Eastern Economic Journal, Volume XV, No. 2, April–June 1989

New Horizons of Macroeconomic Policy: A Conversation with Andrew F. Brimmer

EEJ: Does it appear to you, Dr. Brimmer, as you observe the emerging macroeconomic policy scene in Washington, that the new Administration can anticipate smooth sailing ahead?

Brimmer: Unfortunately, my answer to that must be a cautious "no." The Bush Administration and the Federal Reserve are already on a collision course over the goals of national economic policy. President Bush seeks a high rate of economic growth to obtain additional revenue to reduce the Federal budget deficit. The Federal Reserve seeks a slower pace of economic expansion to prevent an acceleration of an already high rate of inflation. The net result of this conflict is likely to be an unbalanced domestic economy, continued large Federal budget deficits, less saving and investment, and a persistent sizable deficit in the nation's foreign trade balance.

EEJ: Is the source of the possible collision that Mr. Bush and his advisors are, at least thus far, proceeding on the basis of essentially the same assumptions as underpinned the outlook and policy of his predecessor?

Brimmer: President Bush has modified the Reagan assumptions somewhat. But the basic policy outline remains unchanged. The key assumptions of that policy are:

1. That real gross national product (GNP) will rise by 3.5 per cent from the fourth quarter of 1988 through the fourth quarter of 1989. Excluding the effects of inflation the growth rate is projected to be 2.8 percent in 1989 and to average between 3.2 per cent and 3.4 per cent through 1994.
2. That interest rates will be consistent with the actual increases that occurred since last November. Three-month Treasury bills averaged 6.7 per cent in 1988, and are projected to average 7.7 per cent in 1989—and then decline steadily to 3.0 per cent in 1994. Long-term interest rates (illustrated by 10-year issues) are projected to decrease from an average of 8.9 per cent in 1988, to 8.8 per cent in 1989, and to 4.0 per cent in 1994.
3. That inflation will abate noticeably. For example, it is assumed that the rise in the CPI which amounted to 4.4 per cent in 1988, will ease to 3.6 per cent in 1989—and then fall to only 1.5 per cent in 1994.
4. That the unemployment rate will average 5.2 per cent in 1988 and about 5 per cent through 1994. This assumption reflects the expected strong performance of the real economy.

EEJ: How do those projections compare with those being made by private economists and the Congressional Budget Office (CBO)?

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Brimmer: Have a look at this summary table. That will give you a quick over-view of the differences in their degrees of optimism—especially in the forecasts being made for 1990.

Category	*Actual*	*Forecast*	
	1988	*1989*	*1990*
Real GNP			
Administration (4/4)	2.6	3.5	3.4
CBO (4/4)	2.6	2.9	2.2
Blue Chip (4/4)	2.6	2.4	1.8
Consumer Price Index			
Administration (4/4)	4.4	3.6	3.5
CBO (4/4)	4.4	5.0	4.8
Blue Chip (4/4)	4.4	4.8	4.7
Civilian Unemployment Rate			
Administration (Avg.)	5.5	5.2	5.1
CBO (Avg.)	5.5	5.5	5.5
Blue Chip (Avg.)	5.5	5.5	5.7
Three-Month Treasury Bills			
Administration (Avg.)	6.7	6.3	5.5
CBO (Avg.)	6.7	7.9	7.1
Blue Chip (Avg.)	6.7	7.8	7.3
Ten Year U.S. Government Bonds			
Administration (Avg.)	8.9	8.3	7.2
CBO (Avg.)	8.9	9.3	9.0
Blue Chip (Avg.)	8.9	9.0	8.4

EEJ: Interest rate projections are clearly critical are they not?

Brimmer: Absolutely: That is precisely why President Bush publicly cautioned the Federal Reserve against conducting what he described as an excessively restrictive monetary policy soon after assuming office. After the Federal Reserve Board raised the discount rate from 6.5 per cent to 7.0 per cent on February 24, the President renewed his assertion that inflation is not a serious problem and does not justify higher interest rates. Thus, the focus of his administration, at least at this time, is "... to promote further growth and extend the current record breaking peace-time expansion while avoiding an acceleration of inflation."

EEJ: Does not budget reduction necessarily tie in with that announced goals?

Brimmer: Apart from the fact that the reduction of the Federal Budget is also required by the Gramm-Rudman-Hollings Act (GRH), the President has recognized the link between debt reduction and other administration goals. But the magnitude of the task is considerable. In the budget for FY 1990, which he presented to Congress on February 9, President Bush projected total receipts at $1,065.6 billion and outlays at $1,160.4 billion, which leaves a deficit of $94.8 billion. The latter would represent 1.7 per cent of GNP. Contrast this with the final budget in which Reagan projected FY 1990 Receipts at $1,059.3 billion and Outlays at $1,151.8 billion—producing a deficit of $92.5 billion.

In his budget revisions, President Bush has rearranged spending priorities slightly and applied a "flexible freeze" to major segments. The growth of defense spending is to be constrained to the rate of inflation (which will hold the rise below that recommended by President Reagan. President Bush's budget also allocates somewhat more resources to certain domestic programs. However, he has not identified which programs would be cut to meet the GRH deficit reduction goals. These are to be negotiated with Congress.

EEJ: Given the repeated assurance of no new taxes, how does Mr. Bush expect to meet the GRH targets?

Brimmer: This he expects to do exclusively through the additional revenue generated by continued economic growth and cutbacks in Federal expenditures. However, the impact of the Federal budget on the economy would not change appreciably under the Bush budget compared with that submitted by President Reagan. The deficit remains at roughly the same magnitude, which means that the Federal Government will continue to absorb a disproportionate share of the nation's saving.

EEJ: What of the possibility of *lower* taxation?

Brimmer: This is, indeed, a policy that President Bush has proposed in the form of a more favorable tax rate on capital gains realized from the sale of specified types of financial assets. Under the President's plan, an individual taxpayer would be allowed to exclude from taxable income 45 per cent of the gain or to have the entire gain taxed at a maximum rate of 15 per cent. In contrast, wages and salaries are subject to a top tax rate of 33 per cent, and low-income individuals are taxed at a 15 per cent rate.

EEJ: Why does the President think a lower rate of taxation on capital gains would be helpful?

Brimmer: It is the administration's view that taxing capital gains at ordinary income tax rates, as per the Tax Reform Act of 1986, has frozen many investors into existing asset holdings and has reduced the supply of capital to finance new ventures. A lower tax on capital gains would unlock these holdings, increase the availability of funds to finance risky innovations, and promote business investment and long-term economic growth. Moreover, the Bush Administration also says that the reduction in the capital gains tax rate would eventually generate more Federal Government tax revenue. Indeed, the U.S. Treasury believes the plan would bring in $9.3 billion in additional revenue over the six years ending 1994.

EEJ: Does Congress share this optimistic estimate?

Brimmer: Quite the contrary. Congress estimates that the proposal would reduce revenue by $24.2 billion over the same period. The key difference is due to the conflicting assessment of the impact of a lower tax on capital gains on economic performance. The Treasury assumes that a reduction in the rate would encourage investment, which would stimulate economic growth, and generate more income to be taxed. The Congressional Joint Committee on Taxation (JCT) believes that these favorable benefits—if they materialize at all—would be much smaller than assumed by the Treasury. In the meantime, the lower rates would represent actual revenue losses. Thus, both Democrats and Republicans in Congress have expressed opposition. Under the GRH Act, the loss of revenue would have to be made up by higher taxes on individual income or corporate profits. It would also mean a basic modification of the Tax Reform Act of 1986.

EEJ: How would you evaluate the prospects that the administration will be successful in reducing that other important deficit—the deficit in the balance of payments?

Brimmer: Well, the Bush Administration will certainly seek further reductions, but I suspect its achievements are likely to be modest.

EEJ: Why so? Does not the recently adopted foreign trade bill provide a vehicle for reprisal against trading partners who are behaving unfairly with respect to penalizing our exports?

Brimmer: To be sure, the law is on the books, but I don't think it will be administered as vigorously as Congress intended. More than likely the emphasis will be on opening foreign markets for U.S. exports by negotiation rather than by the imposition of restrictions on imports. Considerable stress will be placed on improving the competitiveness of American firms in the world economy.

EEJ: What of the defense of the dollar? Do you see that as a policy goal?

Brimmer: The Bush Administration—through coordination with the Group of Seven (G-7) Govern-

ments—will continue to intervene in the foreign exchange market to influence the level of the U.S. dollar. However, the aim will not be to establish and defend a fixed exchange rate. Over the next few years, the U.S. dollar will depreciate further.

EEJ: Let's return to your earlier remarks in which you anticipated a collision course between the administration and the Fed. Is there really substantial evidence that inflationary pressures are accelerating?

Brimmer: Well, in January, producer prices for finished goods rose by 1.0 per cent. The consumer price index (CPI) also rose by 0.6 per cent. Inflationary pressures also seem to be spreading to other sectors of the economy. For instance, in the fourth quarter of 1988, conpensation per hour rose at an annual rate of 5.5 per cent while output per hour showed no improvement. Thus, unit labor costs are accelerating. In this environment, the Federal Reserve has intensified the degree of monetary restraint. The fact is that the Federal Reserve has pursued a restrictive monetary policy since the spring of 1987. Immediately following the stock market crash in October, 1987, the Federal Reserve shifted aggressively to supply additional reserves, and it announced its commitment to provide whatever liquidity might be needed to stabilize the market. But, once immediate market pressures had eased—the Federal Reserve became less generous in the provision of bank reserves. By the spring of 1988, it returned to its longer-run policy of restraining the growth of money and credit to help prevent the resurgence of inflationary expectations and to check a renewed outburst of actual inflation. Further restraint was exerted in the summer of 1988, and pressure on bank reserves has been maintained since then.

EEJ: And you expect this policy of monetary restraint to continue?

Brimmer: I do. Given the prospective growth of the economy and rising inflationary pressures, a moderate restraint on the supply of money and credit should be expected to continue through most of 1989. Consequently, interest rates should be expected to rise further in the months immediately ahead. These higher rates will dampen spending, moderate economic growth, and help to check inflation.

EEJ: Many thanks for your enlightening insights into some of the factors operating to shape contemporary macroeconomic policy. Allow me also, on behalf of our members, to congratulate you both on your appointment as Wilmer D. Barrett Professor of Economics at the University of Massachusetts and on your election to the position of Vice President for Program of the Eastern Economic Association. We all look forward to our next annual convention which will be held in Cincinnati in March of 1990.