Editors' Introduction

THIS IS THE FIRST ISSUE of *Brookings Papers on Economic Activity,* a publication that will appear three times a year and will contain the articles, reports, and highlights of the discussion from conferences of the Brookings Panel on Economic Activity. Financed by grants from the Alfred P. Sloan Foundation and the Alex C. Walker Foundation, the panel was formed to promote professional research and analysis of key developments in U.S. economic activity. Prosperity and price stability are its basic subjects.

The expertise of the panel is concentrated on the "live" issues of economic performance that confront the maker of public policy and the executive in the private sector. Particular attention is devoted to recent and current economic developments that are directly relevant to the contemporary scene or especially challenging to the expert because they stretch our understanding of economic theory or previous empirical findings. Such issues are typically quantitative in character, and the research findings are often of a statistical nature. Nonetheless, in all the papers and reports, the reasoning and the conclusions are developed in a form both intelligible to the interested and informed nonspecialist and useful to the macroeconomic expert. In short, the papers aim at several objectives—meticulous and incisive professional analysis, timeliness and relevance to current issues, and lucidity of presentation.

The three principal articles and six shorter reports presented in this issue were prepared for the first conference of the Brookings panel, held in Washington on April 16–17, 1970. Participating in the conference were the members of the Brookings panel, the senior advisers to the panel, and a few guests with special expertise in the material covered. The members of the panel for 1970 are:

Charles Bischoff *Yale University*
Barry Bosworth *Harvard University*
William H. Branson *Princeton University*
Robert J. Gordon *University of Chicago*
Robert E. Hall *University of California (Berkeley)*
Saul H. Hymans *University of Michigan*
John H. Kareken *University of Minnesota*
Lawrence B. Krause *Brookings Institution*
Arthur M. Okun *Brookings Institution*
George L. Perry *Brookings Institution*
William Poole *Federal Reserve Board*
Craig Swan *University of Minnesota*
Nancy H. Teeters *Brookings Institution*

Senior advisers attending the first conference were:

Gardner Ackley *University of Michigan*
William C. Brainard *Yale University*
Daniel H. Brill *Commercial Credit Corporation*
David I. Fand *Wayne State University*
William J. Fellner *Yale University*
R. A. Gordon *University of California (Berkeley)*
Alan Greenspan *Townsend-Greenspan Company, Inc.*
Lawrence R. Klein *University of Pennsylvania*
Paul A. Samuelson *Massachusetts Institute of Technology*
Warren L. Smith *University of Michigan*
Robert M. Solow *Massachusetts Institute of Technology*
George Terborgh *Machinery and Allied Products Institute*

Those guests whose comments are incorporated into this volume were:

George Jaszi *U.S. Department of Commerce*
Michael V. Levy *National Industrial Conference Board*
Sherman J. Maisel *Board of Governors of the Federal Reserve System*
Geoffrey H. Moore *U.S. Department of Labor*
Charles L. Schultze *Brookings Institution*

Several other persons at Brookings contributed to the quality and style of this volume. Mendelle Berenson provided editorial assistance; Evelyn Fisher reviewed the accuracy of the facts and figures; Jeffrey E. Frank assisted in the research; and Eunice Godbold and Mary Green prepared the manuscript.

The papers presented here generated spirited discussions at the conference. Many of those attending offered new insights and helpful comments; many had reservations or criticisms about various aspects of the papers. Some of these comments are reflected in the summary of the discussions presented in this volume, some in the final versions of the papers themselves. But in all cases the papers are finally the product of the authors' thinking and do not imply any agreement by those attending the conference. Nor do the papers or any of the other materials in this volume necessarily represent the views of the staff members, officers, or trustees of the Brookings Institution.

In the first article of this issue, Robert J. Gordon focuses attention on the 1969 acceleration of inflation and on prospective price-wage performance in 1970–75. Although the growth of real output slowed down substantially in 1969 and was exceeded by the growth of the nation's capacity to produce, prices actually rose more rapidly than in 1968. Most economists who predicted the slowdown in output had expected a deceleration of prices to accompany it. Gordon's review of price behavior emphasizes the disappointing record of productivity in 1969. According to Gordon's analysis of the determination of prices, a poor productivity performance adds to inflation in two ways: First, it raises unit labor costs, and second, it tightens labor markets by requiring more employment to produce a given output. Gordon does not undertake to explain the source of the productivity slowdown, which has been attributed by other economists to labor hoarding—the practice of retaining workers not immediately needed in order to insure against subsequent higher costs of recruiting new workers.

Gordon demonstrates that his statistical analysis of overall wages and prices in the private nonfarm economy works well in the 1964–69 period. He then applies the model to assess probable wage and price performance in the period ahead. Assuming that the current economic slowdown continues during 1970 and predicting that productivity improves, he reaffirms the forecast that prices and wages will soon slow down. On the assumption of slow growth, the rate of price increase is expected to moderate during the course of 1970 and into the first half of 1971, although it does not get below 3 percent during that period. Assuming a more severe setback of economic activity—a clear recession—during 1970, he sees prices rising at a rate near 2 percent in the first half of 1971.

However, Gordon doubts that the nation can maintain that improved performance in any subsequent rebound of economic activity. If real gross national product (GNP) bounces back to match potential output and the unemployment rate falls, starting in 1971, to a level of 3.8 percent by early 1973, prices will accelerate strongly in 1972. The acceleration of prices would lag somewhat behind the rebound of economic activity, just as the deceleration of prices is currently lagging behind the slowdown of economic activity. But this lag would not be very long; and prices would rise at an estimated 3¾ percent rate after 1973 if full employment is restored along the illustrative path outlined above.

It is a vital characteristic of Gordon's findings that, at any given unchanged unemployment rate, the rate of inflation eventually becomes steady. It does not accelerate continuously, as some economists have hypothesized. Hence, according to Gordon, society can choose to have very low unemployment *or* very stable prices—but not both. In order to limit the rate of price increase to 2½ percent a year, society would be obliged to accept an unemployment rate of 4¾ percent. On the other hand, to maintain an unemployment rate as low as 3.8 percent, the nation would have to tolerate the 3¾ percent inflation mentioned above. Gordon sends the policy maker a mixed message—that high employment and price stability are not consistent objectives, according to the statistical evidence provided by the U.S. postwar record; but that we can expect to have somewhat less inflation than at present even with a historically low unemployment rate of 3.8 percent.

In the second article, Craig Swan analyzes the performance of homebuilding in 1969, comparing it with the experience of 1966 and drawing lessons for the future. By standards of past performance, the intriguing puzzle about homebuilding in 1969 is not why it ultimately fell significantly, but rather why it held up so well and so long in the face of extremely tight and expensive mortgage credit. In point of fact, the annual rate of private nonfarm housing starts reached 1.6 million in the first half of 1969 and was 1.3 million in the fourth quarter. On the basis of past experience it might have been expected to fall below 1 million. A simple statistical model based on mortgage interest rates and net deposit flows into thrift institutions—our main mortgage lenders—explains quite satisfactorily the course of housing starts from 1958 through 1966. But that technique would have seriously underpredicted homebuilding in 1969.

Swan attributes the stronger performance of homebuilding in the latest period of tight money to a combination of factors. First, the rate of household formation rose sharply beginning in 1967; the new families swelled the demand for dwelling space and supply responded partially to the intensity of demand. Second, the development of "equity kickers," the new technique for financing multifamily homes, may have significantly bolstered this kind of building. Third, to the extent that homebuyers expected prices of homes to keep rising in the future, the sharp rise in mortgage interest rates may not have had its full normal influence in deterring demand. Fourth, the vastly increased activity of government-sponsored credit agencies—the Federal Home Loan Banks and the Federal National Mortgage Association—helped to channel funds into mortgage lending during 1969. Swan presents an illustrative calculation which suggests that FNMA's support may have contributed 150,000 starts in 1969.

Swan's analysis does not point to an early dramatic improvement in homebuilding. He finds it implausible that conditions in mortgage markets will ease enough to permit much more than 1.4 million housing starts in 1970. He also points to the prospects of a continuing shortfall in the availability of financing for homebuilding during 1971–75 unless additional public support is provided for this sector.

In the third and last of the principal papers in this volume, Arthur Okun and Nancy Teeters review the conceptual and measurement problems associated with the full employment surplus. They reaffirm its usefulness as a measure of fiscal impact for public discussion of the influence of the budget on economic activity. They stress the inadequacy of the actual surplus or deficit as an indicator of fiscal policy at times when the economy is either booming or falling below its potential path. In the present circumstances of an economic slowdown, federal revenues are held down by the sluggish growth of incomes; this dent in revenues tends to make the budget surplus disappear and makes fiscal policy appear stimulative. But such an erosion of revenues should be recognized as an automatic stabilizer rather than an active stimulus to economic activity. In effect, the fiscal furnace starts working because it is colder, not because the thermostat was turned up.

The authors stress that the full employment surplus is not—and is not intended to be—a precise measure of fiscal impact and is not an adequate summary measure for the analytical uses of fiscal experts. For one thing, the full employment surplus weights equally the stimulative effect of all types of federal expenditure and the restraining effect of all types of federal revenues, even though there is evidence that some types have more "bang for a buck" than others. In actual experience, however, the composition of the budget has remained reasonably stable over time so that the differential effects are not of great practical consequence.

Second, the full employment surplus does not always accurately record the timing of fiscal impacts. To take two examples, defense orders may stimulate economic activity before they are reflected in budgetary outlays, while certain types of taxes may be restrictive even before revenues are collected.

Third, calculation of the full employment surplus involves difficult problems of estimating revenues under a hypothetical full employment situation, although the authors believe that the resulting errors can be kept within reasonable bounds.

Okun and Teeters also grapple with the difficult task of correcting the full employment surplus for extra revenues from excess-demand inflation. They conclude with historical estimates of the full employment surplus since mid-1955 and with projections for calendar 1970 and the first half of 1971, based on the budget program initially presented by the President in January and February. As the authors interpret that program, it would maintain essentially the same degree of fiscal restraint in calendar year 1970 as actually was applied in 1969. However, it would significantly increase fiscal restraint during the first half of 1971.

Six shorter reports in this issue deal with sectors of the economy not covered by the three principal papers—consumer demand, plant and equipment expenditures, inventories, net exports, unemployment, and monetary policy.

In his discussion, Saul Hymans examines how well several consumption equations have tracked actual consumer spending in recent quarters. In particular, he considers the possible role of changes in household wealth in recent fluctuations in consumer demand. Charles Bischoff demonstrates that many techniques of forecasting investment in plant and equipment that had been successful in the past would have substantially underestimated the strength of investment demand in 1969 and at the beginning of 1970. Barry Bosworth considers the state of business inventories in relation to current sales and finds no clear symptoms of serious or general excessive accumulation.

Lawrence Krause sees signs of improvement in U.S. exports and imports from recent data; he uncovers no decisive evidence to date that once inflation is halted, U.S. competitiveness would be weaker than it was prior to the Vietnam buildup. Robert Hall stresses that the increased unemployment in the first quarter of 1970 was concentrated among white workers, and points out that much the same racial profile emerged in the initial months of the 1960–61 recession. According to Hall, increased unemployment has developed primarily from a few cyclically sensitive industries in which only a small fraction of the workers are black. John Kareken discusses the indicators of credit conditions during 1969 and the role they may have played as proximate targets of Federal Reserve open market policy. He notes a number of cases where the movements of these credit market indicators do not seem completely consistent with the intentions expressed in the directives of the Federal Open Market Committee.