Editors' Introduction and Summary

THIS IS THE THIRD ISSUE OF *Brookings Papers on Economic Activity*, a publication that appears three times a year and contains 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 articles and reports, the reasoning and the conclusions are developed in a form both intelligible to the interested, 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 lucid presentation.

The three principal articles and five shorter reports presented in this issue were prepared for the third conference of the Brookings panel, held in Washington on December 3–4, 1970. These papers generated spirited dis-

cussions at the conference. Many of the participants 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 summaries of discussion contained in this issue, 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 issue necessarily represent the views of the staff members, officers, or trustees of the Brookings Institution.

Summary of This Issue

In the first article in this issue, Lawrence Krause makes the case for a passive balance-of-payments strategy by the United States. Under such a strategy, the United States would deliberately refrain from adopting measures designed specifically to eliminate imbalances in its international payments. In Krause's view, the passive strategy is needed because the noncommunist world is, in fact, operating today on a dollar standard monetary system. Partly because of its enhanced value for industrial purposes, gold has lost its essential usefulness as an international money. Moreover, while other countries have the option of converting dollars into gold, they recognize that any major exercise of this right could gravely upset the international monetary system. Given the current preference of nations for a pegged system of exchange rates, the currencies of the world are basically pegged to the dollar, and countries hold dollars as the key reserve asset.

Under the dollar standard, the position of the United States is unique in two respects. On the one hand, because the dollar is the world's principal reserve currency, the United States is not dependent on international reserves; in effect, the U.S. Treasury prints currency that serves as an international medium of exchange. On the other hand, the United States is deprived of the option available to other countries of altering exchange rates in order to correct a disequilibrium in the balance of payments. While the United States can, in principle, change the price of gold, such an action, whatever its demerits or possible merits on other grounds, would not in itself alter exchange rates between the dollar and other currencies.

Krause sees many benefits from the passive strategy. Its adoption would mean the elimination, in due course, of a host of minor distortions and

inefficiencies that have been introduced by U.S. measures to restrain the outflow of dollars during the past decade. Among these measures are the tying of U.S. loans to less developed countries, "Buy American" practices that increase the budgetary costs of federal procurement, and restrictions on American investment abroad. The nation would also benefit from the greater flexibility available to makers of fiscal and monetary policy, since monetary policy would not be constrained by the balance of payments.

Krause views the passive U.S. strategy as a contribution to improvement in the international adjustment mechanism, because its adoption would clear the way for a more effective and sensible arrangement for changing currency parities. In the past, changes in exchange rates have been viewed as evidence of failure of economic policy rather than as instruments for achieving greater economic efficiency. Palliative measures by the United States to adapt to disequilibria among exchange rates have papered them over. If the United States deliberately eschewed such measures, exchange alterations, Krause hopes, would be made more promptly and more frequently, and would be smaller in average size.

To make the passive strategy viable and acceptable to other countries, the United States would have to take on some important obligations. First, U.S. economic performance must be stable and reasonably predictable. In addition, both to minimize the number of parity changes required over time and to avoid any strong upward or downward trend in the dollar value of gold and special drawing right (SDR) assets, it would be most desirable—perhaps even essential—for U.S. price performance to be close to the average for all industrial nations. The United States should focus attention on instances when the stability of world payments might be threatened by undervaluation or overvaluation of any particular currency relative to the dollar. Moreover, the United States would have an obligation to help assure that the volume of special drawing rights is adequate but not excessive. Finally, the United States must be prepared to continue to take unilateral measures in times of crisis to shore up the system.

Krause expresses concern that the U.S. adoption of a passive strategy might be misinterpreted by other countries as arrogant and irresponsible. He contends that the truth is precisely the opposite; the need for a passive balance-of-payments strategy does "not grow out of the arrogance of the United States, but out of the recognition of its relative weakness. The mechanism essentially tries to match obligations with ability to act." Looking further ahead, Krause suggests that, under the passive

strategy, the dollar standard might evolve into any one of several new international monetary systems—possibly one of flexible exchange rates or a mixed standard of dollars and SDRs or ultimately a pure SDR standard, through the assumption by the International Monetary Fund of additional central banking responsibilities.

Robert Hall's article assembles empirical and analytical information on the nature of unemployment in the United States under conditions of essentially full employment. Basically, he asks why unemployment rates significantly below 4 percent are not sustainable, given existing labor market institutions. His answer identifies two major elements. First, most of the unemployment observed at full employment—perhaps enough to account for a rate of more than 3 percent—reflects "normal turnover" of workers between jobs. The smaller, but socially significant, remaining portion reflects the fact that certain groups in the labor force experience excessively frequent spells of unemployment, even at full employment.

In his analysis, Hall takes issue with some widely held views. First, he disputes the contention that a large portion of unemployment in a full employment economy can be accounted for by depressed regions or geographical pockets of particularly weak labor markets. He focuses on the unemployment rates in twelve large metropolitan areas and finds that the rates do differ considerably among the cities. In 1969, for example, three of the twelve cities had rates of 2.3 percent or lower, while three had rates of at least 3.7 percent. And these differentials had persisted in the period from 1965 to 1969. Nonetheless, Hall doubts that enhancing the geographical mobility of workers and employers offers significant possibilities of reducing unemployment at full employment. He uncovers the fact that cities with high unemployment also tend to have high wages, while those with low unemployment tend to have low wages. This wage-unemployment relationship suggests to Hall that the labor markets of the various cities are all close to a type of equilibrium in which relative wages and relative risks of unemployment essentially balance out. To the worker, a high-wage, high-unemployment city offers greater rewards when he is employed, but presents greater difficulties of finding a job. The employer in such a city encounters higher payroll costs but also greater ease in recruiting and retaining a work force. These could be roughly compensating so that neither workers nor employers have strong incentives to shift location.

Hall also reveals the rarity of very long-term chronic unemployment in

a full employment economy. Adult men who had found no job at all after looking for six months or more numbered only 70,000 in April 1969, constituting only 7.4 percent of all unemployed men in the nation.

Hall stresses the importance of normal turnover in the unemployment at full employment. It takes time for people newly entering and reentering the labor force to shop for jobs. Even in a prosperous economy, a few industries and many firms are depressed and lay off unneeded workers. Other workers may quit their jobs to shop for more favorable career opportunities. Although society should strive for better job information and smoother transitions between jobs, unemployment that arises from normal turnover is not necessarily a matter of social concern, providing the unemployed find satisfactory jobs rapidly.

Hall constructs hypothetical rates of turnover for various age groups in the labor force and compares the resulting calculations of unemployment with actual unemployment rates at full employment. Normal turnover based on the hypothetical calculations fully accounts for the actual unemployment rate among white men at full employment. Moreover, the substantial difference between unemployment rates of white teenagers and those of white adults can be explained, Hall shows, if one assumes that (1) people shop for their first job longer than they do for subsequent ones, and (2) they shift jobs more often in the early than in the later stages of their work careers. But Hall emphasizes that the data for all blacks and for white women reveal excessive unemployment, by any reasonable standard of normal turnover. Excess unemployment at full employment is thus, in Hall's view, the result of abnormal turnover—frequent, although not necessarily long, spells of unemployment among many groups in the labor force.

The same groups that experience abnormal turnover fail to experience careers of steady advancement. As a group, only white men enjoy substantial relative improvements in income over the course of their careers from youth to middle age. In contrast, white females and blacks of both sexes encounter a plateau in income early in their work careers. Hall suggests that white youths are aware from the outset of their opportunity to move up the job ladder; over time, they develop attachments to their jobs (or at least to their occupations) and value to their employer. As a result, their rate of turnover is relatively low. On the other hand, the kinds of jobs obtained by most young blacks (and most white women) offer little hope for advancement. The worker does not lose much when he quits his job,

and the employer has no strong incentive to retain his services. The special difficulties of blacks and of white women in a full employment economy lie not so much in finding jobs, but rather in finding jobs worth keeping and employers interested in keeping and advancing them.

In the third article, George Perry analyzes the importance of the composition of unemployment by age and sex for the current inflation and for the trade-off between inflation and unemployment that confronts the nation. The aggregate unemployment rate has long been used as an approximate measure of labor market tightness. Low unemployment rates mean tight labor markets in which wages are bid up more rapidly; higher unemployment rates mean slacker labor markets with less upward pressure on wages. But Perry notes that, because of changes in the composition of unemployment, a given average unemployment rate signals a tighter overall labor market today than it did ten or twenty years ago. As a result, the trade-off between inflation and unemployment has worsened: A given unemployment rate is associated with an estimated annual rate of inflation that is 1½ percentage points faster than the inflation rate with which it was linked in the earlier periods. These results fully account for the rates of inflation experienced during recent years.

Perry develops a measure of labor market tightness that corrects for two kinds of inadequacies in the overall unemployment rate. The unemployment rate counts all individuals equally, implying, for instance, that an unemployed teenager looking for part-time work after school exerts the same downward pressure on wages as an adult looking for full-time work. Furthermore, it takes no account of how unemployment rates are distributed among parts of the labor market. Thus it implies that an economy with very low and very high unemployment rates side by side generates no greater inflationary pressures than does an economy in which all parts of the labor market have some comparable, middle degree of unemployment. To remedy these shortcomings, Perry develops two concepts: (1) a weighted unemployment rate that allows for differences in the contributions individuals would make to production if they were employed; and (2) an indicator of the dispersion of unemployment to be used in conjunction with the aggregate weighted unemployment rate in a measure of labor market tightness. Both of these adjustments are made using employment data disaggregated by age and sex.

Because the age-sex composition of the labor force has changed dras-

tically during the last ten or fifteen years, and because the unemployment experience of the several age-sex groups has not been parallel over this period, Perry's measure shows that labor markets were much tighter in the late sixties than the aggregate unemployment rate indicated.

Compared with the mid-1950s, a much larger proportion of the unemployed are women and young people who exert less downward pressure on average wages in the labor market than do males in prime-age groups. Half of the unemployed in 1969 were less than 25 years old, compared with less than one-third in 1956. These shifts reduce Perry's weighted unemployment rate relative to the official unemployment rate. In addition, unemployment rates for various groups in the labor force were much more dispersed in recent years, with very tight labor markets for prime-age males existing alongside much higher unemployment rates for other groups. Some disparities have always existed among unemployment rates for the age-sex groups and they can be considered normal characteristics of the labor market and work force. But the ratios of unemployment rates in other groups to those for prime-age males have risen persistently and were dramatically higher in recent years than in the mid-1950s. It is this increase in unemployment dispersion that is significant for Perry's findings.

Thus, relative to the official unemployment rate, both parts of Perry's measure of labor market tightness—the weighted unemployment rate and the dispersion of weighted unemployment—have joined to tighten labor markets. Fiscal and monetary policies are insufficient for dealing with this problem: To the extent that they can alter unemployment rates, they can shift the various component rates only more or less in parallel. In order to improve the trade-off and permit a lower average unemployment rate with less inflation, structural policies aimed at reducing unemployment disparities are needed. And other measures aimed at improving the inflation-unemployment trade-off now appear more urgently needed than ever, in light of Perry's findings.

The five shorter reports in this issue deal with various timely subjects: the most recent disappointments in the performance of prices, uncertainties in the overall economic outlook for 1971, the sag in corporate profits, Federal Reserve open market policy in 1970, and the key characteristics of the demand for money.

Robert J. Gordon reviews the recent performance of the price index for nonfarm private output. The index has risen steadily at an annual rate of

4½ percent during the most recent four quarters. The substantial rebound in productivity during the second and third quarters of 1970, combined with the weakness of demand in product markets, should have generated some price slowdown, according to Gordon's statistical evidence from earlier periods. He notes that an extremely sharp and apparently erratic increase in construction costs in the third quarter may have masked a somewhat more favorable trend in other prices. He also suggests that gains in productivity may influence prices with a lag longer than that allowed for in his earlier statistical relationships. Gordon concludes tentatively that if wage increases are no more rapid in 1971 than they were in 1970 and if the productivity rebound continues at anything like its recent pace, some slackening in inflation in 1971 would be predicted by his statistical relationships. But since prices have been less responsive to the changed economic environment in 1970 than they were in previous history, any forecast must be made with extreme caution.

Saul Hymans examines the forecasts for 1971 of three well-known econometric models, and analyzes their common features and differences. They all point to a distinct resumption of economic expansion in 1971, with the growth of real output for the year ranging between 2¾ percent in the most bearish forecast to 3½ percent in the most bullish one. All three project some significant diminution in the inflation rate from above 5 percent in 1970 to less than 4 percent in 1971. They also agree that the leading sectors of the recovery will be homebuilding and consumption, although saving rates will remain above normal in 1971.

For the period between mid-1971 and mid-1972, differences among the forecasts become more pronounced. But even the most bullish of the three econometric models points to a growth of output over that period of only 4½ percent, barely enough to begin reducing unemployment and reactivating idle industrial capacity. These forecasts all assume particular fiscal and monetary policies; they would point to a more vigorous rate of economic recovery in the event of more stimulative policies.

Arthur Okun and George Perry note that the ratio of corporate profits to gross national product is even lower in 1970 than in the recession years 1958 and 1961. They show that, between 1954 and 1966, the level of corporate profits was closely related to the level of actual and potential gross national product. But this regularity broke down rather abruptly after 1966. One factor was a swing of roughly $5 billion in net interest payments by the corporate sector. But even after allowing for this, the earlier rela-

tionship would have overpredicted profits by close to $10 billion for both 1969 and 1970. About half of the departure in 1969 from earlier performance is attributable to the unusually slow growth of productivity since 1969. About one-third reflects the fact that wages apparently overtook prices, and the remaining one-sixth stems from the increasing fixed costs per dollar of output, perhaps attributable to the high rates of capital spending. Because the authors judge that these developments are partly transitory, they suggest that a rebound of the economy to full employment would be accompanied by a major rebound in the profits share of GNP from 8 percent in 1970 to roughly 10 percent in the next full employment year. Should 1973 turn out to be that year, this ratio would mean corporate profits in the neighborhood of $125 billion, about 60 percent above their level of mid-1970.

John Kareken reviews the record of Federal Reserve open market policy in 1970. The statements and actions of the Federal Open Market Committee reveal the intricate balancing of a desire to maintain a targeted growth of money and bank credit against a continuing concern to avoid short-run instability in financial markets. The committee changed its operating strategy in January 1970, when it instructed the manager of open market operations to give "increased stress" to the growth of monetary aggregates. The directive of the March 10 meeting went even farther to establish money and bank credit as the proximate target variables for the conduct of open market policy. Nonetheless, the committee made evident its strong concern about the stability of interest rates and credit conditions on several occasions: when credit markets displayed fairly sharp swings, when the actual performance of monetary growth was deviating from earlier targets, and when the auto strike reduced transaction needs. The conduct of monetary policy is evolving, and further evidence will help to show how the Federal Reserve balances the relative emphasis on quantitative aggregates and interest rates.

Monetary policy will face a key challenge during 1971, Kareken suggests, if the prevailing view of the outlook is accurate. Like the forecasts analyzed by Hymans, the FRB-MIT-Penn econometric model suggests that unemployment will not decline significantly in 1971 unless monetary and fiscal policies, in some combination, become more expansionary.

William Poole reports on further exploration of the relationship between the demand for money and the level of income. In his article in the last issue, Poole relied on the FRB-MIT-Penn model, which calls for the de-

mand for money to grow proportionately with income at given interest rates. In his new report, Poole infers from annual data for 1929–69 that the demand for money over the long run may not quite keep pace with income. These findings point toward a modest reduction of perhaps 1 percentage point in the growth rates for money set forth in the earlier paper as consistent with the path of returning to full employment. The current report also investigates the sensitivity of the demand for money to changes in the rate of interest. This question is crucial in determining whether fiscal policy and variations of private demand can have an important short-run impact on the national income. To the extent that people economize on cash balances as a result of rising interest rates, a given money supply can support a variety of levels of income, depending on the interest rates associated with them. Poole concludes that the statistical finding of a distinct negative relationship between the demand for money and the rate of interest is not spurious.

Participants in the Conference

Participating in the conference and discussing these papers 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 W. Bischoff *Yale University*
Barry Bosworth *Harvard University*
William H. Branson *Princeton University*
Robert J. Gordon *University of Chicago*
Robert E. Hall *Massachusetts Institute of Technology*
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 third 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.*
Walter W. Heller *University of Minnesota*
F. Thomas Juster *National Bureau of Economic Research, Inc.*
Lawrence R. Klein *University of Pennsylvania*
Franco Modigliani *Massachusetts Institute of Technology*
Warren L. Smith *University of Michigan*
Robert M. Solow *Massachusetts Institute of Technology*
James Tobin *Yale University*

Those guests whose comments are incorporated into this volume were:

Charles C. Holt *Urban Institute*
Ronald I. McKinnon *Brookings Institution*
Joseph A. Pechman *Brookings Institution*
Walter S. Salant *Brookings Institution*
Charles L. Schultze *Brookings Institution*

Several others at Brookings contributed to the quality and style of this volume. Mendelle Berenson edited the manuscript; Evelyn Fisher and Genevieve Wimsatt reviewed the accuracy of the facts and figures; Richard H. Mullins assisted in the research; and Joan Gmiter and Mary Green prepared the manuscript.