Editors' Introduction and Summary

THIS IS THE FIFTH 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 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 four principal articles and seven shorter reports presented in this issue were prepared for the fifth conference of the Brookings panel, held in Washington on September 9–10, 1971. These papers generated spirited discussions 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 of this issue, Barry Bosworth analyzes recent patterns of corporate external financing, investigating particularly the growing volume of new issues of corporate bonds that has appeared in recent quarters. Total issues of bonds by nonfinancial corporations jumped from $22.5 billion for the five-year period 1961–65 to $70 billion in the 1966–70 interval. The volume of issues in 1971 is exceeding that of the entire 1961–65 period.

Bosworth explains the volume of corporate bond financing as part of the overall financial management of large firms. Any excess of investment and related uses of funds over the gross retained earnings of a firm represents a financing deficit that must be matched by an increase in short-term or long-term debt, a reduction in liquid assets, or an increase in equity financing. These alternative ways to finance the deficit have various advantages and disadvantages. Short-term borrowing generally involves a lower interest rate than does bond financing and it can normally be negotiated more readily. But long-term debt avoids the costs of renegotiations and "rollovers." Reliance on liquid assets permits great flexibility; but it requires previous accumulation of such assets, and that is costly, since nonfinancial firms normally earn lower interest rates on their liquid assets than they have to pay on their debt.

The issuance of corporate bonds operates through a gradual process of adjustment to the growth in total financial liabilities. Basically, nonfinancial corporations can be viewed as aiming at some target ratio of bond liabilities to total financial liabilities. Bosworth finds statistically that their approach to that target is delayed by particularly high rates of interest, which encourage postponement of bond issues; and it is sped up by growth in retained earnings, which add to the capacity of firms to service long-term debt. Equity issues can be explained by the same adjustment process; they are particularly stimulated in the short run by low dividend yields. A similar target ratio also applies to short-term debt, but the magnitude of increases in short-term debt in any half-year period is most heavily influenced by the size of the corporate deficit in that period. A large current deficit is also mirrored in reductions of liquid assets, but seems to provide no immediate stimulus to bond and stock financing. Thus, short-term borrowing and liquid assets are used to cushion bond and stock financing requirements against the short-run variation in the total deficit.

Bosworth's statistical results provide a reasonably good explanation of the recent growth in corporate bond financing. The weakness of corporate profits and the continuing strength of investment spending during the period since 1965 generated a tremendous increase in the size of the deficit requiring external financing, and that enlarged deficit, in turn, swelled the underlying need for bond financing. The sharp rise in interest rates beyond their 1968 levels held down corporate bond financing by an estimated cumulative total of $7 billion during 1969 and 1970, according to Bosworth. The record volume of corporate bond financing in 1971 has reflected both the unsatisfied backlog from 1969–70 and the 1970–71 decline in interest rates. In short, Bosworth feels that the surge in corporate bond issues can be explained without invoking special or unique developments such as the psychological scars of the tight money period, or the liquidity worries engendered by the Penn Central bankruptcy.

Looking ahead, Bosworth anticipates a mild decline in the volume of gross corporate bond issues from over $25 billion for 1971 to $22 billion or $23 billion in 1972. For such a volume to be successfully marketed, bond yields must continue to attract individual investors (as well as institutional buyers) by exceeding significantly the interest rates offered on thrift deposits. The continued willingness of households to purchase bonds will be particularly important for 1972 since mutual savings banks cannot be expected to absorb corporate bonds at the same high rate as in 1971, when their deposit inflows hit record levels.

The second article, by William H. Branson and Helen B. Junz, analyzes trends in U.S. international trade and comparative advantage. The authors first offer a bird's-eye view of U.S. trade in seven major end-use categories over the period 1925–70. In the years prior to World War II, the nation's net export position within each category was fairly stable. Capital goods and automobiles, for example, reliably yielded export surpluses that displayed no major trend upward or downward, while trade deficits were typical for consumer goods other than automobiles.

Immediately after the war, trade surpluses developed in nearly all major categories, including even such consumer goods as textiles and shoes. World-wide industrial recovery and devaluations of other currencies altered that unusual situation. By the late 1950s, the United States moved into trade deficits for fuels and lubricants and for consumer goods, and away from its substantial export surplus for automobiles. On the other hand, the net export surplus for capital goods expanded dramatically and that for chemicals strengthened. This dynamism of changes within sectors continued during the sixties: In general, the export surpluses widened in areas of strength, and deficits grew larger in areas of weakness. The latter areas deteriorated even during the early sixties when the U.S. overall trade balance was improving; by the same token, surpluses on capital goods and chemicals grew substantially during the late sixties while the overall trade balance was deteriorating. These strong and persistent structural trends within major sectors can generate substantial variability in the overall trade balance, even if relative overall prices, aggregate demand, and output trends stay in step among nations. Branson and Junz offer evidence that the narrowing of the U.S. overall trade surplus between the early and the late sixties was influenced, in part, by adverse structural forces (particularly in agriculture and nondurable consumer goods), as well as by the excess demand and general inflation in the U.S. economy.

In the final portion of their paper, Branson and Junz investigate the sources of U.S. comparative advantage in manufactured goods. Their findings confirm the well-known "Leontief paradox": Typically, the United States imports goods that are capital-intensive and exports goods that are labor-intensive, even though this nation has an outstanding abundance of capital in relation to labor. They also reaffirm a previously advanced explanation for the paradox: The vast endowment the United States has in *human* capital, embodied in the training and education of its workers, is the basic source of its comparative advantage.

Their results also provide statistical support for the "product cycle" thesis. According to this thesis, the United States tends to be a net exporter of newly invented products and then becomes a net importer as production of the good becomes standardized and moves abroad to areas of lower labor costs. The thesis implies that the United States can, and should be expected to, lose competitive position in existing and mature products and yet can hold its own on overall trade so long as new products, and hence new opportunities for export surpluses, are developed. Branson and Junz also conclude that U.S. comparative advantage tends to appear in products subject to economies of large-scale production and in products on which research and development expenditures are high.

In perspective, Branson and Junz shed light on why the United States has been unable to maintain and sustain a strong trade surplus under a set of exchange rates that fit the extraordinary situation immediately after World War II. The international valuation of the dollar that prevailed until August 1971 was basically established in 1949 at a time when the U.S. trade position had historically unprecedented strength as a result of the wartime ravages of the industrial capacity of other major nations. No mistake or mischief either at home or abroad has to be sought to account for the current need for a new alignment of exchange rates. The paper also suggests that the dynamism of structural forces within major components of trade may require continuing adjustments of exchange rates (in either direction) in the future.

In their investigation, Branson and Junz do not uncover any basic U.S. maladjustment that requires correction. But if a stronger trade position is to be sought by means other than exchange rate adjustment and trade liberalization, their findings create a presumption in favor of action to promote investment in human capital rather than physical capital.

In the third article, Craig Swan investigates the nation's supply capabilities for homebuilding by considering the adequacy of labor and materials for a further expansion of residential construction.

To focus on the issue concretely, Swan estimates the additional labor and material requirements for an increase of 500,000 housing units—another step-up of approximately the same size as that achieved between 1970 and the first half of 1971. No prediction of demand is intended; Swan is asking whether the supply side would make such an expansion feasible if it were warranted by strong demand.

In general, Swan's results are encouraging about this possibility. The supply capabilities for homebuilding seem to be remarkably elastic, reflecting particular features of the labor and material requirements for the industry. There is apparently a large group of men with construction skills and with high mobility who move in and out of construction in response to job opportunities elsewhere. When labor markets in other industries are weak, it is remarkably easy to recruit the men needed for construction jobs. In particular, the availability of skilled labor to residential construction is quite sensitive to the needs of nonresidential construction. To a large extent, homebuilders serve as secondary employers within the construction labor market, hiring a larger fraction of less skilled workers and offering less favorable wages and fringe benefits and less job security than do nonresidential contractors. Many homebuilders have developed a dual labor force, with a nucleus of highly skilled and relatively permanent workers, or "keymen," and a majority of transitory workers who are hired and trained as needed. These arrangements contribute greatly to the flexibility—and to the instability—of homebuilding employment. Because hiring and firing are less costly than in many other industries, homebuilders do not have strong incentives to stabilize their work force.

Given the current weakness of overall labor markets and the particular weakness of nonresidential building, homebuilders could readily expand their employment by the approximately 220,000 men required in the event that demand called for an additional 500,000 housing units. Indeed, such an addition would bring total employment in contract construction only to about its 1969 level. The outlook for nonresidential building is sluggish, and that sector seems unlikely to tighten the supply of labor to housing construction in 1972. On the other hand, a very sharp expansion of the overall economy could raise doubts about the feasibility of obtaining the labor needed for a further increase in homebuilding.

An analysis of material requirements for homebuilding yields a similarly optimistic set of results for all products except lumber. No bottlenecks are apparent in the case of plumbing fixtures, paint, heating equipment, clay products, or gypsum goods. In the case of lumber, however, Swan concludes that an increase in the rate of building by 500,000 housing units might raise lumber and plywood prices by roughly 15 to 20 percent, and thereby increase the average selling prices of new homes by between 3 and 4 percent.

Swan also presents evidence that an adequate supply of mortgage financing could be forthcoming to permit an additional expansion of 500,000 housing units, given the continued availability of government assistance to the mortgage market and assuming a generally favorable environment in financial markets. This conclusion takes into account the likelihood that inflows of consumer deposits into thrift institutions will fall off sharply from the extraordinary rate of the first half of 1971.

In the fourth and final major article, Lester Taylor considers differences in the response of consumers to changes in different types of income as a possible explanation for the major swings in personal saving that have puzzled economists during the last few years. The total of household disposable income is a heterogeneous mixture of after-tax earnings from wages and salaries, rent, interest, entrepreneurial pursuits, and transfer benefits such as old-age pensions and unemployment compensation. The composition of income by components has shifted dramatically in the past few years as a result of the slowdown in overall economic activity, the expansion and liberalization of government transfer benefits, and important changes in rates for personal income and social insurance taxes.

Taylor relies on an analytical model in which every dollar of income ultimately adds a dollar to consumption, but in which the time patterns of response are allowed to differ depending on the type of income earned. His statistical investigation rests on quarterly aggregate time series data and hence can explore only a limited number of possible lag patterns. In some respects, the results obtained in an analysis of data from 1953 through 1969 are striking and surprising. Taylor finds that the response of consumers in spending additional wage and salary income is similar to their response to increased property income. But, according to his statistical estimates, the immediate response to increased earnings from both labor and property income is greater than that associated with an increase in transfer payments, or a reduction in personal taxes. The low estimate of the immediate impact of transfer payments on consumption is particularly surprising. Recipients of larger transfer benefits—the aged, the poor, and the unemployed—seem likely to respond especially rapidly in spending increased incomes. Taylor points out, however, that not all transfer recipients have low incomes and those who do may respond slowly because their spending patterns are dominated by uncertainty about the future.

Taylor's statistical findings also imply that increases in social insurance taxes paid by employees initially reduce personal saving more than dollar for dollar. Since employers pay half the tax, Taylor's result could make sense if workers who pay social insurance taxes believe that the government is saving on their behalf both their tax payments and those of their employers.

Taylor emphasizes that, at this stage, his results should not be viewed as offering guidance for fiscal policy. The discussion of the paper at the conference underlined this caveat, identifying a number of analytical and statistical factors that could produce spuriously some of the puzzling results. But Taylor's pioneering exploration clearly points toward the need for further analysis of alternative sources of income and their possible influence on aggregate saving behavior. It is remarkable how well Taylor's equations, fitted through 1969, track the actual bulge in saving during 1970 and the first half of 1971 to a saving rate above 8 percent. Those same statistical estimates predict a moderate decline in the saving rate by the end of 1971 and a further movement during 1972 to a fairly normal saving rate in the range of 6 to 6½ percent.

In one of the shorter reports in this issue, Lawrence Krause, assisted by John Mathieson, estimates the impact on employment of the 1970–71 deterioration in the U.S. trade surplus. Net exports declined during the latter part of the sixties when the U.S. unemployment rate was low and falling. That decline, the author points out, did not cost the United States jobs. Moreover, in principle, the job impact of any adverse shift in the trade balance can be offset by appropriate fiscal-monetary stimulation. Only if an adverse swing is viewed as a surprise can any sense be made out of the question of its impact on total employment. Taking such a view of the reduction in the trade surplus between the first quarter of 1970 and the first quarter of 1971, Krause estimates that the net direct and indirect loss in jobs to the United States amounted to only 17,000. In part, this small number reflects the Leontief paradox that Branson and Junz discussed: On average, the employment gain to the United States per dollar of increased exports exceeds its employment loss from a dollar of increased imports. By any reasonable standard, no significant fraction of the rise in the unemployment rate to 6 percent during 1970 can be attributed plausibly to the adverse shift in the trade balance.

The remainder of this issue consists of six shorter reports devoted to various aspects of the current inflation problem. William Poole and George Perry present contrasting views on a government wage-price policy.

Poole contends that a mild, largely voluntary wage-price policy would be useless, while the costs of strict controls would be sizable and the benefits very likely slight. Among the costs of controls, Poole discusses the loss of individual freedom, misallocation of resources, and the administrative burdens of the control system. Because he feels that the economy is essentially competitive, Poole believes efforts to alter wage and price decisions that would otherwise be made will distort allocation, impair flexibility, and lead either to evasion or a huge bureaucracy of control. He also doubts strongly that a program of selective controls on large firms and unions could be effective. In some product lines, he argues, controlled firms would be unable to meet market demand or to hire required labor with particular skills. Poole points to continued shifts in relative prices during the past year as evidence that considerable price flexibility would be needed to avoid misallocations: Of the ninety-eight detailed product categories in the wholesale price index, nineteen had price increases of over 7 percent between June 1970 and June 1971, while seventeen had price declines.

In Poole's view, the economy has accomplished much of the adjustment to an inflation rate near 5 percent and a sudden reduction of that rate would, in itself, be distorting. He favors a more gradual deceleration of inflation which he believes would take place without controls and even with additional fiscal stimulus to promote a stronger economic recovery. Instead of controls or incomes policy, Poole would favor major structural reforms to enhance competition and mobility of resources.

George Perry, on the other hand, cannot accept Poole's tribute to the efficiency of competitive forces when prices and wages have continued to rise rapidly in the face of pervasive excess supplies of goods and labor. Although overly tight markets initiated the present inflation, Perry suspects that the existence of high "habitual wage standards" are now responsible for maintaining inflationary momentum. These high habitual standards have evolved from the extended period of labor market tightness, which caused rapid wage increases, and from recent large wage increases in visible union settlements that were catching up for past inflation. Because these high habitual standards of wage increases are not rooted in present excess demand, a wage-price policy could reduce them without serious risk of misallocating resources. In particular, to the extent that they can be controlled by a selectively mandatory wage-price system, the absence of tight markets and excess demands would not be likely to put the visible sectors of the economy at a competitive disadvantage for resources. And the slowing of wage and price increases in the controlled sectors would be likely to spread throughout the economy. No businessman or labor leader has had the freedom to get off the wage-price treadmill in the uncontrolled situation; only a concerted federal policy can make that possible.

Charles Schultze presents new evidence of an unfavorable shift of the inflation-unemployment tradeoff, or Phillips curve, supporting and reinforcing the findings of George Perry published in the third issue of this journal. As indicators of labor market conditions, Schultze uses data on the quit rate and the layoff rate, which are available only for manufacturing industries. For any given overall rate of unemployment, the quit rate is higher today and the layoff rate lower than would have been the case a decade ago. Thus, labor markets are tighter and wage increases more rapid than they were in the past, at a given unemployment rate. These findings underline the desirability of manpower policies to improve the functioning of labor markets and reverse the unfavorable shift in the tradeoff.

William Fellner, on the other hand, questions the conclusions reached by Perry and also those of R. J. Gordon in the last issue of this journal. Fellner commends these studies for their analysis of the changing demographic composition of the labor force toward teenagers and women and away from prime-age men. Fellner points out, however, that the quantitative estimates of the effect on inflation of these developments could pick up other forces that were simultaneously at work in the economy. In particular, if some expectational mechanism was shifting the Phillips curve adversely during the same period that women and teenagers were increasing their share of the labor force, the techniques employed by Perry and Gordon could attribute to the latter development effects actually due to the former. Fellner considers it plausible, although not demonstrable, that the structure of inflationary expectations has shifted upward during recent years. He contends that the response of policy to developing inflation in the mid-1960s was more permissive and relaxed than would have been expected from the past tradition of American economic policy. The changing stance of public policy would have altered expectations in such a way as to accelerate inflation. Moreover, Fellner believes that private decision-making mechanisms build in tendencies for inflation to accelerate at very low, though unchanging, rates of unemployment. Fellner suggests that, to the extent that more unemployment must be tolerated to prevent accelerating inflation, public employment programs are a desirable way of avoiding adverse impacts on workers who are particularly vulnerable to unemployment.

Although he does not accept either Fellner's policy prescription or his view of the inflationary mechanism in the private economy, Arthur Okun reinforces Fellner's concern that acceptance of inflation by public policy is likely to spur it. In particular, Okun rejects the case for accepting steady inflation at a 5 percent rate. While he agrees that a steady, fully anticipated inflation would impose only minor social costs, he insists that such a state is only a mirage because of the imperfect capability of economic policy and its influence on expectations. The government cannot deliver steady inflation, and its setting of a target of substantial steady inflation would tend to make price rises more rapid and less steady, Okun argues. Viewing the historical record both here and abroad, the American public has good reason to suspect both the ability and the determination of economic policy to stem inflationary booms; that suspicion is bound to be strengthened by a softening of the government's attitude toward rising prices. A target of steady inflation is not a credible policy strategy, in Okun's view. He espouses efforts, including wage-price policies, to root out inflationary biases, rather than living with inflation.

Robert J. Gordon responds to Okun, developing the case in favor of steady inflation. He argues that the institutions of the U.S. economy do adapt to inflation, once it becomes fairly steady, and thus automatically offer protection against the costs associated with accelerating inflation. He believes the government's actions in recent years have already revealed greater tolerance of inflation, and this changed stance of policy is now embedded in private expectations. Gordon also offers reasons why society might wish to continue pursuing a target of 4 percent unemployment even though the inflation required to reach it is higher now than in the past.

Responding to Fellner, Gordon feels that the statistical analyses of his own study provided a fair—although not decisive—test of the presence of tendencies in the private economy for inflation to accelerate without limit. He agrees, however, that Fellner's reservations are grounds against overly ambitious targets for utilization.

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 following are members of the panel for 1971:

Charles W. Bischoff *Yale University*
Barry Bosworth *Brookings Institution*
William H. Branson *Princeton University*
Richard G. Davis *Federal Reserve Bank of New York*
Robert J. Gordon *University of Chicago*

Robert E. Hall *Massachusetts Institute of Technology*
Arthur M. Okun *Brookings Institution*
George L. Perry *Brookings Institution*
William Poole *Federal Reserve Board*
Craig Swan *University of Minnesota*
Lester D. Taylor *University of Michigan*
Nancy H. Teeters *Brookings Institution*

These senior advisers attended the conference:

Daniel H. Brill *Commercial Credit Corporation*
James Duesenberry *Harvard University*
David I. Fand *Wayne State University*
William J. Fellner *Yale University*
R. A. Gordon *University of California, Berkeley*
Walter W. Heller *University of Minnesota*
Charles C. Holt *Urban Institute*
Saul H. Hymans *University of Michigan*
F. Thomas Juster *National Bureau of Economic Research*
John H. Kareken *University of Minnesota*
Lawrence R. Klein *University of Pennsylvania*
Lawrence B. Krause *Brookings Institution*
Franco Modigliani *Massachusetts Institute of Technology*
Warren L. Smith *University of Michigan*
James Tobin *Yale University*

Writings and comments of these guests are also incorporated into this volume:

George Jaszi *Department of Commerce*
Helen B. Junz *Federal Reserve Board*
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 T. Berenson edited the manuscript; Evelyn Fisher reviewed the accuracy of the facts and figures; Richard H. Mullins and Herbert Lowrey assisted in the research; and Mary Green and Evelyn Waltz prepared the manuscript.