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PRIME MINISTER

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MARTIN FELDSTEIN'S VIEWS ON THE US ECONOMY

1. The Recovery

Feldstein's judgement that the recovery has begun is based on fairly firm foundations. The two main indicators are, as I reported in November, new housing starts and the automobile industry. These real signs are buttressed by increases in order books.

But what we do not know is whether the recovery will persist. Will it merely peter out after a few months, as ours did in 1981, and the US economy stagnate yet again? He was arguing that this would not occur and that there would be a recovery faster than the 3½% or so which was incorporated in the estimates of the future budget deficits. (Traditionally the bounce back of the American economy from a slump tends to be quite rapid - about 5% growth is the normal rate of recovery in the post war years. But this is not a normal slump, nor will there be a normal recovery.)

These arguments for a more rapid recovery, circa 5%, are supported by the monetarists such as Karl Brunner. They argue that there has been such a monetary stimulus from the late summer of last year that there is bound to be a very rapid increase in real output followed a year or so later by a resumption of inflationary pressure. Feldstein, on the hand, argues that the monetary stimulus since the summer has been a once and for all response to the increase in the demand for money caused by the reduction in the rate of inflation. Although there has been 15% p.a. increase in M1 over the last two or three months, this will not be reflected, he argues, in a long run increase in inflation. In the next three years he anticipates that inflation will be of the order of 5% or so.

2. Money and the Federal Deficit

The surge in M1 can be explained in terms of the sharp change in velocity associated with a reduction in inflation. As short term interest rates and inflation falls, people will wish to hold more money of the non-interest bearing kind. This is what we are now experiencing and is quite consistent with continuation of progress in reducing inflation. What is a cause for alarm, however, is the

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fall in the velocity also of M2. In terms of the historical record, one would certainly not experience a fall in velocity of M2 under circumstances of falling inflation. This would then suggest that there has been a real relaxation of monetary conditions and that inflation up to 8% or so is likely to ensue.

Feldstein is clearly very worried about this fall in the velocity, or undue expansion, of M2. He and Volcker both believe it may be due to the change in banking regulations such that accounts which were in the M3 magnitude have shifted recently into M2. They are inclined, therefore, to explain it away as being simply a consequence of a change in the banking structure. Unfortunately, they have no evidence to back their conjecture since the statistics of M3 are only reported at much less frequent intervals, about three months, and the data are not yet available to check their conjecture. Feldstein drew some comfort from the fact that our statistics are behaving in a consistent way - that is to say the increase in velocity of M1 is associated with a fall in the velocity of both M2 and M3, as has appeared in recent months.

3. Conclusion

I can find no reason to disagree with both Feldstein and Karl Brunner that there will be a fairly rapid recovery in the United States over the next months. But I am afraid that the recovery will not continue for very long. The monetary expansion has brought down short term interest rates circa 8%-9%, but the long term bond rates remain stubbornly high at about 11%. The high long term interest rates mean that either the recovery will be short and soon aborted, or that inflation will rise again to levels of about 8% or so which will disappoint anticipations of low inflation and recovery. The presistent budget deficits and the belief that Congress and the administration do not have the political courage to bring them down will simply reaffirm the market's view that the accumulated debt will be monetised. All this suggests, therefore, that there will be a fairly rapid recovery which will peter out in 1984. Short interest rates will remain low for a while but will increase towards the end of this year, and long rates are likely to be little changed. If there is any dramatic progress on the deficit, however, the prognostication could change remarkably but in a predictable way.

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