	24.6	28.9	55.8	30.7	32.3	34.0	56.4
Real GNP	1446.2	1430.0	1442.0	1505.7	1494.8	1465.5	1504.7	1552.3
Nominal GNP	3008.8	2970.5	2978.1	3056.2	3414.8	3329.0	3391.8	3399.9
Profit bt. share	6.3	6.0	6.2	7.1	6.5	6.0	7.4	7.5
Personal inc. share	82.2	82.4	82.5	81.8	81.9	87.5	81.1	80.7
Saving rate	4.75	3.7	5.2	6.7	5.89	5.0	4.7	7.0
Auto sales; units	10.0	--	9.1	9.3	9.9	--	10.1	10.6
Housing starts	1.52	--	1.57	1.45	1.80	--	1.87	1.86
3-mo. bill rate	13.85	13.5	12.40	13.12	17.71	13.4	10.51	11.17
Unemployment rate	7.9	8.8	7.9	8.2	7.3	9.3	7.5	7.8
Federal surplus	-55.9	-81.1	-89.9	-62.2	-57.4	-99.4	-78.5	-66.5
State and local surplus	23.6	14.5	32.3	36.0	23.5	11.6	42.0	40.2
Operating	-10.3	--	-4.5	--	-12.8	--	0.8	--

TABLE 3 (con't)

COMPARISON OF MODEL SIMULATIONS
FASTER M-1B GROWTH

	1981				1982			
	DRI	MPS	Wharton	Chase	DRI	MPS	Wharton	Chase
Percent change, fourth quarter to fourth quarter								
Real GNP	1.2	0.7	1.7	1.3	4.4	4.1	4.5	3.2
PCE	1.3	2.4	1.6	0.9	3.3	3.7	3.5	2.5
BFI	0.4	-6.1	-0.1	1.8	8.8	7.0	7.9	4.8
Residential	5.3	-18.8	9.3	7.9	28.8	-7.8	19.8	21.2
Exports	1.5	3.8	-1.2	1.4	6.5	9.8	7.3	6.0
Imports	3.6	6.0	0.3	1.7	7.3	8.3	4.5	8.8
Federal	0.3	3.2	1.6	0.6	1.1	1.1	0.8	3.3
State and local	-0.9	1.1	-1.0	-0.8	0.1	1.8	-0.6	0.4
GNP deflator	10.3	10.4	9.9	10.0	10.2	9.3	9.1	8.0
C/MII	10.1	11.5	11.1	9.7	10.3	10.9	10.6	9.1
O/MII	0.5	1.2	0.4	-0.4	2.0	2.6	2.0	1.1
M-1B	6.8	9.1	7.5	7.5	8.8	7.4	7.0	7.0
Level at fourth quarter								
Real inv. accum.	6.9	4.2	3.4	4.6	11.5	10.6	10.5	5.0
Real net exports	78.2	24.5	28.8	55.4	29.3	28.5	33.7	55.8
Real GNP	1448.9	1439.6	1442.5	1507.3	1512.7	1498.0	1507.4	1555.2
Nominal GNP	3015.0	2989.0	2979.0	3059.8	3468.2	3398.6	3395.8	3410.1
Profit bt. share	6.3	6.6	6.2	7.1	6.9	7.4	7.4	7.4
Personal inc. share	82.1	81.9	82.5	81.6	81.2	81.9	81.0	80.7
Saving rate	4.63	3.3	5.2	6.9	5.32	4.2	4.6	7.0
Auto sales; units	10.2	--	9.2	9.4	10.6	--	10.1	10.7
Housing starts	1.56	--	1.58	1.48	2.01	--	1.91	1.89
3-mo. bill rate	12.39	10.9	12.02	12.81	14.21	10.0	9.85	10.93
Unemployment rate	7.8	8.6	7.9	8.1	7.0	8.3	7.4	7.6
Federal surplus	-52.5	-72.9	-89.6	-60.7	-34.2	-73.1	-77.2	-64.0
State and local surplus	24.0	14.9	32.3	36.2	26.4	14.1	42.3	40.7
Operating	-10.0	--	-4.4	2.7	-10.0	--	1.0	1.9

Salutation

(Perhaps several sentences about the return of the hostages.)

Tonight is my first opportunity to talk to you since the Inauguration. And I would like to spend the time to tell you about the state of the economy and what I propose to do about it.

I would like to be able to tell you that the economy is in excellent health, but I cannot because it isn't. I would like to be able to tell you that the Federal budget is under control, but I cannot because it isn't. I would like to be able to tell you that there are quick and easy solutions to our economic problems, but I cannot because there are none.

What I can tell you is that while the U.S. economy is suffering -- that is plain enough from the economic statistics -- it remains potentially strong and vital, reflecting the strength and vitality of the American people. But that strength and vitality has been drained by high unemployment, accelerating inflation, increasing tax burdens, and chaotic rules and regulations affecting all sectors of the economy. To put it simply, the golden goose is laying smaller eggs. Our task in the years ahead will be to nurture that strength and vitality by reducing the burdensome, intrusive role of the Federal Government, lowering tax rates and cutting spending and by providing incentives for individuals to work and save.

Let me begin with a short review of the economic conditions that my Administration has inherited. First, inflation, which averaged near 1 percent in the early 1960's, has risen with few interruptions to the level of over 10 percent at the end of 1980. The costs to the economy of this high a rate of inflation are enormous. It robs the average worker of over $100 a year in higher individual tax burdens. It erodes the purchasing power of those on fixed incomes, typically the elderly and the poor. It increases the taxes on business income and reduces the attractiveness of investment in new productive capital. It has turned the average consumer into a credit-card-crazy borrower who buys in advance of expected price increases hoping to repay the bill with inflation-cheapened dollars. It increases uncertainty and risk. It is clear that a reduction in the rate of inflation lies at the heart of any long-term improvement in the economic vitality of the U.S.

But inflation is not our only problem. Unemployment remains far too high. The 1980 recession pushed unemployment rates from about 6 percent of the labor force to their current level, near 7½ percent. The slowing pace of economic activity -- largely the results of the tight financial conditions of late last year -- means that this is likely to go higher still.

As a result hundreds of thousands of workers will be jobless with individual hardship as well as huge losses of output and income to the economy as a whole.

The productivity of American workers has declined for the last several years. The declines in productivity translate into reduced income to workers and lower standards of living.

/BUDGET DETAIL TO BE ADDED/

While it is convenient to blame these economic failings on factors beyond our control -- oil price increases, poor harvests, declines in the dollar -- we cannot escape the fact that much of the blame belongs right here in Washington. Since the early 1960's we have followed policies based on the hope that we could "fine tune" our way out of inflation and unemployment. The result has been 20 years of stop-and-go policies fighting inflation one year and unemployment the next. Whenever inflation became too high, Washington would increase unemployment by raising taxes, cutting spending and reducing the money supply. Whenever the unemployment rate became too high, Washington would reopen the budget and money-supply flood gates and stimulate aggregate demand. The problem with these policies is that each time we apply the appropriate cure, the patient seems to need even larger doses of medicine. Reducing inflation now seems to require prolonged periods of very high unemployment. By the same token, reducing unemployment by stimulating the economy seem to be translated quickly into higher inflation rates with little lasting reductions in unemployment.

It is fair to say that continuation of these policies could easily result in steady inflation rates of between 15 and 20 percent -- as compared with the current 10 percent -- and unemployment rates that remain in the 6 to 7 percent range.

What is needed now are steady, consistent policies which will simultaneously reduce inflation and unemployment. Stop-and-go policies are doomed to yield higher inflation and no long-term improvement in unemployment. The policies need to be based on believable long-term goals.

In this regard, we support the actions of the Federal Reserve Board which are designed to gradually reduce the rate of growth of the money supply during 1981 and in subsequent years. There is no way that we can reduce the rate of inflation without this reduction in the rate of growth of the money supply. Temporarily high rates of interest are the price we must pay for many years of overly rapid money growth.

But let me tell you about the approach to economic policy that will be the centerpiece of my Administration's proposals submitted to the Congress later this month. And, in particular, I would like to contrast it with the policies of previous

Administrations. It has been called "supply-side" economics to contrast it with demand management policies of the last 20 years. But we needn't worry about the various names applied to it, its notion is very simple. It is this: if you want less of something you tax it, if you want more of something you reward it. If you want more work and saving you reward work and saving. If you want more productivity you reward productivity. Unfortunately the tax and budget policies of the last 20 years have not done this. Instead they have taxed work and productivity, and rewarded borrowers not savers. We are a debt-ridden society that devotes enormous resources to avoiding taxes. Hard-working men and women struggle to earn more income and then are laughed at by a cruel tax system that often grabs over one-half of their additional income.

Businesses are taxed on meaningless inflation-bloated profits. As a result many businesses have neither the incentive nor the resources available to invest in new productivie technologies and expanded facilities. The result has been declining worker productivity in the U.S. and great ill-will by individuals who feel the government is working against them.

We have taxed work, saving, and productivity, and so there should be little surprise then when we get so little of it from our businesses and our workers.

Meanwhile the Federal Government has hardly been a model of productivity and thrift. Despite record high tax burdens on the American people, the Federal Government is unable to live within its means. Huge budget deficits follow year after year. In fiscal 1980 the deficit was $60 billion, the second highest on record. With no change, the Carter budget for fiscal 1981 promises to be near that or even higher.

Our policies are designed to force the Federal Government to live within its means. To reduce the size, burden, power, and intrusiveness of Washington and return the resources to those responsible for creating them in the first place. Who are those responsible for creating the great resources of the U.S.? They are you and your neighbors and the businesses and corporations for whom you work. That, in a nut shell, is what supply-side economics is all about. We are going to nurture that golden goose, not strangle it.

What I will propose is a package of expenditure cuts and tax cuts and regulatory reform which together will help us achieve our long-term goals. No single element can work in isolation.

The tax cuts are those that I have discussed with you many times over the last year. Personal tax rates would be reduced by 30 percent in three steps between now and 1984. We want to reward work, not penalize it. For businesses we propose to liberalize depreciation in a way that stimulates investment in new plant and equipment and which allows corporations to keep a greater portion of their earnings.

I will propose a sweeping review of Federal regulations, those proposed as well as those already issued. Our goal is to remove the intrusive big-brother role that the Federal Government plays in all aspects of our affairs.

I said at the beginning of this talk that I would like to be able to tell you that these solutions would be quick and easy. I cannot do that. It has taken decades to get us into the economic mess that we are in today. I have no doubt that we will succeed but it will take time, not decades but not one year or even two. However, one thing is clear, we mean to make these changes. We are set on our course.