Editors' Summary

WITH THE NATION caught in its worst postwar recession, the sixteenth conference of the Brookings Panel on Economic Activity, held on April 24–25, 1975, devoted much of its attention to the current state of the economy. One of the three articles and six of the seven reports in this issue address questions directly related to the recession, including the events and policies of 1974 and policies for the future.

James Pierce examines the recent and prospective behavior of interest rates and money demand in the third article of this issue. The first half of 1974 was characterized by soaring interest rates; the last half by a near standstill in money growth. Pierce examines this experience for evidence of a basic shift in the historic relationships among money, interest rates, and the gross national product that might carry into the future. Looking ahead, he examines the likely path of interest rates in an expanding economy experiencing the historically large federal budget deficit being projected for fiscal year 1976.

Using the SMP econometric model, Pierce finds little unusual in the relation between money demand and its principal determinants—GNP growth and the Treasury bill rate—in the first half of 1974. He does find that an unusual spread developed in this period between the rates on Treasury bills and those on private short-term instruments, such as commercial paper, certificates of deposit, and prime bank loans, all of which rose to unprecedented highs in July. During the second half of the year, the situation was reversed. Short-term rates in general fell substantially and the spread

between rates on private instruments and Treasury bills returned to normal. Money demand was surprisingly weak during this period, with the SMP model overestimating the actual demand by historically large amounts. Pierce emphasizes that the large errors in estimating money demand in the second half of 1974 are not sufficient to explain the slow growth in M_1. If more bank reserves had been supplied, interest rates would have fallen further and the money supply would have expanded more rapidly.

Pierce explores several possible reasons for the large errors in estimating money demand during the second half of 1974. He shows that an alternative to the conventional view of what motivates economizing on money balances when real income falls helps explain 1974 but worsens the explanation for previous recessions. He also shows that actual money demand was nearer predictions based on private short-term rates than predictions based on the Treasury bill rate for 1974. While this unusual spread may be another clue to the errors of 1974, it is not a factor for future projections, because Treasury and private rates have moved back into their historic relation. Finally, he finds no help in explaining 1974 in the behavior of near-money—the savings- and time-deposit liabilities of banks and nonbank thrift institutions. Errors in predicting such interest-bearing deposits were large in 1974, but offered no clear offset to the overprediction of money demand in the second half of the year. All in all, Pierce sees no reason to expect the unusual weakness in money demand of late 1974 to persist through 1975.

Pierce analyzes future money demand and interest rates against an economic forecast provided by George Perry which predicts, between the first half of 1975 and the first half of 1976, 6 percent real growth in GNP along with slowing inflation that averages a little over 5 percent. The forecast assumes that present congessional budget targets are met and the 1975 tax reductions are extended through 1976, yielding a deficit of $76 billion for fiscal year 1976. It also assumes that the money supply is allowed to grow fast enough to maintain Treasury bill rates around a 5½ percent plateau. According to the SMP model, the forecast is not consistent with the 5 to 7.5 percent range of money growth recently announced by the Federal Reserve. With such rates of money growth, interest rates could well start rising early in the expansion as money demand outpaces the money supply.

Pierce goes on to consider whether the large federal deficit in prospect and the corresponding rise in the national debt could be an *additional* force contributing to a rise in interest rates over the coming quarters. He notes

that the present state of analysis denies such an additional effect. On the basis of existing models and past performance, once real growth, inflation, and the money supply are known, the relative supplies of public and private debt do not contribute to a projection of general interest rates. Nonetheless, because the prospective deficit is especially large, Pierce explores its possible significance for interest rates through less conventional analysis.

He shows that the stock of government debt as a percent of GNP will rise, but only to 1969–71 levels, which are well below those for earlier years. Using a flow-of-funds analysis that corresponds to the economic forecast, he shows that the projected $80 billion rise in U.S. government borrowing during 1975 is almost totally offset by a $72 billion decline in the projected borrowing of other nonfinancial sectors. According to the projection, both the household and corporate business sectors sharply increase their saving or reduce their borrowing at the same time that the government's borrowing will have to expand.

Finally, Pierce considers the possibility that financial markets will become congested from government borrowing that is disproportionate to other borrowing needs. He concedes that the expected shift in the weight of the public sector in the borrowing mix could temporarily disrupt financial markets. But since even this level of borrowing does not imply a dramatic shift in the composition of the public's total holdings of credit-market debt—the share of U.S. government securities in this total will still be very low by postwar standards—any disruption will be only temporary. Interest rates on government securities may rise somewhat relative to those on private issues, but not for long. And there is no reason to suspect that this rise would push up the general level of interest rates.

Thus, Pierce concludes that the future of interest rates rests on monetary policies, as it usually does, and not on the deficit. If monetary policy proves to be much more restrictive than Perry projects, interest rates will rise and his forecast will be too bullish. This outcome would result from the conventional effects of monetary restriction and not from the large expansion in government debt.

In the first report of this issue, William Poole evaluates monetary policy during 1974, approving the performance of the Federal Reserve during the first half and sharply criticizing its actions during the second. Poole insists that any appraisal of policy should be based on the evidence available at the time the decisions were made. Reviewing the seriousness of inflation early

in 1974 and the consensus forecast of a plateau in economic activity, and stressing the historical judgment that significant accelerations or decelerations of money growth have usually proved regrettable ex post, Poole concludes that "the Federal Reserve was playing the odds correctly in the first half of 1974 by holding money growth to about 6 percent."

With equal vigor, he criticizes the sharp deceleration of money growth in the second half. Poole finds no consistent rationale for that policy in explanations provided by the Federal Reserve that stress the multiplicity of monetary aggregates and the imprecision of control techniques. All of the standard monetary aggregates decelerated during 1974, as did bank reserves, which the Federal Reserve can control quite effectively. In Poole's judgment, money grew very slowly because the Federal Reserve operates its monetary policy by pegging the interest rate on federal funds, and was unwilling to move that peg down rapidly enough to maintain money growth.

The money stock in April 1975 was 2½ percent below a 6 percent growth path projected from June 1974. Poole urges the Federal Reserve "to erase the mistake of the second half" by adding that amount to the money stock promptly, and then to maintain a 6 percent growth path until the economy has recovered sufficiently to warrant a lower trend. More generally, he recommends a reform of Federal Reserve operating procedures to focus on the rate of growth in nonborrowed reserves, and to permit the federal funds rate to fluctuate without limit.

In the report that follows, Franco Modigliani and Lucas Papademos focus on the economy rather than the money supply in their analysis of where monetary policy should go from here. In contrast to Poole, they point to tight credit markets and sharply rising interest rates reached during the spring and summer of 1974—before money growth decelerated—as the principal cause of the severe recession. And they conclude that an extended period of low interest rates is now called for to achieve the needed recovery and expansion in the economy.

The authors deal squarely with the problem of inflation in analyzing appropriate targets for the economy. Recognizing that it is urgent to reduce both inflation and unemployment, they identify 6 percent unemployment as a "conservative target" that is achievable within two years and consistent with steadily slowing inflation. They choose this interim target on the basis of statistical analysis showing that inflation will decelerate when-

ever unemployment is at or above that level, which they call the noninflationary rate of unemployment, or NIRU. In order to reach this target unemployment rate in two years, real GNP should grow at a rate of 9 to 10 percent over the four quarters to 1976:2. With the price increases that will occur over this period even as inflation slows, the target annual rate of growth for GNP over the coming year should be around 16 percent. To achieve this target, the authors argue that, in addition to fiscal stimulus even stronger than that now being projected, short-term interest rates should not be allowed to rise from current levels during the initial quarters of recovery. They estimate that, under such a policy of interest-rate stability and rapid real growth, the money supply would have to grow at a rate not much lower than 16 percent. Later in the expansion, inflation should lessen further, slower real growth in the economy will be desirable, and a rise in interest rates from present levels will be appropriate. Under those conditions, a considerably slower rate of growth in the money supply would be required.

Modigliani and Papademos specifically reject the possibility that a rapid growth in the money supply such as they advocate would foster more inflation regardless of the unemployment level achieved. They present statistical evidence showing that, while the growth of the money stock is an important determinant of the expansion of GNP, it leads to inflation only insofar as it pushes real output too high and unemployment into the danger zone below NIRU.

In the extensive discussion of the tradeoff between inflation and unemployment in recent years, analysis has paid little attention to the optimal timing of unemployment. In the third report, Edward Gramlich addresses this issue. He asks whether spreading a given total of unemployment evenly over time is more effective in fighting inflation than some other strategy might be.

Gramlich identifies two effects that must be considered. The widely accepted nonlinearity of the inflation-unemployment tradeoff argues for spreading unemployment evenly. A little more unemployment when unemployment is already high buys less price moderation than a little more when it is low. But the influence of past price changes on current inflation pushes the policy choice toward taking more unemployment now than later. Any inflation that is killed now means that much less fuel for inflation in future years as well.

Gramlich uses a mathematical optimizing model to work out the appropriate compromise between these two conflicting forces, applying it to estimates of the tradeoff and the influence of past inflation from the SMP econometric model. He concludes that, for a wide variety of assumptions concerning national priorities regarding inflation and unemployment, it is desirable to take most of any bitter unemployment medicine early and then reap the benefits by reducing unemployment steadily. In a representative example, he calculates that if policy chose to accept an average unemployment rate of 6 percent for five years in order to fight inflation, the optimal procedure would be to make unemployment 7.3 percent in the first year and reduce it steadily to 4.8 percent in the fifth. In the present situation, he argues that, having taken so much unemployment already, the economy can now take a strong recovery.

In the fourth report, Robert J. Gordon analyzes the policy issues posed by an inflation initiated by commodity shortages—like a decline in farm output or the cartelization of oil—rather than by general excess demand. If after a crop failure, for example, policymakers strive to stabilize the dollar value of GNP, they will create a recessionary decline in nonfarm output and employment. A crop reduction leads to a more than proportionate rise in farm prices and hence to a rise in the dollar value of farm output. Thus, with a constant value of total output, the value of nonfarm output is pushed down.

If, on the other hand, the policymakers seek to stabilize nonfarm output and employment, they must permit an overall increase in the price level. That inflation will be only temporary if the crop reduction is not repeated. If, however, the new relative scarcity of farm products becomes permanent and if higher food prices push up wages, a policy of stabilizing nonfarm output and employment may permanently increase the rate of inflation. In such cases, one attractive, although unfamiliar, policy option involves tax cuts that lower the consumer's cost of living; the candidates for reduction would include sales, excise, and payroll taxes. Gordon's general thesis is that the policy remedies appropriate for commodity shocks are different from those for widespread excess-demand inflation; he feels that the distinction between these two cases should be more clearly and carefully recognized.

In the fifth report, Arthur Okun reviews the adversities of the economy and the economic forecasters in 1974. He attributes the severe weakness of

consumption demand largely to an "unusual income squeeze" on the consumer. Real disposable personal income fell much more than cyclical experience would have suggested, partly because of the surge in the prices of imported oil and partly because inflation pushed up the effective rate of personal income taxes. The other sector of major weakness was homebuilding, and its collapse stemmed from the high short-term interest rates of the spring and summer. For much of the year, business hiring policies and investment in plant, equipment, and inventories were remarkably buoyant, reflecting both the momentum of the 1973 boom and a misinterpretation by businessmen of the consumer slump as a merely temporary "energy spasm." When they finally made their agonizing reappraisal, the whole economy plunged in the closing months of 1974.

Regardless of ideology and methodology, economic forecasters were generally far too optimistic. Okun points to several bearish clues that were properly recognized by at least a few forecasters during 1974: the depressive effect of the explosion in oil prices on real consumer income; indications that unanticipated inflation might depress consumer demand; the unsustainable strength of employment demand in relation to output; the inflationary threat posed by the end of wage and price controls; the dangers to homebuilding from soaring interest rates; and the growing excess of inventories in relation to final sales. Okun stresses the last element, suggesting that the signs of an emerging inventory recession of a traditional (and particularly severe) character were ignored by many forecasters, who seemed to regard the business cycle as obsolete.

George Perry also looks back at 1974, in the sixth report, but he emphasizes policy developments. Although from the start of the year, economists outside the government were warning of the depressing effect on the economy of rising oil prices, neither fiscal nor monetary policymakers took any offsetting action. Perry estimates how much difference it would have made if policies had been more responsive to the emerging danger of higher oil prices.

Perry does not seek an optimal policy mix based on perfect hindsight. Instead, he considers policy alternatives that correspond roughly to proposals that were being made during the year by analysts outside the government. The strongest of these is a $20 billion reduction in taxes effective at the start of 1974 combined with a monetary policy that holds short-term interest rates on a moderate plateau for most of the year. The forecasting version of the SMP model projects that this policy mix would have made

unemployment 1 point lower than it actually was by year-end while adding about ½ percent to the price level. Perry argues that the policy might have done even better and prevented most of the steep slide the economy actually experienced. He reasons that the SMP model probably fails to capture the extent to which a stronger economy throughout the year would have averted the overhang that developed in inventories and industrial capacity and thus would have headed off more of the correction that came in these sectors than the model projects.

The alternative policy would have required rapid growth rates in money during parts of 1974 when rising energy prices were adding sharply to the demand for money accompanying any level of real activity. Perry finds these rapid growth rates acceptable, and an unavoidable consequence of forestalling the depressing effects of rising oil prices. He also points out that support from both fiscal and monetary policy is desirable in a situation like that of 1974. He offers several reasons why, when the economy needs such a push as it did last year, it pays to use both hands.

While the panel focused on the questions posed by the current recession, it also addressed other issues of long-range importance.

In the first article of this issue, Stephen Marston presents a detailed statistical investigation of the effects of unemployment insurance on the duration of unemployment. The critics of the system argue that, by reducing the cost of joblessness to a laid-off worker, unemployment insurance encourages him to hold out for a better job than he might otherwise take and thus tends to lengthen his period of unemployment. Marston's overall verdict is that this criticism has some substance, but not enough to outweigh the many positive aspects of the unemployment insurance system.

Marston's estimates and his evidence are derived from an analysis of the total unemployment data for the nationwide sample of the Bureau of Labor Statistics and of Michigan data on the insured unemployed in the Detroit metropolitan area. In using these two sources, Marston must fit together a jigsaw puzzle with some missing pieces. The BLS data allow him to estimate the average duration of unemployment for all U.S. workers in various age-sex groups, but they do not identify the insured and uninsured jobless. The unemployment insurance data provide enough information for him to estimate the duration of unemployment for the insured in Detroit, without offering a comparable group of unemployed workers who are not insured. Using a variety of statistical models and alternative assumptions to derive

quantitative estimates, Marston concludes that, holding age-sex characteristics constant, the average insured job seeker is likely to experience a spell of unemployment that is between 16 and 31 percent longer than that of his uninsured counterpart. In part, that lengthened duration reflects the less intensive efforts and more selective behavior of those searching for jobs when they have the cushion of unemployment insurance, confirming some of the allegations of the critics. But the duration is also stretched out because the insurance system requires beneficiaries to keep looking for work. Thus, they tend to stay in the labor force (and hence in the ranks of the unemployed) until they take another job rather than dropping out as discouraged job seekers. But Marston offers no quantitative estimate of what fraction of the longer duration can be attributed to this (favorable) incentive for insured workers to stay in the labor force.

Marston applies his quantitative estimates to ask how some hypothetical alternative systems of unemployment insurance might have affected the nation's unemployment rate under conditions of a tight labor market such as was experienced in 1969. In that year the actual unemployment rate was 3.5 percent. Assuming the same number of spells of unemployment, the lower average duration in a hypothetical world of no unemployment insurance might have lowered the unemployment rate to somewhere between 3.16 and 3.31 percent. On the other hand, if the extended benefits (up to 65 weeks) instituted during the recession of 1974–75 had been in effect in a labor market as tight as that of 1969, they might have pushed the unemployment rate up to 3.74 percent.

Marston feels that these estimates cannot be extrapolated to a world of feeble labor demand and limited job vacancies such as that of 1975. Indeed, he judges that, during the recession, unemployment insurance may have held down the unemployment rate because the stabilizing fiscal effects of supporting household income "probably outweighed the adverse effects of the system on duration." But even in the depths of recession, the disincentive effect imposes some social costs which, according to Marston, are "probably manifested in less deceleration in wages" because insured workers are less inclined to accept low-paying jobs.

All in all, the paper concludes that "the existing system causes a perceptible, but small, amount of unemployment in the United States—between 0.2 and 0.3 percent of the labor force." The findings reject the arguments of both the most enthusiastic supporters of unemployment insurance, who have denied any disincentive effects at all, and the sharpest

critics, who have blamed it for a much larger amount of unemployment than he estimates. In Marston's personal judgment, unemployment insurance is "the most successful" form of income support for the unemployed, with the safeguards that make it self-policing and relatively free of scandal and with its avoidance of a humiliating means test.

Marston's findings were subjected to a thoroughgoing critique by discussants of the paper. Martin Feldstein, who has written extensively on the need to reform the existing unemployment insurance system, regarded Marston's 31 percent figure for increased duration as a plausible middle-of-the-range estimate, rather than as the upper limit that Marston judged it to be. He also stressed that Marston's statistical estimates did not include another disincentive effect—namely, the increased tendency of some employers to lay off workers whom they might wish soon to recall, because they believed that insurance benefits would keep them from taking other jobs. In his comments on the paper, Robert Hall suggested that the larger number of people engaged in search activity as a result of unemployment insurance may actually enhance the flexibility of the production process and thus increase the long-term efficiency of the economy. He also noted that most insured workers had been laid off, while most uninsured workers had either quit voluntarily or newly entered the labor force. To the extent that the length of unemployment is related to the reason for unemployment, that effect would not be distinguishable from the impact of unemployment insurance in Marston's estimates.

In the second article, Robert Solomon investigates the allocation of "oil deficits" among industrial countries of the Organisation for Economic Cooperation and Development. The quadrupling of oil prices generated current-account deficits in the balance of payments of most OECD countries in 1974. As a group, they registered a deficit of $25 billion, in contrast with their average surplus of about $10 billion in preceding years. Their collective deficit, of course, reflected the huge current surplus of the oil-producing countries, which emerged as petroleum revenues soared with only a fractional offset from increased imports by OPEC nations.

If, as Solomon assumes, the oil producers maintain some substantial current surplus for a number of years, the rest of the world will have a corresponding current-account deficit, much of which is bound to be borne by the OECD countries. Since every deficit on current account is necessarily matched by an increase in foreign debt, the industrial countries will also be

converted from lenders into borrowers. Because the OECD nations have been accustomed to current-account surpluses, because rich countries do not like to incur foreign debt, and because a current surplus has come to be regarded as a virtue, Solomon sees the possibility that OECD countries, acting individually, may take strong measures in an effort to balance their current accounts—using such instruments as devaluation, deflation, restrictions on imports, or subsidies to exports. But those actions would essentially shift the deficit among oil-importing nations and would become "mutually frustrating and destructive." Hence, Solomon sees the need for negotiations among the OECD countries to ensure against destructive measures.

The OECD nations could avoid this specter by agreeing to follow a laissez-faire prescription—not intervening in exchange markets and not engaging in direct attempts to influence capital or trade flows. This "do-nothing" strategy relies on freely floating exchange rates to provide a market solution to the problem. If the oil-exporting countries wish to invest in any OECD country more (less) than the amount of its current-account deficit, that would tend to strengthen (weaken) that country's exchange rate. At some set of equilibrium exchange rates, the intended inflow of capital would match the current deficit of each nation. But Solomon is not convinced that the resulting pattern of current deficits and capital flows would necessarily be stable. Problems arise because exchange rates affect the volume of trade only with a pronounced lag. For example, a country that initially experiences a sharp decline in its exchange rate may find the higher prices of its imports exerting a prompt inflationary effect, long before the new exchange rate significantly discourages imports (or encourages exports). The initial inflationary impact may not be reversible, and the ultimate adjustment of the volume of trade to the new exchange rate may "overshoot," producing a subsequent rebound of the exchange rate and further rounds of oscillations. In Solomon's judgment, the doubts about the laissez-faire case are sufficient to explain why governments eschew that strategy and insist on managing their balance of payments by a variety of measures ranging from official borrowing and interest rate policies to export subsidies.

The basic alternative to the laissez-faire case involves coordinated setting of targets for current deficits by the OECD countries. Solomon provides six possible criteria by which OECD members might allocate their collective deficit. Among these criteria, Solomon finds four likely to be difficult

to negotiate for either political or economic reasons. These include an allocation of the current deficit per capita in inverse proportion to GNP per capita (in an effort to allow the less affluent industrialized countries to defer their belt-tightening); an allocation concentrated on those countries that have the highest social rate of return on investment (so as to use most efficiently the increase in world saving provided by OPEC surpluses); a criterion that would concentrate the deficit in countries with the greatest potential for producing substitutes for OPEC oil; and one that would emphasize the potential of countries for expanding exports to the OPEC nations.

The two criteria that Solomon regards as prime candidates are an allocation in proportion to GNP and one that he calls "normal surpluses adjusted for oil deficits." The GNP criterion assigns particularly large deficits to big economies that can handle debt readily and would be likely naturally to attract substantial inflows of capital. The criterion of adjusted "normal surpluses" takes off from the broad consensus achieved by OECD in 1971 on the appropriate pattern of current surpluses. That figure for each nation would be adjusted for the increase in its imports imposed by higher oil prices and for the increase in its exports to OPEC nations. Solomon concludes that these two criteria merit further consideration; they seem feasible politically for a negotiated agreement and constructive economically as an alternative to the pursuit of inconsistent and destructive policies.

In light of the recent concern about long-term scarcity of natural resources, Richard Cooper reviews a set of projections of U.S. needs for materials made in 1952, when, as now, the nation was anxious about supplies. In the final report of this issue, he finds that the projections generally overestimated the needs of the economy for mineral raw materials in the 1970s. Cooper suggests that "the ratio of material input to output fell faster than [was] allowed for, reflecting technical and managerial changes . . ." He concludes on an optimistic note that the same forces of technical change will operate in the future, yielding benefits that are not foreseen in some dire current assessments.