bination of special factors, including a catch-up as controls broke down. Taking the controls period as a whole, the inflation rate is not surprising; between 1971:3 and 1974:1 the GNP deflator rose at an annual rate of 5.4 percent.

Basically, then, I feel that the recent rate of inflation—8.1 percent annual rate on the GNP deflator between 1972:4 and 1974:1—embodies a trend component of about 5 percent and a temporary component of about 3 percent. The need now is to avoid overreaction to the temporary component—either by accelerating money growth to validate the higher inflation or by clamping down on money growth in an attempt to eliminate inflation quickly. A stable policy cannot be sold as a guarantor of a happy outcome, but then no economist has a scientific basis for promising very much in the present circumstances. Under a stable policy, unemployment could rise to well over 6 percent, but the probabilities of such a rise are not so great as to require more expansionary policies now. Given the risks of acceleration of inflation, and given the political problems of promptly reversing more expansionary policies should they prove inappropriate, policy instruments should remain at neutral settings until there is a clear and present danger of a substantial recession. A year or two from now, the United States could do much worse than emerge from the current situation with a mild recession fading away and an inflation rate stabilized at 5 to 6 percent. In view of public preferences on both inflation and unemployment, I have little confidence that any other policies have a genuine prospect of doing much better.

Discussion

ROBERT J. GORDON began the discussion by noting the wide divergence between Tobin's and Poole's predictions of the path of the economy, given a steady 5 to 6 percent annual growth in the money supply. While Poole saw the possibility of decelerating inflation and recovery from a mild recession in a year or so, Tobin, even in his more optimistic view, had unemployment increasing until 1978. Gordon found that his own calculations tended to support Tobin's results. Because increases in wage rates could not be expected to ease markedly for a long time, the resulting rate of inflation would allow only a 2 to 2½ percent growth rate in output over a five- to ten-year period to accompany a 6 percent growth in the money supply. Unemployment would thus creep upward, as Tobin forecast. Gordon felt that the major effect of more rapid growth in the money supply—say, 8 percent—would be to hold down the unemployment rate, rather than to raise the inflation rate.

Houthakker noted recent indications that the unemployment rate, even when adjusted for changes in the composition of the labor force, is an inadequate measure of excess demand. His own preliminary research findings suggest that, in addition to unemployment, the statistical analysis should include the ratio of inventories to sales and the rate of capacity utilization. Since capacity utilization seems to have played a prominent role in the recent inflation, he saw the need for accelerated expansion of capacity and hence expressed concern over Tobin's gloomy prognosis for investment demand. In this light, Houthakker could make a case for tax incentives for business investment, though he recognized the political problems involved in obtaining such tax relief at this time.

R. A. Gordon seconded Tobin's argument for a new "social contract" with the labor unions that would obviate the need to take generally restrictive measures against inflation in food and fuel prices. He pointed to the ratchet effect that has been at work in union bargaining during the past generation: the longer the unemployment rate remains below 5½ or 6 percent, the bolder unions have been in demanding wage increases that exceed productivity increases. Michael Wachter, on the other hand, expressed pessimism as to the possibility of achieving such a social contract, pointing to the extreme diversity in the wage structure, both union and nonunion, and conflicting interests among labor leaders. He doubted that anyone could "sign the treaty" in behalf of labor.

Several points were raised regarding Poole's recommendation for a "steady-as-she-goes" posture in monetary and fiscal policy. Daniel Brill was concerned with the effects of the Federal Reserve's actions on financial markets in general and the housing market in particular. Even if the Federal Reserve bails the system out of any financial crisis, a policy of brinksmanship imposes costs on participants in these markets who are forced to hedge against crises. The costs of such hedging actions must be weighed against the benefits of restrictive policies, Brill warned. Edward Gramlich pointed out that, even if "steady-as-she-goes" is accepted, current fiscal policy must be considered restrictive by Poole's criteria, since the full employment surplus is sizable and rising. In his paper, Poole mentioned the need for a tax cut in the interest of fiscal steadiness; but other opponents of activism, concerned about the uncertainties associated with such discretionary action, would allow the surplus to rise. William Nordhaus felt that Poole's strategy was not correctly described as "steady-as-she-goes," since that label implies a desire to stabilize the current inflation rate—whatever it might be.

Thomas Juster agreed with Tobin that the general public would have to learn to live with rates of inflation higher than those experienced in the past. He was concerned, however, with inflation's adverse psychological effects, as revealed by surveys of households. The most serious of these is uncertainty about the impact on real income. Juster felt that the resentment and uneasiness aroused by high and variable rates of inflation should be considered real social costs. He also noted perverse distributional effects in favor of better-educated and higher-income groups, who are better equipped to cope with an inflationary environment.