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Hazardous Monetary – Fiscal Parallels: 1981-82 and 1990-93

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HAZARDOUS MONETARY - FISCAL PARALLELS: 1981-82 AND 1990-93

by

Robert H. Parks, Ph.D.

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INTRODUCTION

Bad theory is the mother of bad policy, a truth surely applicable to fiscal theory and policy. One classic example of this is policy mismanagement under Reaganomics that culminated, predictably, in the severe 1981-82 recession [1, 2, 3]. My concern is that the same theoretical and applied blunders made then will be repeated in 1993. In that event, the United States, already suffering from a prolonged growth recession, could move back into outright recession in 1993.

Specifically, this article (1) reviews the theory of nonmonetized Treasury financing, a process widely misunderstood; (2) tracks the actions of senior government officials and economists in charge of policy mismanagement in 1981; and (3) documents the consensus forecast error of professional economists, who tripped ever so badly on basic fiscal and monetary theory. It concludes (4) by noting the parallels today with the haywire theories, policies, and forecasts of 1981-82. Therein lies huge risk in the future.

(1) THE THEORY OF NONMONOTIZED TREASURY FINANCING

The Reagan platform signaled serious recession, an easy call. All this forecaster had to do was note in early 1981 - 82 how the three macro legs of the Reagan platform would likely contradict each other and knock the platform asunder [1, 2, 3]. Here, then, are the three macro legs that crossed and tripped the economy into the 1981-82 slump:

* **Supply-Side Declamation:** Cut taxes to spur investment, saving, incentives, and economic growth.

* **Monetarist Oratory:** Tighten monetary policy to curb money growth, hence contain the devil of inflation.

* **Military Rhetoric:** Cut nonmilitary but raise military spending to slow total spending, cut waste, and strengthen defense, hence contain the Evil Empire.

How did the "Blue-Chip" consensus of some fifty private economists react to the tax and spending prospects? They forecast a 2.2 percent rise in real GNP in 1982, instead it plummeted a blockbuster 2.5 percent [4]. What about government "supply-side" and "monetarist" economists in the Treasury, the Council of Economic Advisers, the Office of Management and Budget, and the Federal Reserve? They proclaimed a rosy scenario of higher saving, investment, profits, and real output; and lower inflation and interest rates. They got the last two right, but that's not to say they believed all they preached.

These were haywire forecasts. The economy peaked in July 1981 and plunged for sixteen months to its nadir in November 1982 for the worst slump since the Great Depression [5]. How

could so many have been so wrong? How? As a start, all one had to do was to analyze the individual macro legs of Reaganomics, then make three easy assumptions:

* Total Federal spending would continue to rise at a fast clip. Why was that? Well, We The People offered little resistance to big increases in military outlays and were in no mood to cut nonmilitary spending, especially entitlements. Anybody could have predicted that.

* Tax rates would be cut. Why? The answer is that everybody loves tax cuts, especially in recession. That call was a shoe-in too.

* The Fed would not adequately monetize huge Treasury deficits. Reserve restriction made that abundantly clear by mid-1981, a statistical piece of cake [6].

So, the only question that remained was this: What would be the impact of huge nonmonetized deficits? The idea generally bandied about was that the tax cuts and higher spending programs would put more money into the pockets of the public and quicken demand and growth. That conclusion, widely held, was wrong. No, nonmonetized deficit financing merely shuffled money from one pocket to another. No new money comes into existence, not one cent, when the Treasury sells its bills, notes, and bonds to the public at large. The T-Accounts in Exhibit 2 make clear that such borrowing from Peter to pay Paul is but a big money shuffle. Worse, given the economic circumstances of the time, huge nonmonetized deficits were bound to "crowd out" private financing and choke off consumer and investment spending.

That requires explanation. *Nonmonetized borrowing*, also called *nonmonetized deficit financing*, need be neither expansionary nor inflationary. Under certain conditions, it can be contractionary and deflationary. That was the case in 1981-82. Track what then happened step-by-step:

* The tax cuts plus higher Federal spending resulted in huge Treasury deficits.

* The Treasury had to finance those deficits by soaking up moneys from the public at large. Fed restriction saw to that as it cut off the growth of new credit and money.

* Since the economy was already in a borrowing binge, additional Treasury financing raised the total demand for borrowing even higher. Soaring private and Treasury deficits clashed head-on with Federal Reserve monetary constriction.

* The clash sent interest rates soaring. But the rise in rates should have been seen to be temporary, consistent with the *initial liquidity effect*, after the famed monetary theorist Irving Fisher.

* Crowding out of private borrowing and spending produced, with a lag, major recession, a collapse of private borrowing, disinflation, and sharp declines in interest rates. This was the *lagged "Fisher" effect.*

So, what can we conclude from the 1981-82 experience? All we had to do was to remember Economics and Finance 101, where we learned never to divorce fiscal from monetary analysis. All we had to do was to ask just how these huge deficits were to be financed. It's as simple as that. Even so, professional economists and policymakers continue to avoid this critical nexus, just as in 1981. That's even true of the favorite fiscal measures of professional economists, including the Congressional Budget office's "structural" and "full-employment" deficits; the IMF's "fiscal impulse" measures of stimulus and restraint; and the Conference Board's formula for "fiscal thrust," which defines fiscal stimulus as the sum of tax cuts and spending increases. Fiscal thrust is the very worst. On that count, the economy should have soared to the moon in 1981-82.

Query: How can one explain why economists have persisted in using these measures even as they proclaim for all to hear that one should never divorce fiscal from monetary actions?

(2) THE MONETARIST TRIPLETS AND SUPPLY-SIDERS

We can get a partial answer to that question by meeting the officials in charge of fiscal and monetary mismanagement in 1981-82. Let's first meet the Monetarist Triplets. They are Dr. Beryl Sprinkel, then Treasury Under Secretary for Monetary Affairs; Dr. Jerry Jordan, a member of the Council of Economic Advisers (CEA); and Dr. Larry Kudlow, Associate Director, Office of Management and Budget. (Kudlow fluctuated between a monetarist and a supply-sider.)

I had the pleasure of hosting institutional investor forums with each of these gentlemen, and on a fairly regular basis with Dr. Sprinkel. Now, what do you think they were thinking about in the second half of 1981? We know what the Triplets had to say for public consumption, namely, that we should look for continued economic expansion, a slowing of inflation, and a galaxy of goodies thrown in. But that's not my question. What did they really believe was in store for the economy?

My conviction in 1981 was that the Monetarist Triplets were looking for recession [2]. They talked sunshine publicly but looked for rain privately. They knew recession was at hand; at least I was so convinced. How could they not have known? They had the same data I had, which shouted out the high risk of recession straight ahead. I asked Dr. Sprinkel about all this after the fact, that is, after the economy had emerged from the 1981-82 mini-depression. The occasion was that of an institutional investor forum I hosted for him and other Washington officials. We met in the Arlington Room, Madison Hotel, in Washington, D.C. on December 13, 1983. I (RH) asked Dr. Sprinkel (BS) this question at 10:15 p.m.:

RH: Beryl, what were you really thinking in the second half of 1981 about the course of the economy? You were talking economic sunshine for public consumption.

BS: Look Robert, we asked the Fed to slow money growth by 50 percent over a period of several years to bring inflation under control while promoting continued economic growth. What we got instead was an abrupt and almost total freeze on money growth in a matter of months, virtually all of that in 1981. Now you can't slam on the money and credit brakes like that without bringing on a severe contraction in the economy. So what do you think I was saying for internal consumption?

The Supply-Side Ruler and Court

It's clear what Dr. Sprinkel was thinking. It's also clear that what he was thinking about by late 1981 had nothing to do with what he was saying for public consumption. The same holds for the Supply-Side Ruler and his court. The ruler was the Assistant Treasury Secretary for Economic Policy, Dr. Paul Craig Roberts. His court proteges included deputies Steve Entin and Manuel Johnson. (Johnson later became Vice Chairman of the Federal Reserve Board.) Our interest here is what Dr. Roberts (PR) said versus what he thought. So consider this exchange, a telephone conversation we had on the afternoon of April 18, 1989:

RH: Do you remember our June 1981 forum in Washington?

PR: Not really.

RH: We met at 9:30 a.m. on Tuesday, June 2, 1981, in Treasury Conference Room 4121. You had two Treasury officers, John Auten and John Schmidt, with you. I brought along thirty-five institutional investment officers.

PR: Yes, I remember now.

RH: Remember that I asked you about the second half of 1980? I asked you why the Fed was imitating the central bank of Brazil in printing money like mad and driving inflation and interest rates higher and higher. Then I asked you about Fed policy overkill in 1981.

PR: Yes, I refused to answer.

RH: I remember. You said you wouldn't answer. Why?

PR: You knew very well that we were all under wraps not to criticize the Fed or Volcker [*former chairman of the Fed, Paul Volcker*] . We were gagged.

RH: Was Volcker off track? Will you answer my question now, eight years later?

PR: Way off track. The Fed targeted interest rates in 1980, a disastrous policy. The Fed killed the economy in 1981, and supply-siders took a bad rap for that.

(3) BOND AND BEAR CONFUSION OVER NONMONETIZED DEFICITS

Paul Craig Roberts said the supply-siders got a bad rap. That's debatable, and another matter. But speaking of raps, I must lay one on the Wall Street Bond Bears of 1981. They missed out badly. They misread Federal Reserve policy despite the overwhelming evidence of monetary overkill. They misinterpreted just how *nonmonetized* tax cuts and spending hikes would impact the economy and interest rates (Exhibits 1 and 2). Their failure in 1981-82 to analyze fiscal and monetary policy *jointly* is duplicated today across the board.

Let's explain. The Bond Bears misread [John Maynard] Keynes, and Keynesian economics. Watch out for the tax-cut and spending "multipliers," they warned. Higher government spending and lower taxes, they said, would propel private consumer and investment spending higher. That would bring with it accelerating inflation and sharply higher interest rates. Stay away from long bonds, they screamed. Bond prices will dive. So they declared [3]. This represented the very worst aspect of the analysis in failing to separate the initial liquidity and lagged effects of monetary constriction. It omitted also the crucial question of how the deficit was to be financed.

Poor John Maynard Keynes. He would have gagged on all this. Keynes argued in his *Treatise on Money* (1930), *General Theory* (1936), and *How to Pay for the War* (1940) that the question of the economic effects of tax cuts and higher government spending could not be answered unless one made explicit just how budgetary deficits would be financed [7]. Always inquire, he repeatedly warned (as I now repeat, and repeat), to what extent any deficit is to be monetized.

Keynes recommended *monetized* tax cuts and *monetized* higher spending in an economic slump. He recommended big tax hikes, cuts in government *nonmilitary* spending, and nonmonetized borrowing in war. Keynes, like the farmer, recommended irrigation in time of drought and drainage in time of flood. So, contrary to the popular conviction of fixed-income managers across the land, he was never a big spender for all seasons. If Keynes had been alive in 1981, I think he would have fired this missile at the big bond bears:

Tell me, Bears, will these deficits be monetized?

(4) THE DIRE PARALLELS OF 1981-82 AND 1991-93

I believe Keynes would have asked the same question today. Indeed, one important lesson of 1981-82 relevant to 1992-93 is this: To what extent should we expand the deficit, and to what extent should it be monetized? The question is critical again, for real private credit and

the broad money supply still contract, velocity is weakening, and price and wage inflation are down sharply. Given unemployed labor and capital here and abroad, the risk of a resurgence of demand-pull inflation is minimal. Deflation is the big risk.

The very life blood of the economy in credit and money is being drained away, a development confirmed by the Federal Reserve flow-of-funds data through the second quarter of 1992 [8]. The Fed reported that private credit rose a minuscule 2.2 percent or below inflation, which means real liquidity and buying power was still being siphoned from the economy. Broad money M2 also fell absolutely in real dollars and has gone nowhere in five years. That comes as no surprise to monetary theorists. After all, M2 is but the rough counterpart of credit, and when private credit creation collapses, broad money follows suit. More precisely, broad money falls unless the Federal Reserve makes heavy open-market purchases to bolster reserve and money growth.

True, the Fed has made substantial open-market purchases, but the reserves were mostly offset by (a) increases in legal reserve requirements as funds have been shifted from nonreservable accounts in M2 and M3 to accounts reservable at 10 percent in M1, itself a reflection of collapsing short-term interest rates, and (b) by external drain, or the flow of currency into circulation that strips away high-power reserve money dollar-for-dollar. No wonder, then, that real private credit has continued to contract [8]. The Fed has not pursued a policy of aggressive ease. No, it followed (not led) rates down, a lagged result of fiscal tightening, monetary constriction, and capital constraints on the banks and the insurance companies. This was classic policy overkill.

You can see the fiscal strangulation in the budgetary numbers [9]. Thus, about 70 percent of Federal outlays is for "recycling." Money is shuffled from one pocket to another for net interest payments, social security, S&L bailouts, and related shuffles. Call this "treadmill" spending, for it won't spur a satisfactory and sustained economic recovery. Moreover, Federal spending on goods and services contracts, with outlays in constant 1987 dollars, was down about $10 billion the past year [10]. That's a drain, too, on incomes, jobs, confidence, and hope. Federal policies, then, remained procyclical even as the economy and the forward indicators weakened. Shades of 1981-82?

What about the economic prospects for 1993 and beyond? The answer, I believe, critically depends on the monetary and fiscal policies adopted. If we repeat the policy mistakes of 1981-82, the economy will likely veer back into a slump. That's a clear and unambiguous risk. Let's see why by first making explicit my key assumptions on fiscal-monetary policy for 1993.

First, assume the economy will continue to falter. Relevant here is that, while real GDP was up in 1992, another broad economic gauge, the index of coincident indicators (ICI), was down. Indeed, the ICI, an amalgam of payroll employment, industrial production, real income net of transfers, and real retail and wholesale sales, stood as of October 1992 below March 1991, which the consensus identified as the low point of the recession. As measured by the ICI,

then, this economy has experienced no recovery whatsoever. Never before have real GDP and the ICI gone their separate ways, at least not for very long. Perhaps the National Bureau of Economic Research, the unofficial arbiter of when recessions end, should take note of the ICI before it calls an end to this recession. Maybe it should add the rise in real GDP to the fall in the ICI, and divide by two.

More important in looking ahead, the forecaster has to recognize that both real GDP and the ICI are best classed as "rear-view mirror" indicators. They tell you where the economy has been, not where it's going. To see where the economy is headed, one must look at policy and the forward indicators. Policy is constrictive, as we have argued. What about the official composite index of leading indicators? Well, it is up nicely since its low in January 1991, but it failed completely to signal the slump in the ICI. The failure is understandable, for the official index omits key forward series, including the collapse in real private credit and private placements, a process still underway. Surely the Department of Commerce should scrap the leading index as presently constituted.

This takes us to our second set of assumptions. Given continued growth recession or outright recession, assume now that taxes will be cut, that new Federal spending programs will be enacted, and that the deficit will swell. *Most important, assume that huge Treasury deficits to finance tax cuts and new spending programs will not be sufficiently monetized.* On those assumptions, I would make this forecast for 1993, and perhaps beyond:

* With a lag well into 1993, new fiscal programs will be enacted. Meanwhile, the on-budget deficit will soar far beyond the $400 billion estimated for fiscal 1993 [11].

* Many fixed-income managers will be frightened to death over the prospect of economic recovery and inflation.

* The huge deficit, however, will not be adequately monetized. Fed zero-inflation hawks will see to that.

* The absence of sufficient monetization could produce an interest-rate spike, but the spike should prove to be moderate and short-lived. This judgment rests mainly on the lagged depressant on the economy of big nonmonetized borrowing.

* Once mistaken inflationary expectations crack, continued recession will push long-term yields on prime bonds down far below current levels.

* The bitter irony is that benign neglect, a euphemism for fiscal-monetary-capital overkill, could rob the economy of growth of jobs, income, and revenues, and propel the on-budget deficit towards $500 billion. Deja vu?

My assumption of inadequate monetization is the least discussed but surely among the most critical factors in any forecast for 1993. Indeed, one would almost believe a conspiracy

of silence is involved in analyzing the theory and history of nonmonetized financing. It's as though the 1981-82 recession never happened.

On the Question of Fed Ease

I don't mean to imply that the Fed has not provided some ease. It just hasn't been sufficiently aggressive in providing reserves to the financial system. To be sure, the banks have loaded up on Treasuries, even as loan demands have plummeted. One has offset the other to produce zero real credit growth. To be sure, the rise in holdings of Treasuries is better than nothing, but a much greater degree of monetization is now required. That's why I believe it would be foolish, and dangerous, for the Federal Reserve to cut its money target for M2. But, given the dominion of the Federal Reserve hawks in pursuit of zero inflation, the prospect of a cut looms.

The Federal Reserve hawks include Chairman Alan Greenspan himself, who wants to cut money targets. He offers a most curious explanation for the observed slow growth of M2 [12]. Most damaging, his contention that M2 falls when people shift from short-term deposits into mutual funds is wrong and violates basic accounting and monetary mechanics (Exhibit 3). To be charitable, let's assume Greenspan knows his explanation is (say) strained. In that case, however, we would have to charge him with dancing around his own error of excessive monetary constriction. What's new? Authorities in power for centuries past have side-stepped away from their own mistakes.

Crowding Out in an Underemployed Economy

Query: How could crowding out materialize in the face of the private credit implosion already underway? That makes no sense, I'm often told. How do you crowd out in an economy operating far below capacity? Well, I suspect that private lenders would be all too willing to hand over their funds to Uncle Sam when they foresee high risk and bleak prospects in private credit markets; when they finally realize that the private debt implosion, a reaction to the debt explosion of the 1980s, has a long way yet to run; when they see unending anemia in incomes, jobs, and confidence; and, most important, when they see no satisfactory policies by government to spur sustained and believable economic recovery.

How do I know this? Again, Keynes taught us long ago that whenever the marginal efficiency of capital falls sharply (jargon for expectations of bleak and falling marginal investment returns) and private risks soar, lenders will be delighted to provide their funds to prime government borrowers. So he contended, correctly. That truth is supported by Queen Opportunity Cost. She exercises dominion in both real and financial markets, whether fully employed, as in 1981, or seriously underemployed, as in 1992-93. The Queen exercises power even over the bond vigilantes who seem forever frightened of what they perceive as the monolithic devil, the devil of inflation.

CONCLUSION

A major risk for 1993 is for the U.S. Treasury to run huge *nonmonetized* deficits to fund new tax cuts and spending programs. Huge nonmonetized Treasury borrowing can soak up private funds, crowd out private borrowing and spending for consumption and investment, and push the economy into even deeper recession. Do we ever learn? Must we repeat the monetary and fiscal mistakes of 1981-82?

ENDNOTES

[1]. "Look for a post-election blowoff in interest rates as the Fed is finally forced to restrict the explosive growth of money and credit," said Robert H. Parks. "The delayed monetary restraint will collide head-on with an inflation-fired climb in credit demands, abort recovery and produce a deepening recession in 1981." (*The Wall Street Journal*, 10/20/80). We got all that.

[2]. "Parks believes the monetarist quintet is willing to risk recession." (*Portfolio Letter*, Institutional Investor Publication, 4/27/81). By monetarist quintet I meant Norman Ture, Beryl Sprinkel, Paul Craig Roberts, Larry Kudlow, and Jerry Jordan, all key Washington officials. All remained mute on how *nonmonetized* tax cuts and higher Federal spending signaled recession. See text.

[3]. "Parks told *Bondweek* that 'the four major interest-rate bears (were wrong) and that worldwide recession would represent the first crack in the stranglehold of the oil cartel.'" (*Bondweek*, Institutional Investor, 7/20/81). To repeat, huge *nonmonetized* deficits signaled recession, not boom and inflation. See Exhibits 1 and 2 for documentation and explanation.

[4]. The consensus also greatly understated the 1973-75 and 1990-92 recessions. As noted, they missed completely the 1981-82 recession. That's a strikeout for the "Blue Chip" consensus polled by Robert Eggert (Blue Chip Economic Indicators, Alexandria, Virginia).

[5]. The National Bureau of Economic Research set these reference dates, which are reported monthly in the *Survey of Current Business*, U.S. Department of Commerce.

[6]. *The Money and Capital Markets Monitor*, 9 June 1981, a publication of Robert H. Parks & Associates, then a division of Moore & Schley, Cameron & Co., a Wall Street Securities firm. I wrote that "adjusted reserves for depository institutions had gone virtually nowhere since November (1980) while real interest rates had climbed to the highest levels in United States history....While the monetary base has risen, the reason is mainly the rise in currency in circulation (which is) at the expense of high-power reserve growth."

[7]. See in particular the quintessential satire of monetized deficit financing to combat depression in Keynes's *General Theory*, in which he would have private enterprise bid to dig up bank notes the Treasury had buried in disused coal mines (*General Theory*, New York: Harcourt, Brace and Company, 1936, 129); and his forced, nonmonetized savings plan plus tax hikes to fight inflation during war (*How To Pay for*

the War, New York: Harcourt, Brace and Company, New York, 1940). This is must reading for monetarists who unfairly dub Keynes a big spender expansionist for all seasons.

[8]. The Federal Reserve *Flow-of-Funds Accounts, Flows and Outstandings*, Z.1., 9/28/92, Second Quarter, p. viii.

[9]. *Survey of Current Business*, Department of Commerce, August 1992, Table 3.2, p. 15

[10]. *Survey of Current Business*, Department of Commerce, August 1992, Table 1.2, p. 10.

[11]. *Economic Indicators*, Council of Economic Advisers, August 1992, p. 32.

[12]. See Alan Greenspan's comments in *The New York Times*, 2 December 1992, p. D2.

EXHIBITS

EXHIBIT 1: THE MONEY AND CAPITAL MARKET MONITOR
Excerpts, 9 July 1981

(*The Money and Capital Market Monitor* is published by Robert H. Parks & Associates, Inc. for institutional investors. *The Monitor* of 7/9/81 was also published in the 7/20/81 issue of *Bondweek*.)

9 July 1981 **IN RECESSION**

The Seven Financial Fallacies of the Four Bond Bears

In the 6 August 1980 *Monitor* we cautioned: "Given the hard evidence of an emerging worldwide recession, we expect to see...the first crack in the stranglehold of the oil cartel...."

The United States is now in its eighth post-World War II recession. Bravermanian, Kaufmanian, Nakagamanian, and Wojnilowerian **bond bears**** may be right, but we don't think so. The essence of their analysis can be put forth in seven propositions, none of which is convincing....

(1) "No recession is in sight. Anyone who wants money can get it." They are backtracking fast on this thesis....

(3) "The tax cut in October, or whenever, will lift rates higher." No, not unless excessively monetized. Nonmonetized tax cuts add not one penny to the money stock...and are unlikely to fuel an excessive increase in total demand.

(4) "Higher military spending will push rates up." No, not unless excessively monetized.

(6) "Funding will push long rates back up." This waiting-in-the-wings argument has limited validity, but overlooks the fact that (a) funding entails no net demand for credit, (b) pushes short rates down, and (c) entails a reduction in bank loans and the money stock, hence can be perceived as disinflationary (positive for bonds).

Conclusion

Now is the time to make major commitments (to) long prime bonds.

Robert H. Parks

** The four Wall Street bond bears were Dr. Phil Braverman, Chase Manhattan Bank; Dr. Henry Kaufman (Dr. Doom), Salomon Brothers; Dr. Sam Nakagama, Kidder Peabody; and Dr. Al Wojnilower (Dr. Death), First Boston Corporation.

EXHIBIT 2: NONMONETIZED TAX CUTS AND NONMONETIZED SPENDING A MONEY SHUFFLE FROM "PETER" TO PAY "PAUL"

	Federal Reserve		Commercial Banks, Special Depository Institutions	
(1) Borrowing				- DD p + T&L
(2) Treasury Call		- DD r + DD t	- R	- T&L
(3) Tax Refund (or Higher Outlays)		+ DD r - DD t	+ R	+ DD p
(4) Net (1+2+3)		0	0	0

(1) **Nonmonetized Treasury Borrowing:** Treasury sells Treasury obligations to the consumer and business public. Buyers draft checks against their demand deposits **- DD** payable to the Treasury. The result is to reduce the demand balances of the public **- DD p** and increase the Treasury's checking account at the private commercial banking level, which shows up as an increase in the Treasury's tax and loan account **+ T&L**.

(2) **Treasury Call:** The Treasury shifts its account from private depository institutions **- T&L** to the Federal Reserve, which shows up as an increase in the demand deposits of the Treasury at the Federal Reserve **+DD t**, a decrease in reserves at depository institutions **-R**, which is the same thing as a decrease in the Federal Reserve's liabilities to depository institutions **- DD r**.

(3) **Treasury Payment of Tax Refunds (Tax Cut):** The Treasury drafts checks payable as tax refunds which reduces its account at the Federal Reserve **- DD t**, which, in turn, increases the demand deposits of the public as they deposit the tax-refund checks **+ DD p**, and replenishes the reserves of depository institutions **+ R**, which is the same thing as increasing the reserve liabilities of the Federal Reserve to depository institutions **+ DD r**.

(4) **Net Results.** Nonmonetized tax cuts (and nonmonetized Federal outlays) do **not** put cash into the pockets of the public at large but instead shuffle money from one pocket to another. True, the recipient of the tax refund has a higher net worth that may offset somewhat the reduced liquidity of the purchaser, who has given up cash for Treasuries. But the important point to note, one almost universally misunderstood, is the shuffle.

Robert H. Parks

EXHIBIT 3: THE CIRCUIT VELOCITY OF MONEY: A MONEY SHUFFLE

	Commercial Banking System		Mutual Funds	
	Assets	Liabilities	Assets	Liabilities
(1)		- SD i + DD i		
(2)		- DD i + DD mf	+ DD mf	+ MFS (i)
(3)		- DD mf + DD s	- DD mf + I	
(4)		- DD s + DD v		

(1) Individual **i** shifts from saving deposit - **SD i** to demand deposit + **DD i** in expectation of purchasing mutual fund shares **MFS.**

(2) Individual **i** purchases mutual fund shares + **MFS i.** When check is cleared, the demand balances of the individual at the commercial banks fall - **DD i**, the liabilities of the mutual fund to the individual increase by the amount of the mutual fund shares +**MFS i**, and the demand deposit of the mutual fund at the commercial banking level increases + **DD mf.**

(3) The fund manager purchases investment instruments +**I** via drafts on his or her demand deposits at the commercial banks, and this shuffles demand deposit ownership from the fund -**DD mf** to the sellers of the investment instruments + **DD s**. The instruments may be newly created or outstanding Treasury bills, commercial paper, stocks, or other contracts depending on the type of fund.

(4) The seller **s** of investment paper, public or private, then drafts checks payable to a vendor of goods and services **v** shuffling demand balances from the seller - **DD s** to the vendor + **DD v**.

I have dubbed this money shuffling (1) through (4) the circuit velocity of money. Just add up the pluses and minuses in the first column. They add to zero, which makes clear that shifts to bond or stock funds from deposits do not involve any disappearance of M2, despite Mr. Greenspan's contention (*The New York Times*, 2 December 1992, p. D2). Let's put this in plain English: M2 does not disappear when one buys a bond fund. If you switch from a time certificate to a demand account, that doesn't change the M2 total. (Remember, M2 embraces

M1.) If you then write a check against your demand account for a bond fund sold by Fidelity, that doesn't reduce M2 either. No, Fidelity has your check, Fidelity's demand balance is up, and your balance is down, for a shuffle of reserves and demand balances, but no change in total M2. To repeat, the correct explanation for the fall in M2 lies instead in the near-zero growth of credit (loans plus investments) by the banks and the thrifts. Thus, while the collapse in loans destroyed assets and deposits (freeing up reserves), bank acquisition of Treasuries created new deposits (increasing required reserves). The result is that net growth of loan plus investment portfolios slowed far beyond earlier experiences for recovery, and with it nominal M2. Indeed, real M2 has remained flat for over five years and fell below zero in 1991-92. So, the implosion in real private credit and real M2 is at the heart of our earlier projections of recession and growth recession. That implosion continues.

Funding Misconceptions on M2, Monetarist Muddles on M1

But what about all the money raised in the bond and stock markets? Doesn't that offset the fall in M2? No, not this time around. When corporations raise money through new security issues, that represents a shuffle of the existing money stock, from investors to corporate issuers. This time around, however, the proceeds of securities issues have been used almost exclusively to pay down short-term debt which, by itself, destroys loans and deposits. Yes, the financial restructuring has long-run benefits. Still, funding (borrowing long to repay short) entailed little net growth in private credit and M2. That's unprecedented, for, historically, credit growth and M2 have surged in recovery.

What about, finally, the sharp advance in M1? Isn't that evidence of Fed largesse? No, that's analysis at its worst. The rise in M1 represented a shift out of time money to demand money, but, again, the magnitude of M2 was not affected. (Usually the shift is the other way, from the creation of credit and demand balances, and the simultaneous conversion of demand balances to time money.) Note to muddled monetarists: look at the left-hand side of the balance sheet, which shows a slowdown in assets, hence a comparable fall in nominal M2.

Institutional Investors' Reactions To Greenspan

We telephoned institutional investors in the U.S., Canada, and Great Britain, and asked them what they thought of Greenspan's comment in *The New York Times*. The answers were (a) the reporter is confused, (b) Mr. Greenspan is confused, (c) Mr. Greenspan is not confused, but wants to explain away Fed failure to reach M2 goals, (d) Mr. Greenspan wants to dampen fears of the bond-bear vigilantes, and (e) Mr. Greenspan must be right, for his views are

supported by comparable declarations of authorities in power on M2, including top Wall Street economists and muddled monetarists of the Shadow Open Market Committee. What's your answer? I would check (b) or (c).

Source: Excerpts from recent issues of *The Money and Capital Market Monitor* and from *Witch Doctor on Wall Street*, to be published in 1993.

Robert H. Parks

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