Editors' Summary

THE FOUR PRINCIPAL articles and the report appearing in this issue of *Brookings Papers on Economic Activity* were presented at the fifteenth conference of the Brookings Panel on Economic Activity held in Washington on December 5–6, 1974. One of the papers deals with the role of the dollar in the world economy, one with the fundamental nature of the labor market in the United States, and three with different aspects of the economy's cyclical performance: the viability of thrift institutions during periods of tight money, the cyclical behavior of productivity in manufacturing, and the impact of recession on different groups in the labor market.

In the first article of this issue, Marina Whitman examines the past, present, and future roles of the U.S. dollar in the world monetary system. Under the Bretton Woods system that operated for a generation prior to 1971, the dollar was different from all other currencies in several respects. First, it served as the major world "vehicle" currency and was used by private parties abroad even in many international transactions that involved no American resident. Second, it was linked to gold by the U.S. obligation to buy and sell gold for monetary purposes at a fixed price. In contrast, other countries maintained the par value of their currencies by buying and selling foreign exchange, generally using dollars for those transactions (or "interventions"). Thus, the dollar was the intervention currency. Furthermore, it was the yardstick by which the International Monetary Fund defined the value of other currencies. It was also the major reserve currency; most of the growth of official international reserves came from the acquisition of dollars by central banks. Finally, the United States did not change the exchange rate of the dollar vis-à-vis any other currency; through this passivity, the surplus or deficit in the U.S. balance of payments was simply the mirror image of the combined imbalances of all other countries.

The era of Bretton Woods ended on August 15, 1971, when the United States explicitly terminated its obligation to sell gold for dollars to foreign central banks. While the world monetary framework now operates with informal cooperative arrangements and fluctuating exchange rates, blueprints for a new international monetary system generally envision a more symmetrical treatment of the dollar and other currencies. The United States has made clear that it intends to have the option of altering the exchange rate of the dollar vis-à-vis other currencies, and will not again link the dollar to gold. In its recent blueprint for monetary reform, the Committee of Twenty of the IMF emphasized the symmetry of rights, obligations, and criteria for conduct among nations.

Despite such proposals and despite recent upheavals in foreign exchange markets, the financial importance of the dollar has not significantly lessened, according to Whitman. In its private function, the dollar remains the major vehicle currency for the invoicing and settlement of international trade transactions. Dollar-denominated assets constituted 72 percent of private international liquidity at the end of 1973, about the same share as a decade earlier, although down markedly from the 86 percent high point of 1969. To be sure, dollar-denominated claims on Eurocurrency institutions rose in importance and those on U.S. residents shrank. But the rapid growth of the Eurodollar market itself reflects the world's desire to deal in dollar-denominated assets. In its official use for intervention by central banks, any reduction in the reliance on the dollar has been "at most marginal," in Whitman's view. Moreover, dollar-denominated assets accounted for about three-quarters of all foreign exchange reserve holdings at the end of 1973.

Thus, the dollar retains its appeal as a key currency even though its exchange rate has fluctuated widely in recent years relative to the average of other currencies, in sharp contrast with the stability before 1971. Apparently, the dominant force is the genuine benefits in efficiency that nations obtain from the acceptance of a key currency that is readily traded and exchanged at low transaction costs: the world needs a key currency, and the dollar has no serious rival for that role.

While the special role of the dollar in the Bretton Woods era conferred economic benefits, some countries felt that it also imposed heavy political costs on them. They saw themselves vulnerable to and dependent on U.S. economic developments and policies. Some contended that they lost control of their own domestic monetary policies when dollars flooded in from U.S. deficits.

The paper stresses that, in the 1970s, interdependence has clearly emerged—international financial relations are now a two-way street. Foreign trade has grown in importance for the U.S. economy; the U.S. inflation of 1973–74 was mightily affected by devaluation of the dollar. The U.S. securities market has become more exposed to influences from abroad, partly because foreigners now own so much of the U.S. public debt. The greater symmetry of interdependence should allay some of the concerns of other countries about special roles for the dollar—so long as safeguards are installed against any resumption of protracted and cumulative U.S. payments deficits.

Reviewing recent developments, Whitman sees the need for the United States to resume some kind of passive role in international adjustment to help reconcile the targets of other nations. The oil-consuming industrial countries must run a huge collective trade deficit—$60 billion to $80 billion a year—as a counterpart of the massive trade surpluses of the oil producers. If they all try to avoid trade deficits, their efforts are bound to be self-defeating and damaging to one another. The United States can help by accepting some trade deficit—within limits—and by exercising leadership to establish a framework for ensuring overall consistency on payments adjustment.

In light of her analysis, Whitman argues for some special roles for the dollar as a key currency and hence against strict and thoroughgoing symmetry. She believes, moreover, that the United States should bear some special responsibility for the international monetary system. Whitman recognizes the pressures to embody legal symmetries in any document that requires the formal approval of sovereign states. And given the tension between those pressures and the economic realities that favor some degree of asymmetry, she believes that informal piecemeal evolution is a better route to a new international monetary system than is a formal constitutional convention.

As a result of the deposit outflows from thrift institutions that occurred when interest rates on marketable securities attained unusual heights during 1973 and 1974, great concern developed about the future of savings and loan associations and mutual savings banks, which together compose an industry that holds one-third of all deposits in the country and makes two-thirds of residential mortgage loans. In the second article, William Gibson examines the viability of the industry in the face of its exposure to these rapid and massive outflows of interest-sensitive deposits, or "hot money."

Interest rates paid by the thrift institutions fluctuate much less over time than do the yields on marketable securities like Treasury bills; thus yields on thrift deposits are attractive when market interest rates are relatively low, and unattractive when market rates are high. The volatility of the deposits depends on how much and how fast people shift their savings in response to changing interest differentials—on how "hot" money is. If it is extremely hot, the viability of the industry can be threatened.

Gibson distinguishes two criteria of viability: (1) the ability merely to survive (or to avoid bankruptcy); and (2) the ability to maintain customary functions. To assess viability in both senses, Gibson examines statistically the "temperature" of the money deposited in thrift institutions. He finds that the magnitude of thrift deposits as a fraction of total household wealth depends on the interest rates on these deposits, competitive interest rates on securities and commercial bank time deposits, the level of disposable income, and the size of capital gains earned by households. The relationships show a lagged process of adjustment, which, in Gibson's view, has two components: a delay in people's perception of interest rate differentials, and then the gradual adjustment of their portfolios to these differentials. The statistical investigation also provides evidence that money has become hotter since 1965. In particular, savers respond considerably more rapidly and more substantially to movements of the Treasury bill rate in relation to the yields on thrift deposits.

Despite the sizable withdrawals during 1973 and 1974, total thrift deposits actually increased throughout the period. The growth was slow in savings and loan associations, and negligible in mutual savings banks. Still, the problems posed by slow—or even zero—growth of total deposits are not as serious as those that might develop if total deposits were actually to decline. Through statistical "experiments" or simulations, Gibson investigates how the institutions might have fared during this recent period if the swings in market interest rates had been smaller or bigger than those actually experienced.

As a worst case, he adds an extra 3½ percentage points to the actual path of Treasury bill rates and an extra 1½ points to that of commercial bank rates. In each case, that extra rise is the largest increase that the rate ever in fact experienced in a three-quarter interval. The hypothetical worst case is thus, in a sense, a double dose of the worst that has actually happened. Under those extreme circumstances, the simulation estimates that total deposits would have fallen by nearly 10 percent for savings and loan associations and by more than 20 percent for mutual savings banks. In that event, the mere cessation of new mortgage lending would not have been an adequate adjustment. The industry might not have been able to meet its cash requirements merely by drawing on its reserves and nondeposit sources of cash flow. But it takes an extreme rise in market interest rates—and the maintenance of the higher levels of rates over time—to pose such problems to the thrift institutions.

The paper also estimates how much worse thrift institutions might have fared had some new competitors that entered the scene in 1974 been established previously. One simulation supposes that variable rate notes, which were in fact introduced in the summer of 1974, had become available starting in 1971. It is estimated that these notes would then have generated added withdrawals from the thrift institutions averaging about $1½ billion a quarter during the tight money period in 1973 and the first half of 1974.

Gibson then considers three alternative ways that thrift institutions can and do adjust to deposit outflows. Assuming that they obtained the approval of the federal regulatory agencies that set ceilings on interest rates of thrift deposits, they might raise the yields to depositors in order to become more competitive with securities and with commercial banks. But for the hypothetical worst case, this would have been a very expensive strategy: the rise in yields necessary to stabilize thrift deposits would have put both the savings and loans and mutual savings banks into the red. A second alternative—borrowing from the Federal Home Loan Banks—proves to be much less costly as a means of riding out a period of declining deposits. The third alternative involves the sale of mortgages out of the portfolios of thrift institutions. For mortgages that qualify for purchase by government agencies, that technique of adjustment is inexpensive. For mortgages that have to be sold in the open market at a discount, the costs are sizable, but still lower than those associated with raising deposit rates. By efficiently using the various opportunities for adjustment, the institutions clearly could have survived even Gibson's worst case for the early seventies.

In the sense of mere survival, Gibson offers a reassuring verdict on the viability of the thrift institutions. In the sense of their ability to function as the nation's chief mortgage lenders, he offers a contrasting message: assuming continuation of present arrangements and regulations, "thrift institutions will remain prone to difficult times and disruption of their support for the mortgage market."

In the third article, Michael Wachter presents a critique of the theory of the "dual labor market," which was developed by a number of economists in recent years. The dual theory sees two more or less distinct sectors in the labor market, one offering "primary" (high-wage) jobs and the other "secondary" (low-wage) jobs. According to the dualists, the determination of wages, employment, and unemployment is distinctly different in the two sectors, and the separation between the two is maintained by barriers to movement into the primary sector from secondary jobs. Basically, they view the economy as consisting of good jobs and bad jobs, rather than skilled and unskilled workers. Their diagnosis is that good jobs are unduly scarce; and their prescription for federal policies to reduce poverty and unemployment is to create more good jobs. In Wachter's judgment, the dual literature is "rich and provocative," but he challenges many of its conclusions. Furthermore, he argues that many of its findings are better understood in the context of the traditional or neoclassical model of the labor market than in the new framework of duality.

The dualists emphasize that employers in the primary sector typically fill higher-paying and higher-rated jobs by promoting from within rather than by hiring outside their ranks. Thus they operate an "internal labor market" with well-established wage and job structures. As the dualists see it, the internal labor market keeps the "ins" in and the "outs" out. Its features develop by custom and habit and they create viable relationships between workers and employers. But the structure is not responsive to changes in supplies and demand—for example, greater availability of skilled workers does not necessarily generate more primary jobs. Nor are the arrangements dictated primarily by efficiency considerations.

Wachter disagrees with this interpretation of the internal labor market. He sees it as an "efficiency-oriented institutional response to the market forces generated by idiosyncratic jobs and the technology of on-the-job training." Workers are specialized and trained for particular jobs; once they are trained, they have genuine advantages (relative to inexperienced workers) that are valuable to their employers but would not be worth much to other firms. Hence, wage, job, and promotion scales serve important economic functions by minimizing the costs of turnover and of ad hoc bargaining. Through them, trained workers and their employers share the returns to the investment made in their skill and experience. In addition, internal promotions hold down information costs since the firm has a great deal of knowledge about its own experienced workers (as the workers do about the firm). Thus, in sharp contrast with the dualists, Wachter believes that many aspects of the internal labor market serve efficiently to stimulate and reward the development of skill.

In the secondary sector, according to the dualists, firms pay low wages and offer little or no on-the-job training or incentive for career advancement. As a result, the worker has no strong motive to remain on the job or to perform exceptionally well, and the employer has no real stake in holding on to the worker. These characteristics result in high rates of quits and layoffs, and in high unemployment rates among secondary workers, even during periods of prosperity. Such unemployment is due not to any shortage of secondary jobs but rather to the short-term, unstable character of those jobs.

Wachter accepts this description of employment and unemployment in some poor jobs, but he takes issue with the dualists in several respects. First, he cites evidence that the distribution of wages does not fit a strict dichotomy, although he finds some justification for referring to high-wage and low-wage sectors as a simplifying expositional device. Jobs come in various degrees of goodness or badness. Second, Wachter presents evidence that mobility from bad to good jobs is greater than the dualists imply. Many low-wage workers do, in fact, surmount the alleged barriers stressed by the dualists, such as racial and sexual discrimination, regional disparities, and the basic scarcity of good jobs. Third, he questions the dualists' conviction that workers now in secondary jobs generally could perform productively in the high-wage sector if they were merely given the chance. In his view, scarcity of education and training is a real problem, limiting the ability of many to function satisfactorily in primary jobs. Indeed, Wachter contends that the dualists' views on this issue contradict their own concept of "feedback effects"—whereby workers who hold bad jobs are led to adopt bad work habits because productivity is not rewarded. But, Wachter insists, once the secondary worker has developed bad habits through feedback, he genuinely becomes less productive and less trainable.

To remedy the scarcity of good jobs, the dualists urge direct government action to create more of them. They have set forth many specific proposals, including the broadening and raising of minimum wage floors, public encouragement to unionization, and direct hiring by government into an expanded high-wage public sector. In contrast to the antirecession programs of public service employment that aim to create jobs of rather low quality for those who have none, the dualists want permanent public job programs that create high-wage jobs for people now trapped in secondary jobs. Wachter sees dangers in the proposals to legislate higher wages and to create specially privileged public service jobs; he believes they might erect new monopoly positions and new shields of favoritism for particular groups of workers, thus erecting new barriers in the process of breaking down old ones. He agrees that the number of good jobs tends to be lower than the social optimum, because of the costs of information and training. But since he believes that more good jobs would emerge in response to an increased supply of skilled workers, he advocates programs of manpower training and new subsidies and taxes designed to encourage the private sector to expand on-the-job training.

Wachter's critique generated a particularly lively discussion at the conference. Michael Piore, a leading dualist, offered a sharp counter-critique, insisting that Wachter's neoclassical approach could not explain some of the critical features of the labor market because it takes technology and tastes as given. Piore also warned that a new secondary labor force was emerging in the form of illegal immigrants who meet employers' needs for bodies to fill bad jobs.

One of the persistent cyclical characteristics of the economy is the positive correlation between movements in output and movements in labor productivity. In the fourth major article of this issue, Christopher Sims reports on a careful statistical analysis of the short-run relation between output and the input of production workers in manufacturing industries that sheds further light on cyclical movements in productivity. Since labor is only one of several inputs to the production process, a simple, static view of that process would imply that a change in the amount of labor used would result in a less than proportional change in output, other things being held equal. Procyclical movements in labor productivity reflect the contrary observation of less than proportionate changes in labor input to changes in output in the short run—the condition technically described as short-run increasing returns to labor, or SRIRL.

Explanations of SRIRL recognize, directly or indirectly, a cost to adjusting labor input fully in response to short-run variations in output. Such costs can arise from contractual provisions between employers and employees, from costs of hiring and training workers, or from technical relations in the production process that make some part of a firm's work force an overhead component that cannot be efficiently varied, at least over some range of output. Sims also shows that, if firms employ labor according to forecasts of production requirements, plausible versions of how these forecasts are made will lead to relations between current output and labor employed that exhibit SRIRL.

Many of the explanations offered for short-run increasing returns to labor rely on an adjustment process that will be completed gradually with the passage of time. Some part of the firm's work force that cannot be economically expanded or curtailed in response to an immediate change in output may eventually be varied if the new output level persists long enough; Thus for some classes of labor, the existence of SRIRL may be a real but short-lived phenomenon. In selecting and working with his data, Sims pays particular attention to this time dimension of the adjustment process.

Analyzing the most variable labor input—manhours of production workers—he finds that the response of labor input to output is completed within six months, by which time manhours have been adjusted proportionately to variations in output. Short-run increasing returns to labor—less than proportionate changes—are observed during the period before this adjustment is complete, giving rise to procyclical variations in manhour productivity even for this most variable form of labor input, but only for a brief period.

In a parallel statistical analysis explaining the number of employees, Sims finds the response of employment is somewhat slower and is never completely proportional to variations in output over observed episodes of cyclical variation. Thus changes in the average hours worked per man provide a "permanent" buffer between cyclical changes in output and employment.

Sims' results cannot be extended to an economy-wide analysis of cyclical productivity movements because manhours of production workers in manufacturing are representative of only a small part of total employment in the economy. In many other employment categories, more of labor would have a relatively fixed or overhead character, with manhours and employment less variable in response to output changes than is the case for production workers in manufacturing. Thus his results are consistent with substantially larger procyclical swings in economy-wide productivity such as those implied in the aggregate relations Okun and others have estimated. His statistical results do sharpen understanding of the timing and extent of the adjustment of labor in the important manufacturing sector itself, and narrow the range of uncertainty about the nature of the employment response of firms.

Sims utilizes his equation estimates to compare the actual productivity of production workers during 1973 and the first half of 1974 against the predictions of his equations. Compared with his predictions for this interval, actual productivity consistently fell short—and by growing amounts toward the end of the period. Errors of the magnitude he observes are not unprecedented in earlier years of his observations, and Sims does not interpret the recent errors as signalling a new pattern in the dynamic behavior of productivity. Rather, he speculates that productivity in this interval was affected by the unusual difficulties of making short-term demand forecasts, an explanation that complements Okun's recent analysis (*BPEA*, 2:1974) of why the economy-wide unemployment rate rose as little as it did during the first half of 1974.

In a report appearing in this issue, Ralph Smith, Jean Vanski, and Charles Holt present a detailed analysis of how recession in 1975 can be expected to hit various demographic groups in the population. They note that it is important to identify the people who will be most harmed since programs to ameliorate or offset the impacts of recession are often targeted at particular groups in the labor market. Using a detailed model based on the process of job search and turnover in the labor market, they estimate the experiences that workers in different age, sex, and race categories would have in a deteriorating overall job market. Their analysis allows them to track the average experience of workers in each of these groups in terms of finding a job or losing one, and of entering the labor force or leaving it in discouragement.

The authors compare two situations: in one, unemployment rises throughout 1975 to a level of 8.1 percent by December, with an average unemployment rate of 7.2 percent for the year as a whole; in the alternative, unemployment is maintained at a steady rate of 6 percent throughout the year. They find that, in the worsening recession, every major demographic group would suffer deeper unemployment, but those with the highest initial unemployment rates would suffer the most. Compared with an average employment loss of 1⅔ percent for the economy as a whole, white workers in the two youngest age groups—16 to 19 and 20 to 24—would suffer employment losses ranging from 2½ to 3½ percent, and losses for nonwhite teenagers would range from 9½ to 12 percent. For workers over 25, proportional employment losses would be much smaller and would differ little for white and nonwhite workers. For young workers and women especially, these impacts on employment experience would not show up fully in the official unemployment statistics because many workers in these groups leave the labor force when job opportunities dwindle.

In conclusion, the authors note that the individuals who will suffer the greatest loss of employment are those who, on a demographic analysis, already bear the greatest handicaps in the job market. For many of these workers, particularly the youngest ones, unemployment compensation is unavailable because they do not meet the work-history requirements of the program. Well-designed public employment programs or subsidies to private employers could ameliorate the poor employment opportunities for these workers, although neither is a substitute for a good job market. The authors believe that there are serious structural problems and inequities in the way the American labor market works, and that these largely unsolved and untreated structural problems are seriously aggravated by recession.