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It is clear that Reagan's tax victory of August gave away too much in the way of revenue. We can explain the difference between the Treasury's quite apparent pressure for an increase in the rate of increase of "money" and the to-date Federal Reserve insistence that they will persist in their policy of restraint by differences in their forecasts of the expected deficit. If you believe that the current tax and spending program will lead to an eighty billion dollar deficit you would have a "tighter" monetary policy than if you believed that the deficit will be the forty-six billion the administration is now forecasting.

A Federal Reserve monetary policy aimed at constraining inflation in the face of an expected rise in the deficit may be somewhat of a self-fulfilling prophecy. The high interest rate, slow monetary growth pattern that the Federal Reserve tries to impose may lead by way of credit market difficulties to a decline in money incomes below the level anticipated by the administration. A lower than anticipated income will of course mean lower tax receipts and greater non-defense spending. Thus we can expect the Federal Reserve to try to maintain a tight rein on monetary expansion. Recently this has resulted in continued high - although slightly declining - short term interest rates combined with still rising intermediate and longer term interest rates.

Because of the overhang of corporate refunding operations, we should see a return to a "normal" upward sloping yield curve when short term rates decline.

The Reagan tax and spending measures that have been passed to date lowered expected tax revenues by more than they lowered expenditures. As far as I can tell, the extent of the revenue loss is still not known with any surety. For example, the All Savers Certificate will decrease tax revenues, but how great this reduction will be depends upon how popular the All Savers Certificates will be and the tax bracket of the buyers. Thus, the deficit in calendar '82 will be greater by some factor than has been anticipated.

Congress does not legislate tax receipts and government spending. It legislates complex "formulas" that determine taxes and spending; these formulas make taxes and spending functions of various variables like income, employment, interest rates. It is perhaps enlightening at this juncture to think of the tax and spending variables as functions of the unemployment rate. Thus the Reagan reforms have increased the deficit that is to be expected at, say, the present 7.5% unemployment rate. If the unemployment rate increases from 7.5% then spending wil go up and tax receipts will decrease, thus raising the deficit. The inverse will take place as the unemployment rate falls.

The deficit is made up of government spending and taxes. The lower spending by government increases unemployment both directly as government employment decreases and indirectly as transfer payments decrease. However, the increase in the government deficit is a factor increasing profits. Thus, at the assumed 7.5% unemployment rate, profits are higher than they would have been at the same unemployment rate before the Reagan restructuring of taxes and spending.

Even though profits are higher at a given 7.5% unemployment rate, the new tax and spending program means that the deficit will increase at a slower rate than previously whenever the unemployment rate increases. Thus if investment falls, a larger than hitherto fall in employment will be needed to sustain profits.

The downward shift in the government spending schedule should directly decrease employment and output, thus decreasing business's need for funds. The continuation of high interest rates because of policy and the inflationary expectations due the government deficit should lead to a decline in interest sensitive spending. Because of the combination of a fall in interest sensitive investments and the rise in the government deficit, we may very well see a combination of a sharp fall in income, employment and business demand for financing even as gross capital income rises.

The fall in business demand for financing will lead to sharp decline in short term interest rates; furthermore, this sharp fall in financing demand will reflect a decline in investment which tends to lower profits. The course of profits, in the sense of gross capital income of business, will depend upon the relative size of the declines in investments and the rise in the deficit. Eventually, the plus impact of the increasing deficit upon profits will offset the negative impact of lower investment on profits. When this happens, the decline in profits and income will cease.

The protracted period of high interest rates is changing the portion of gross capital income that goes to interest and decreasing the portion that is net profits. The rise in business debt and interest rates may very well mean that for many firms the net profits will fall sharply even as the deficit sustains gross capital income. This can lead to both further declines in investment and income.

The increased debt burden compounded out of rising ratios of debts and rising interest rates can be made worse by any fall in gross capital income. If the administration and Congress view the large deficit that seems in store undesirable, then taxes may be raised or spending may be further reduced. Any such move to decrease the deficit will tend to lower gross capital income.

The above scenario has not included the possibility of a financial crisis. The 1980-81 period of high interest rates did push the savings and loan associations over the line to both a huge negative net worth of "marked to market" and a significant net loss income position. Given the minute size of the F.S.L.I.C. fund relative to both the losses of the S & L's and the "marked to market" negative net worth the only explanation for the continued ability of S & L's to hold and attract deposits is that the public views their liabilities as full faith and credit liabilities of the Federal Government.

Thus, we now have two significant forms by which government underwrites private debt. One is the large and chronic deficit and the second is the guaranteeing of deposit and other financial market liabilities. The Vokler Federal Reserve Board has been constraining on money supply growth but supportive on refinancing of troubled financial and large scale businesses. (Hunt/Bache, Chrysler, First of Philadelphia and S & L's come to mind). Thus, on the one hand they intervene to prevent the normal result of such constraint - the credit crunches and financial market failures. The length of the period of high interest rates - (I would consider the dip in 1980 an interlude brought on by the triple crises of the spring) - is due to this combination. The result is a generally weakened liability structure and cash flow posture even as any serious crunch has been avoided to date.

If we are to have a spate of failures of the kind that both forces the Federal Reserve to intervene and dramatically lower investment programs it will have to come from other than the "core" banking and savings deposit institutions. The candidates are "giant" corporations or offshore "fringe" banking institutions. I expect financial markets have already taken into account the likely formal bankruptcy of PanAm, International Harvester, etc.

A weakness in oil prices and housing markets might be a source of a spate of financial market difficulties.

The problem is to put the argument into a time frame.

At the minimum, we can expect a two quarter (mid 4th 81 - mid 2nd 82) sharp drop in GNP, rise in unemployment. This would give us a sharp decline (to a 10%-12% range) of money market rates, mainly because of the decline in demand rather than because of a rise in the rate of increase of bank reserves). This period will see some quite disastrous net profit figures for major corporations and an "induced" rather than an "inducing" series of financial restructurings.

Inasmuch as the first serious cut in income taxes takes place at the end of the second quarter of 1982, I expect that there will be a recovery of business profits at that time and a stabilization of interest rates. The third quarter of 1982 should see a halt to the decline in both income and rates; the fourth quarter should see a recovery which at this perspective, seems to be weak.

Because we can expect a flood of large term debt issues from business whenever the long term market opens, I expect longer term rates to decline by less than the short term rates and that there will be a significant demand for credit to "make on the carry" by financing longs with short borrowing. The combination of long term funding of private debt and the need to finance the government deficit will keep short rates from falling much below the 10%-12% range.

The prospect of a weak economy in the first half of 1982 should go far to abate inflation. The trade union movement is in disarray - state and local governments cannot live up to their prior "relaxed" attitude towards labor costs. Until we set a "free market" feedback for the enormous projected demand for skilled workers in defense related productions, we can expect passive wage behavior. Security rather than improvements in real income will be the major aim of workers. We can expect a "standstill" in labor contracts with partial cost of living adjustments becoming dominant.

The likelihood of 1982 being the poorest performance year in income and employment since World War II is high; the likelihood that inflation will come down signficiantly is also high. On the other hand, the likelihood of a debacle and a set of ~~cases~~ crises such as led to 1929-33 is very low. The scenario is for troubled times, not for disaster. In the present circumstances with the compromised net worth of many of the entrepreneurial businesses and businessmen, there is not much of a prospect for a recovery from below. Strong recovery in 1983 will depend largely upon the "expansion" of 'military spending'". It is perhaps paradoxical that now more than ever the stability and progress of the American economy depends upon the impact of "big government" upon profit flows.