Editors' Summary

THIS ISSUE of *Brookings Papers on Economic Activity* contains articles and reports presented at the thirty-fifth conference of the Brookings Panel on Economic Activity, which was held in Washington, D.C., on April 14 and 15, 1983. The papers address puzzles and policy issues from many parts of the current economic scene: floating exchange rates, U.S. competitiveness, labor market conditions, interest rate developments, unemployment insurance in the United States, and unemployment around the world.

MORE THAN TEN YEARS have passed since the abandonment of the Bretton Woods exchange rate system and its replacement by a regime of managed floating exchange rates. Many economists and policymakers were hopeful that a flexible rate system would simplify the problems of policymaking and enhance the performance of the international economy. In the first article of this issue, Jeffrey R. Shafer and Bonnie E. Loopesko review the experience with floating exchange rates and its implications for the adequacy of existing theories of exchange rate determination, the choice of exchange rate regime, and the conduct of policy.

According to Shafer and Loopesko, the advocates of flexible exchange rates made four principal claims: real exchange rates would be stabilized and would vary mainly in response to changes in the terms of trade between economics; individual economies would be relatively insulated against macroeconomic shocks from abroad and hence authorities would enjoy greater independence to pursue domestic stabilization; national policymakers would find it unnecessary to impose restrictions on trade and capital flows for macroeconomic reasons, thus enhancing the efficiency of resource allocation in the world economy; and current accounts would automatically be kept consistent with net capital flows which, in turn, would appropriately reflect differences in wealth accumulation and investment potential in different countries.

In the event, the past decade has been anything but tranquil and policymakers have found that floating rates are not a panacea. The period of floating exchange rates has been marked by great instability in the world economy and by relatively poor economic performance when compared with the 1960s. But Shafer and Loopesko argue that floating rates should not be blamed for most of the economic ills experienced during the period. They note that the rapid growth of the economies of Europe and Japan in the 1950s and 1960s was in part a catching up after World War II and was unlikely to be sustained; that the floating rate period inherited international disequilibrium and inflation; that the growth in international trade and Eurocurrency markets made all economies more vulnerable to economic and financial disturbances from abroad; and that the world economy suffered major oil price shocks in 1973, 1974, and 1979. Given these events, it is hard to imagine that the previous regime of fixed exchange rates was a viable alternative. Nevertheless, the troubled economic performance of the past decade has revived interest in increased intervention in exchange markets.

The authors begin their evaluation of the floating rate experience by examining the adequacy of the three major models of exchange rate determination: the flexible-price monetary model, the sticky-price monetary model, and the portfolio-balance model.

Under the assumptions of the flexible-price monetary model, the advantages of a floating rate system are most apparent. The model assumes that goods and financial assets (bonds) of different countries are perfect substitutes, thus assuring purchasing power parity—the price of traded goods is the same wherever they are produced—and the equality of expected real returns on foreign and domestic bonds. It follows that real exchange rates are stable and that nominal interest rates in different countries differ by the expected rate of appreciation or depreciation of their currencies—the condition known as uncovered (nominal) interest rate parity—and hence by the differences in their expected rates of inflation. As a result, monetary shocks in this simplest of the three models, whether from policy or any other source, can affect the nominal exchange rate but not the real exchange rate or the real interest rate.

According to the authors, as early as 1975 it was becoming clear that

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flexible exchange rates were not maintaining purchasing power parity. Perhaps more surprising, variations in real exchange rates were actually larger than they had been under the fixed-rate regime. Monetary growth itself, which might be expected to parallel inflation, was not closely correlated with nominal exchange rate movements. And a tendency became evident by 1974–75 for rising interest rates to be associated with a strong currency. All these observations, which were contrary to predictions of the flexible-price monetary model, led to the development of the sticky-price monetary model.

As Shafer and Loopesko observe, the sticky-price model was able to explain many of these observations by abandoning the assumption of purchasing power parity. According to the model, after a monetary disturbance, goods prices adjust slowly to parity while nominal exchange rates respond instantaneously, which thus leads to variations in the real exchange rate. Although the model retained the assumption that assets denominated in different currencies must provide the same expected rate of return, this no longer implied that real interest rates must be the same for all countries. Instead, differences in real interest rates were supposed to match real appreciation or depreciation of currencies. The model also provided a consistent explanation of why an increase in the nominal interest rate would be associated with a strong currency, which was not a theoretical possibility in the flexible-price monetary model. Hence relaxation of just one assumption of the flexible-price modelpurchasing power parity-appeared to accommodate most of the experience of the first three years after the adoption of floating rates.

It was not until after 1976 that evidence less favorable to the stickyprice model began to emerge, contradicting the assumption of uncovered interest parity that had been retained from the flexible-price model. This assumption has very strong implications: authorities cannot expect to influence the exchange rate by "sterilized" interventions in the foreign exchange market—that is, by interventions that do not change the stock of money; and shifts in the portfolio preferences of private investors among currencies cannot affect exchange rates. Shafer and Loopesko observe that two types of evidence contrary to the model began to surface. First, most formal tests rejected the hypothesis of uncovered interest parity; as more data became available, there was increasing evidence of systematic profit opportunities in exchange rate speculation. Second, it became increasingly apparent that actual variations in exchange rates around those implied by the hypothesis of uncovered interest rate parity were large. The theory had no explanation for the wide fluctuations in exchange rates that occurred. And it allowed no role in the determination of rates for the large cumulative deficits or surpluses in the current account or for the international diversification of asset portfolios that were occurring, although many observers believed these developments were influencing rates.

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Shafer and Loopesko show that the portfolio-balance model, which relaxes the assumption that assets denominated in different currencies are perfect substitutes, allows for the possibility that cumulative imbalances in the current account, international portfolio shifts, and official intervention all can influence the exchange rate. However, the theory allows so many potential influences on exchange rates, including unmeasurable ones such as perceived risk, and imposes so little restriction on the timing of their effects, that it is extremely difficult to test.

The authors' portrayal of the evolution of exchange rate theory as a response to the inadequate performance of successive models should not give policymakers much confidence in any particular theory. Models have had to be continuously modified to incorporate new stylized facts, and empirical confirmation of any theory has proven elusive. The authors report that, when evaluated by their ability to predict out of sample, earlier research shows structural models of the exchange rate fail for all forecasting horizons to outperform a simple random-walk model. Despite this poor forecasting record, they undertake an extensive empirical investigation to see whether within-sample statistical analysis can identify variables that are important to explaining exchange rates. They estimate a vector autoregressive (VAR) system that imposes a minimum of a priori restrictions on the relation between the exchange rate and current and lagged values of its possible determinants, and find evidence that asset market variables, price developments, and current account balances are relatively important. However, they also show that, although 60 to 70 percent of the variation in exchange rates in their sample period can be ascribed to the theoretically suggested variables, this is only 8 to 16 percentage points better than would be expected from purely random data. They conclude that much of the variability of exchange rates during the past decade remains unexplained.

Shafer and Loopesko observe that these VAR results may be too negative as tests of theory. If the exchange rate moves in anticipation of changes in other variables, and if the exchange markets possess information superior to that contained in the history of these other variables, then the exchange rate will appear to move autonomously (and to have explanatory power for other economic variables).

The authors urge researchers to focus on longer-term movements in exchange rates and not to reject models simply because they fail to explain short-term volatility. In this vein they discuss the ability of the sticky-price monetary model to explain longer-run movements in real exchange rates by real interest rate differentials. They claim some success for the model when myopic inflation forecasts are assumed, but not when it is assumed that inflation was forecast rationally in the 1970s.

Shafer and Loopesko conclude with some observations about policymaking in light of the experience of the past decade. Their work reveals great uncertainty about the key structural relations affecting exchange rates. Because of this uncertainty they advise policymakers to avoid any policy extreme—floating rates with intervention barred, fully managed rates, or fixed rates. They observe that "policies that avoid disastrous consequences under a broad range of models are preferable to policies that are optimal for a strict interpretation of one model but would serve very badly for other plausible models."

The evidence that so much of exchange rate movements is not well explained by fundamentals suggests to them that volatile market expectations and bandwagons, or unstable portfolio demands for different currencies, must be taken seriously as undesirable influences on exchange rates and thus warrant intervention. They also reason that intervention to reduce very short-run volatility in rates may be useful as a way of influencing market participants to focus on longer-run considerations as opposed to very short-run movements that command their attention when rates are highly volatile.

But the theoretical case for intervention under some circumstances is easier to make than is the case for a particular intervention strategy. The authors recognize that, to intervene successfully, authorities must sort out "inappropriate movements" in exchange rates from those changes that represent appropriate responses to fundamental changes, including domestic policy moves, and that this is difficult to do. Thus they acknowledge risks in any intervention strategy and advocate a cautious approach: they suggest that consultation among authorities from different nations would help in determining when intervention strategy.

While Shafer and Loopesko argue against reliance on fully flexible

rates without intervention, they argue even more strongly against the other extreme of returning to a system of fixed exchange rates. Policymakers can be expected to put national economic goals ahead of the supranational goal of maintaining the fixed value of exchange rates. So long as they do, fixed rates will not be sustainable. Furthermore, knowing that national goals are likely to dominate when pressures develop that require either a change in those goals or a change in the exchange rate, speculators will attack the currency under pressure in this system, as they did in the final years of Bretton Woods and as they have more recently done in the European Monetary System.

Shafer and Loopesko also stress the need to recognize the consequences of monetary and fiscal policies for exchange rates under any exchange regime. They observe that, without a balance of monetary and fiscal policies, cumulative movements in exchange rates can alter international competitive positions and affect capital formation. In particular, persistently large budget deficits in one country, checked by monetary restraint, will lead to high real interest rates, an appreciating currency, and an erosion of the competitive position of export- and importcompeting industries—a message obviously relevant to U.S. policymakers today.

THE DECADE of the 1970s is best known as a period in which inflation accelerated and productivity growth slowed. It is less widely recognized that employment in the United States grew rapidly in this period, with 20 million jobs added between 1970 and 1980. In the second article of this issue, James L. Medoff argues that the rapid employment growth and the disappointing performance in inflation and productivity were related. Wage pressure and productivity problems can arise from the difficulty employers have in satisfying their labor demands. And, he reasons, at any given unemployment rate, this difficulty is related to how fast those demands are growing. Thus, according to Medoff, even if the labor force is growing in pace with the need for workers, rapid expansion brings problems for firms. Not only does it make finding applicants with the right attributes more difficult, but training and other start-up costs must be incurred when employment expands, and discharge and quit rates are high among the newly hired.

Medoff explores these ideas in the context of Beveridge curves—the relation of job vacancies to unemployment. Vacancies reflect the number

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of jobs offered by firms, and unemployment is related to the pool of workers available to fill those jobs. Medoff shows that the national index of help-wanted advertising, which is a proxy for vacancies, rose relative to the unemployment rate for prime-age males during the early 1970s and remained high thereafter, indicating an outward shift in the Beveridge curve. He finds that similar shifts occurred in discharge and quit rates in manufacturing relative to unemployment, two other indicators of the difficulty employers experience in filling jobs and keeping them filled. Medoff regards all these changes as indicators of growing imbalance in labor markets.

Such aggregate developments could be subject to many interpretations. And in particular, the help-wanted index has been questioned as a measure of changing job vacancies through time because of possible biases in the way it is sampled and because of possible increases in the use of help-wanted advertising arising from the change in the composition of jobs or from pressure to conform with equal-opportunity hiring practices. For these reasons, and to identify more precisely the economic relations that he has hypothesized, Medoff turns to cross-sectional data using individual states and an aggregation of states into six regions of the country.

During the 1970s the Pacific and Southwest regions stand out as the areas where employment growth accelerated the most. At the same time, employment growth slowed in the Northeast and Middle Atlantic regions. Medoff finds these regional employment patterns correlate with available evidence on the imbalance of vacancies relative to unemployment across regions. He also finds that employment growth and the acceleration of employment growth in individual states help explain the increase in help-wanted advertising by state. These results are consistent with the idea that the help-wanted index is a useful proxy for vacancies and that vacancies are related to the desired change in employment by firms.

Medoff finds that the change in help-wanted advertising helps to explain the relative acceleration of wages in individual states. He also compares the relative importance of vacancies and unemployment in explaining wage behavior using cross-regional regressions and some alternative proxies for vacancy rates that were available. Although the data on vacancies are not ideally suited to the task, the cross-sectional regressions for both the 1960s and 1970s indicate that pressure on wages is better captured by vacancies than by unemployment. Medoff reasons that, to the extent that unemployment is correlated with vacancies, as it will be cyclically, unemployment will be correlated with wage growth. But when taken together with information on vacancies, unemployment does not contribute to explaining wages. In Medoff's words, to predict wage behavior "the analyst will do much better knowing about employers rather than about the unemployed."

This general verdict is supported in Medoff's time-series regressions for the growth of aggregate hourly compensation. When the aggregate help-wanted index and unemployment rate are both included in the regression, only the index is significant. Furthermore, the estimated effect of help-wanted advertising on wage inflation in the time-series analysis is very near the effect estimated from the cross-sectional regressions, lending credibility to both. Based on these results, Medoff estimates that, starting in 1973, the rate of inflation was 0.4 to 0.5percentage point higher for a given rate of unemployment-an upward shift in the Phillips curve as a result of the increased difficulty employers were having in filling jobs. Allowing for full price-wage feedbacks, the added inflation is about twice this much, or almost a full percentage point. Such an effect accounts for only a modest part of the inflation experience in the latter part of the 1970s; but it does support Medoff's hypothesis that the difficulty in filling jobs, as reflected in his various indicators, adds to wage pressures.

Medoff also turns to regional evidence for insight on the slowdown in productivity growth. In an analysis focusing on the long run, favorable productivity performance is usually identified with a high level of investment that introduces new technology and deepens capital. In cyclical analysis, productivity grows rapidly in the short run when an expansion of output and employment permits the fuller utilization of relatively fixed inputs, including overhead labor. But any such effects were dominated by other developments affecting productivity in the 1970s. Medoff finds that the regions in which employment growth accelerated during the 1970s did not experience especially fast productivity growth. At the same time, productivity grew faster than the national average in the Northeast and Middle Atlantic regions, which had the poorest record of employment growth in the period. These regional developments are consistent with Medoff's hypothesis that rapid employment growth is associated with high costs that hold down productivity performance.

Medoff's hypothesis that rapid employment growth in the 1970s has contributed to increased labor market imbalance leads him to a relatively optimistic assessment of labor market conditions in the years ahead. The annual growth rate of the labor force is forecast to decline from 2.5 percent in the 1970s to 1.4 percent in the 1980s and to 0.5 percent in the 1990s. Assuming a constant unemployment rate, so that supply shortages do not come to dominate developments in the labor market, these slowdowns in labor force growth will correspond with slower employment growth. In Medoff's analysis this will reduce the labor market imbalance that has contributed to upward pressure on wages and downward pressure on productivity during the 1970s.

AT BOTH the political and popular levels, there is a fear that the U.S. industrial sector is losing its ability to compete in the world economy. Foreign countries continue to penetrate the markets for standardized products, and now foreign competition is also challenging the U.S. dominance in products at the upper end of the technology spectrum. Extending these trends, some observers project the future of the United States as "a nation of hamburger stands." Such concerns add to the political pressures to intervene with policies of protection and subsidies such as those that have aided the automobile and steel industries, among others, in recent years. In the third article of this issue, Robert Z. Lawrence evaluates the factual basis for these concerns.

Lawrence examines the role of foreign trade in the performance of the U.S. manufacturing sector, its individual industries, and several aggregations of individual industries. Increases in trade obviously cut two ways: rising imports displace domestic production and employment and rising exports increase them. Lawrence separately examines the effects of exports, imports, and domestic demand, including the indirect effects from each on supplying industries, which he estimates using input-output tables.

The analysis distinguishes between the decade of the 1970s and the period since 1980 because policies and economic circumstances—in particular the behavior of the exchange rate—have been very different in the past few years. Between 1970 and 1980, employment in manufac-

turing grew only 4.7 percent and manufacturing output continued its long-term decline as a share of total GNP. Lawrence shows that the small rise in manufacturing employment during this decade was just accounted for by slowly rising domestic demand. On balance, foreign trade neither generated nor cost jobs. Within manufacturing, employment in high-technology industries expanded 16 percent, with foreign trade accounting for about one-fifth of the gain. Employment in the rest of manufacturing declined slightly, with job losses due to foreign trade more than offsetting a small rise in domestic demand during the decade.

Experience in some individual industries departed significantly from the broader aggregates. The problems posed by foreign competition in the steel and automobile industries were especially noticeable because of their size and prominence in the U.S. industrial scene. During the decade, employment declined by 14 percent in the steel industry, with one-fifth of the decline due to foreign trade. In the automobile industry, employment declined by 1 percent over the decade and would have grown by 10 percent without the rise in imports that occurred. In both these industries, wages at the beginning of the decade were well above the average for all manufacturing, and the gap expanded as hourly earnings rose 174 percent in steel and 144 percent in automobiles between 1970 and 1980, compared with 117 percent for all manufacturing. To an important extent, these industries priced themselves into an uncompetitive position in world markets during this period, with the decline that occurred in the dollar exchange rate only partly offsetting these higher costs and resulting higher prices. But Lawrence reasons that some longterm trend toward imports and away from domestic production in such basic industries would have been expected in any case.

Lawrence sees the gradual move toward the production of hightechnology products and away from production of other manufactured goods as a reflection of the comparative advantage of the United States in high technology. He observes that such a gradual shift in the composition of the U.S. manufacturing output is both expected and desirable. During the 1970s it occurred along with a modest decline in the exchange value of the dollar, and it happened gradually enough that employment disruptions were minimal. Trend declines in employment of 1 to 2 percent a year would not pose serious adjustment problems if they were broadly dispersed in space and time. Adjustment problems arise because, in basic industries such as steel and automobiles, the changes typically are not dispersed. They occur abruptly with the closing of entire plants during periods of economic slack.

Lawrence finds that both domestic demand and real exchange rate movements are important in explaining actual U.S. employment growth. Between 1973 and 1980, for instance—the period most affected by world oil-price shocks and different national responses to those shocks—U.S. policy was comparatively expansionary and the dollar exchange rate fell. As a result, employment in U.S. manufacturing grew modestly while it declined in every other major industrial economy. And only eleven of the fifty-two industries that Lawrence examines individually experienced employment declines due to the net effects of trade. Actual developments in these years hardly fit the image of a U.S. manufacturing sector being destroyed by foreign competition.

The situation has changed abruptly in the past few years. Between 1980 and 1982, record high interest rates in the United States adversely affected U.S. industries in two ways. By attracting foreign capital, high interest rates in the United States contributed to a 33 percent rise in the value of the dollar relative to foreign currencies, which made imports correspondingly less expensive in the U.S. market and U.S. exports correspondingly more expensive on world markets. Lawrence estimates that foreign trade accounted for at least a third of the employment decline in manufacturing in this period. And even before they affected the exchange rate and trade balance, high interest rates brought on the recession that lasted until the winter of 1982, sharply reducing the domestic demand for manufactured output.

Because of the recession and the large increase in the exchange value of the dollar, employment and output in both the high-technology and basic industries are currently well below the trend line that one would project from the experience of the 1970s. As a consequence, Lawrence estimates that employment and output in manufacturing would perform well in the remainder of the decade if the dollar's exchange rate returned to more competitive levels and, at the same time, the economic recovery was sustained.

THE LEVEL AND VOLATILITY of interest rates in recent years have attracted considerable attention among market analysts and challenged academic economists to provide a satisfactory explanation of interest rate behavior. There has been a general perception that long-term rates are higher than would be expected, given their historical relation to short-term rates and other variables that should influence expectations of future rates, and that both short- and long-term rates have shown remarkable sensitivity to unexpected growth in the stock of money. In the first report of this issue, Robert J. Shiller, John Y. Campbell, and Kermit L. Schoenholtz reexamine the usefulness of the simple expectations theory of the term structure in explaining these and other features of interest rate behavior in recent years. They also explore some possible explanations of the apparently variable risk premium on long-term bonds.

The central feature of the expectations theory is that long-term rates are assumed to reflect the entire sequence of short-term rates expected to prevail over the life of the bond. According to the theory, forward interest rates-the rates available today by arbitraging bonds of differing maturities-provide direct measures of the market's expectation of future interest rates. However, the forward rates implicit in the term structure of bond yields are a nonlinear function of these yields that cannot be solved analytically, making empirical work difficult. Shiller, Campbell, and Schoenholtz argue that a natural and useful way to describe the forward rate is to define it in the same way that basic bond yields are defined: by the yield to maturity on a loan with coupon payments made over the life of the loan. Using this definition, the authors derive an approximation of the forward rate that is a simple linear function of the underlying bond yield. They present a correspondingly simple expression for the holding-period return on a long-term bond that is sold before maturity and show that the expectations theory of the term structure can be stated and tested either in terms of forward rates or of holding returns.

The authors use their analytical framework to test the idea that forward rates represent "rational" expectations of future interest rates, that is, predictions that cannot be improved upon using information available at the time transactions are made. When the term structure is relatively steep, so that forward rates are higher than the current interest rate by more than a constant risk premium, the expectations theory predicts increases in future short-term rates. But the authors show that interest rates actually have no tendency to increase at such times. In fact they find that the current interest rate is a better predictor of future interest rates than are the forward rates derived from the term structure. Confirming earlier results of other researchers, their tests reject the

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expectations theory of the term structure and make clear that, as a practical matter, the information content of the forward rates by themselves is negligible.

The preceding results come from the simplest model of the term structure in which the risk premium is a constant. One way to attempt to resurrect the expectations theory is to introduce the possibility of a varying risk or liquidity premium. Shiller, Campbell, and Schoenholtz show that movements in risk premiums would have to be extremely large in order to salvage the expectations theory. They also explore the usefulness of various observable proxies for risk in explaining changes in the term structure. Two such proxies do help explain the change in spot rates: a moving standard deviation of short-term rates, and a measure of the volume of new issues at the short and long ends of the bond market. But when the authors integrate these risk proxies into the explanation of changes in interest rates, they find that the forward rates are still poor predictors of future rates. Hence varying risk over time does not rehabilitate the expectations theory.

The authors use their framework to study the overnight response of very short-term interest rates and the term structure of rates to the weekly announcement of the money stock during the recent period when the Federal Reserve has placed increased emphasis on achieving monetary targets in conducting short-term policy. They show that the yields on securities of all maturities have a significant tendency to increase when an unexpectedly high level of M1 is announced. This does not mean, however, that all forward rates respond since the longer-term rates reflect changes in the entire spectrum of forward rates. In fact, the authors show that the two-year forward rate, five years ahead, is the rate furthest in the future affected by money surprises. They argue that, while the response to money surprises of the federal funds rate, the shortest-term interest rate, primarily reflects the system of lagged reserve accounting, the response of longer-term rates can be explained in a variety of ways, including expected changes in future monetary policy or in money demand. Some observers have suggested that interest rates overreact to money announcements. But the authors show that, if anything, the term structure has underreacted in the past three years: the response of forward rates to a given surprise has tended to be somewhat smaller than the subsequent response of spot rates corresponding in time to those forward rates.

The authors confirm the common impression that long-term rates are higher in the 1980s than would be predicted using a conventional equation based on current and lagged rates of inflation and short-term rates. The conventional equation assumes that the coefficients on past short-term rates are constant. The authors show that when the general level of interest rates and the coupon rate on new bond issues rise, payments in the early part of the life of the bond become more important in determining its price. This means that the yields of long-term bonds should move more closely with short-term rates when interest rates are high than when they are low. However, the authors show that, even after correcting for this effect, bond yields have still been unusually high in the period since 1979. They conclude that if the historical relation between shortand long-term rates is a guide, then today, risk aside, investors should expect a higher return over any holding period from long- rather than short-term securities.

DURING THE RECENT RECESSION an unusually small fraction of the unemployed received unemployment compensation. In 1982, when the unemployment rate for all civilian workers averaged 9.7 percent, the insured unemployment rate, based on the number of workers receiving regular (that is, up to twenty-six weeks) unemployment benefits, averaged only 4.7 percent, or 5.0 percentage points lower than the total rate. By contrast, in the steep recession of 1975, the insured and total unemployment rates were only 2.6 points apart—5.9 percent and 8.5 percent, respectively. The comparison is even more striking if benefits to the long-term unemployed are included: only 45 percent of the unemployed received regular, extended, or supplemental benefits in 1982 compared with 78 percent in 1975 when a generous program of supplemental benefits was in effect. By June 1983, the fraction of unemployed who were covered by benefits dropped below 40 percent. In the second report of this issue, Gary Burtless explores why unemployment benefits have been so low in recent years.

Burtless offers a straightforward explanation for the relatively low levels of extended and supplemental benefits. In part they are low because the number of workers receiving regular benefits is low. This connection exists because the number receiving regular benefits determines the insured unemployment rate that is used as the trigger for extended benefit programs in individual states and because an individual

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must receive and exhaust regular benefits before becoming eligible for extended benefits. But more importantly, the low levels of extended and supplemental benefits reflect changes in the law. Because the trigger governing extended benefits was tightened, those benefits were available in only fourteen states by the end of 1982 and in only five states by the end of July 1983. Burtless estimates that, in late 1982, all fifty states would have been offering extended benefits under the pre-1981 law, even with the relatively low insured unemployment rate that prevailed. The law providing federal supplemental benefits for workers whose regular and extended benefits were exhausted was not renewed in the recent recession until October 1982. By contrast, during 1975–76, an average of 1.1 million workers received supplemental benefits under the program then in existence.

Burtless finds the low level of the insured unemployment ratereflecting the relatively small number of workers receiving regular benefits—much harder to explain. In principle, it could arise from a change in the composition of the unemployed away from workers who are normally eligible for unemployment compensation. These benefits are available primarily to workers who have been laid off from establishments covered by the insurance program; and Burtless shows that, until 1979, insured unemployment was well predicted by the number of unemployed job losers (as opposed to unemployed job leavers, new entrants, and reentrants). However, by 1982, 1.1 million fewer workers received regular unemployed insurance benefits than would have been predicted from the number of workers on layoff, a shortfall of 22 percent. Burtless establishes that, in the 1980–82 period, fewer job losers than expected filed initial claims. But using detailed data from the Current Population Survey, he finds nothing in the previous work experience or demographic composition of job losers in 1982 to explain the relatively low level of initial claims. And he finds no evidence that benefit denials rose. He does find some indication that the duration of benefits may have declined because workers had used up part of the maximum duration available to them in recent previous spells of unemployment.

Burtless considers legal and administrative changes in unemployment insurance that may have contributed to the decline in new jobless claims, but finds none that can explain it. Some tightening of eligibility criteria and a revised treatment of pension income appear to account for very little if any of the puzzle. And although since 1979 some portion of unemployment compensation is taxable for individuals above certain minimum income levels, Burtless finds it implausible that this change accounted for much of the decline in initial claims.

The mystery of why so few of the unemployed received benefits under the regular unemployment insurance program thus becomes largely an unsolved mystery about why so few job losers collected benefits. Burtless concludes that, because the insured unemployment rate has departed from its historical relation to job loss, it has lost its value as a sensitive indicator of conditions in the labor market. For this reason he urges less reliance on it as a trigger for the extended benefit program. In its place, he advocates that a measure of unemployed job losers be the national trigger, with insured unemployment rates used only as an index of relative unemployment conditions across states, for which other reliable data are not available.

A DEEP AND PROLONGED RECESSION increased unemployment in the United States by 4 percentage points between 1979 and 1982. In most other industrial countries, the recession in this period was only an acceleration of a malady that started much earlier: unemployment in Europe rose in every year since 1973. In the United States, Europe, and Japan there is now active debate about how unemployment would respond to expansionary policies and what costs such policies might entail in inflation. In an earlier Brookings paper (*BPEA*, 2:1979), Jeffrey D. Sachs argued that much of the unemployment in Europe during the 1970s resulted from real wages being too high, so-called classical unemployment, rather than from a deficiency of demand, the cyclical unemployment that characterized postwar recessions in the United States. In the third report of this issue, Sachs reexamines this view in the light of the experience through 1982 using a framework that allows for classical as well as cyclical sources of unemployment.

The analysis centers on a concept Sachs calls the wage gap. This is an index of the normalized labor share of total output—what the share would be, given actual real wages but with productivity adjusted to high employment levels—relative to the labor share in the 1965–69 period, which Sachs regards as the share consistent with full employment. Equivalently, the wage gap is an index of real unit-labor costs measured at high employment levels of productivity relative to real unit-labor costs

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in 1965–69. Thus the wage gap is larger with higher nominal wages and smaller with higher product prices or higher productivity levels.

In the classical model, or in the original Keynesian model, the demand for labor is directly related to real unit-labor costs, which are proxied by the wage gap. The classical idea that too high a real wage is responsible for high unemployment is equivalent to the idea that real unit-labor costs are so high that firms do not want to hire more labor. By contrast, in modern cyclical analysis, high unemployment can arise without any associated increase in real or nominal wages: firms respond to declines in demand mainly by reducing output and employment rather than prices and wages; and, once in recession, firms respond to a rise in demand by expanding output and employment, again at the prevailing real wage.

Sachs provides estimates of several key behavioral parameters showing that U.S. experience and performance differ from those of other major industrial nations in ways that could make a difference to the diagnosis of and prescription for observed unemployment. Regressions explaining unemployment rates in the 1961–81 period, with cyclical and classical effects both allowed for, are consistent with the possibility that both demand and real wages have been important at different times and in different places. The wage gap is significant for industrial countries except the United States, while demand effects, measured by the real money supply, are significant in Europe and the United States. The wage gap helps explain manufacturing prices only in some European countries. And in the United States, wages respond more gradually to previous changes in consumer prices than they do elsewhere.

Sachs attributes much of the employment weakness of the 1970s in Europe and Japan to the high level of the wage gap (or real wages), thereby confirming the verdict of his 1979 paper. But he attributes the rise in unemployment since 1979—in Europe and Japan as well as in the United States—to the policies of demand restraint that have been imposed to slow inflation. Today firms in all countries want more business at the current level of real wages.

Sachs concludes that much of the rise in unemployment since 1979 can be reversed through policies that stimulate demand. Although granting that the fear of inflation gives policymakers less room to maneuver than they have had at other times, he reasons that, in most countries, inflation should continue to decline with economic recovery and even without any reduction of the wage gap. He concludes that the high level of real wages in many countries should not now be a reason to continue contractionary policies.

Sachs is relatively pessimistic about the more difficult problem of restoring full employment around the world. He reasons that it will require a reduction in the wage gap in most of Europe and Japan where it is currently excessive and where, on the basis of his analysis, the wage gap was a source of rising unemployment during the 1970s. Recession has slowed inflation. But Sachs finds little evidence that it has significantly reduced wage gaps, let alone returned them to the zero level of the last half of the 1960s that he regards as consistent with full employment.

Because the restrictive policies of recent years have done so little to moderate real wages and have imposed severe costs in high unemployment and slow growth, he advocates policies aimed at moderating real wages in Europe and Japan more directly. However, he notes that trade unionists in the major European economies are skeptical that real wage levels are responsible for high unemployment and are unlikely to accept a reduction in real wages without an assurance that the number of jobs would expand. Sachs therefore recommends negotiations between governments and trade unions in which faster demand expansion is offered in return for moderation in real wages.

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