

Towards Full Employment and Price Stability

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TOWARDS FULL EMPLOYMENT AND PRICE STABILITY*

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I

Yet another paper on full employment and price stability would seem to be a leading candidate for prizes in the Departments of Futility and Temerity. For over a decade now we have had a persisting problem of inflation, and for most of that period the unemployment rate has also been high. The probability that after a decade any new approaches or new insights can be developed would seem to be low. If Mark Twain were writing today he would probably cite inflation and unemployment, rather than weather, as something much discussed and about which obviously little is done.

It seems equally evident, however, that questions of increasing urgency about our social and political as well as our economic future will be raised if we continue on a path offering no apparent exit from an inflation which extinguishes half the purchasing power of money in a decade and from unemployment rates which leave some groups with little hope for a change from the welfare culture to the work culture.

II

We must recognize at the outset that the world economy since the mid-1960s has been distorted by an exceptional clustering of shocks, and the sheer statistical probability that we would in the future experience such a convergence of disequilibrating episodes ought to be remote. While these are well known, they are so crucial to a discussion of our present condition that it may be useful briefly to recall them here. First in this dreary sequence would, of course, be the inflationary fiscal policies of the U.S.

*This paper (the title of which was drawn from a 1977 O.E.C.D. publication) was presented as the C. Woody Thompson Memorial Lecture at the annual meeting of the Midwest Economics Association, Chicago, April 6, 1978. Some parts of the paper were also used in the W. Frank Hipp Lecture, University of South Carolina, April 27, 1978.

government beginning in 1966, when the added taxes needed to cover increased outlays for national security were delayed for two years. This was a major factor in those upward pressures on the price level which brought the U.S. rate of inflation from a 1.4 percent average for the years 1958 to 1965 to 4.7 percent during 1968 and to 6.1 percent during 1969.

The second major shock to the world economy came in August, 1971, with the breakdown of the fixed exchange rate international monetary system. The acceleration in the U.S. rate of inflation clearly played a major role in the deterioration of the U.S. external trade balance from a surplus in the \$5-6 billion range during the early 1960s to a deficit by late 1968, and, after a brief recovery in 1969 and 1970, a return to deficits in 1971 as expansion in the domestic economy resumed after the shallow recession. Since dollars were the principal component of international reserves, and the dollar was the numeraire currency in a fixed exchange rate system, the accelerating U.S. inflation after the mid-1960s became a significant inflationary force in the world economy. We do need to keep in mind here, of course, that helping to focus this external impact of the U.S. inflation was the asymmetric tendency for exchange rate adjustments against the standard to be prompt if the problem were an overvalued currency and to be delayed if the exchange rate were undervaluing the currency. The net of these changes was, therefore, a devaluation against the standard—namely, the U.S. dollar. Thus the numeraire currency was also being pushed by the logic of the process in the direction of overvaluation. There was, in short, a systemic problem also that was interacting with the U.S. inflation to produce the demise of the structure fashioned at Bretton Woods.

The third major problem was the overly expansive demand management policies in 1972 and 1973, to which the breakdown of the international monetary system in turn contributed. The shift to a flexible exchange rate system seemingly released governments from the old discipline, imposed by a decline in foreign exchange reserves, of having to employ policies of restraint in order to correct an overheated domestic economy. In fact, governments then learned that a flexible rate system does impose disciplines of its own. Even a flexible rate system seems to require international reserves. More importantly, governments had to learn by experience the reality that a deteriorating exchange rate is a major force further aggravating domestic inflation. Until that lesson was learned, however, there seemed to be a weakened reluctance to pursue overly expansive demand management policies.

Even yet the figures look a bit unreal. By 1972 the broadly defined money stock for nine O.E.C.D. countries (the so-called “big seven,” plus Sweden and the Netherlands) was rising at the rate of about 16 percent

per year (compared with roughly 5 percent in the mid-1960s), and for six European O.E.C.D. countries the figure was 19 percent in 1972. While short-run variations between changes in the money stock (M_2) and subsequent movements in the economy can be substantial, that 16 or 19 percent rate of increase in the money stock was establishing a rate of expansion in the demand for output far in excess of the capability of these economies to enlarge output.

Finally, came the shocks from the explosion of raw materials prices. In the United States, for example, the index of grain prices rose at the annual rate of 112 percent during the second half of 1972 and another 81 percent during 1973—mirroring adverse world food supply problems ranging from droughts to the failure of anchovies to appear. This in turn was followed by the sharp advance in oil prices, which had a pervasive and profound effect on the course of economic events. These developments in raw materials prices raised the wholesale prices of industrial commodities generally 39 percent during 1973 and 1974.

III

The extent to which these developments have displaced our economies from the path of reasonably full utilization of labor and other productive resources is a painfully familiar story. Even for 1978 the O.E.C.D. Secretariat has estimated that economic growth in real terms for the twenty-four countries combined would with unchanged policies be a full percentage point below the 4½ percent required to avoid a rise in unemployment. Moreover, it is far below the “5 percent or more” which the Finance Ministers at their annual June meeting in 1976 indicated to be their target for the remainder of this decade.

Moreover, rates of inflation remain high. Rates during the last twelve months for which data are available would double the U.S. price level in ten years, in seven to eight years for France and the United Kingdom, and even for West Germany in twenty-three years. There is little evidence that adjustment mechanisms in our societies are responsive enough to avoid capricious gains and losses among people when money is losing half of its purchasing power in a decade or less, and it is the capriciousness of these gains and losses that makes them so destructive of that broad consensus so essential for our free institutions to flourish.

At the same time, the international economy is in a state of severe disequilibrium. In 1977 the current account surplus of the OPEC countries plus that of Japan and Germany was well over \$50 billion, matched by enormous deficits on the part of the United States and much of the

non-OPEC developing world. The disequilibrating forces that these imbalances have set in motion are courting the risk that any semblance of a liberal international economic order will not survive. The huge \$31 billion American trade deficit is not acceptable to other nations because of the deterioration in the exchange rate of the dollar that is its inevitable result, and it is not politically acceptable in the United States because of its displacement effects on domestic employment.

While the simple arithmetic of the problem can be misleading, it does provide insights into why this has become such a sensitive domestic political issue. From 1975 to 1977 the U.S. merchandise trade position moved from a \$9 billion surplus to a \$31 billion deficit, an adverse swing of \$40 billion. GNP per person employed in the United States is now about \$20,000. This failure of the demand for domestic output to rise as rapidly as the domestic demand for output would then arithmetically translate into roughly 2 million jobs. Obviously, this overstates the case. Some of the additional output would have come from more rapid gains in productivity and longer hours. Prices and price elasticities would have to be taken into account. U.S. demand management policies might then also have been less expansive. It is, however, probably safe to conclude that the deterioration in our trade position has left the unemployment rate at least one percentage point higher than would have been the case if the rise in the demand for domestic output had paralleled the rise in the domestic demand for output.¹ And the governments of countries which are our major trading partners (Canada, Japan, and Germany, in order) have found themselves unable to pursue the more expansive demand management policies that would have enlarged our exports. In some cases the problems were political. In others there was fear that an already difficult problem of domestic inflation would be exacerbated. In still others there was genuine skepticism about whether domestic economies would respond to more expansive demand management policies.

It is a sobering experience to view where we are today. Four decades after Keynes published *The General Theory of Employment, Interest and Money*, which provided the theoretical rationale for demand management policies, governments are not at all certain that domestic economies even respond to these instruments of policy. Two decades after Professor A. W. Phillips published his study, we can no longer seem to find a Phillips curve

¹It may be that uncertainties about how the economy would have responded "otherwise" make any judgments about the adverse effects of these developments on domestic employment of little value. Cf., for example, Gottfried Haberler, "Reflections on the U.S. Trade Deficit and the Floating Dollar," in *Contemporary Economic Problems, 1978* (American Enterprise Institute for Public Policy Research).

with sufficient stability to serve as the basis for policy judgments about inflation and unemployment. Three decades after the Employment Act of 1946 in the United States, the Beveridge Report in the United Kingdom, and comparable declarations of national economic policy elsewhere, unemployment seems to be more sustained than at any time since the 1930s. After shifting away from an international system of fixed exchange rates we find large and persisting disequilibria in the pattern of external payments—not the equilibrating processes which some of us in academic seminars and elsewhere assured the world would emerge with floating rates.

It is all enough to make one wonder if somehow we have been transmogrified into a world of non-Euclidean economics—an economic world where, in the language of geometry, parallel lines intersect, and a straight line is the longest distance between two points.

IV

The record of recent years should at least drive one lesson home to us. Unless we approach the problem with a fundamental alteration in basic strategy, the probability of finding the route to a greater stability of the price level is low. Indeed, general economic policy in the period ahead must make substantial headway toward a lower rate of inflation if we are to hold even. We must assume that the real price of energy will continue to rise. And the change in the exchange rate of the dollar, though not as large as dramatic changes against the yen or Swiss franc would imply, can still be expected to add a half a point or so to the domestic price level.

Numerous ingenious approaches have been proposed, and with a problem that has been so persistent and has become so urgent these quests are to be encouraged. The purpose of this paper, however, is not to review these proposals. Most of them are variants of what have been called by the elastic term “incomes policies,” and the evidence from experience about their effectiveness is not encouraging. Programs covering the spectrum from admonition and voluntary restraint to outright wage and price control (which is simply a particularly severe form of income policy) have all been tried before. Most empirical studies have produced inconclusive results about the effectiveness of incomes policies, and even outright controls do not seem to show us the route to a more stable price level. The rate of inflation in Canada, for example, is higher than ours, and our own recent experience with these controls was no more encouraging. The O.E.C.D. study of experience with these programs in the industrial countries summarized its findings as follows: “The record seems to show fairly clearly that price incomes policy of both the national bargain and guidelines variety has succeeded in restraining price rises for periods of up to

one to two years. . . . To what extent any long-term success has been achieved, is, however, more doubtful and controversial.”² John Dunlop arrived at much the same conclusion as he evaluated our own controls program in the 1971-1973 period.³

Where, then, do we turn? If we are to achieve a more stable price level, what are the elements of a strategy for policy that would be effective? One thing by now should be clear. Since what we have been doing has brought us to persistently high rates for both inflation and unemployment, we must be prepared to move in directions that will in some respects seem to be strange and perhaps even harsh to what has come to be the conventional wisdom of contemporary economics.

The first and most fundamental requirement is a set of demand management policies that would produce a persistently declining rate of increase in the nominal volume of economic activity. This should persist until the 5 to 6 percent per year pace is reached that would be consistent with the growth in productive capacity, plus a rise in the price level that would be little more than the unmeasured improvements in quality. The trail blazed by demand management policies is the basic path along which the economy tends to move somewhat later. The simple ratio obtained by dividing GNP into the money stock somewhat earlier is one of the more stable relationships in economic analysis. The response mechanisms of the economy also seem to react in reasonably rational ways to changes in fiscal policy—no unambiguous measures exist for calibrating fiscal policy and its changes. The most analytically unambiguous measure would be the annual rise in outlays from legislated program changes plus the revenue value of tax rate reductions, but no time series for these data exist. In any case, the economy in nominal terms is not apt to stray far from the basic path traversed somewhat earlier by demand management policies.

Demand management policies could be managed in a much more sure-footed way if we increased the resistance to strong pressures for channeling a growing proportion of the national income through the public sector. For most countries the secular rise in the ratio of public outlays to national income accelerated sharply early in this decade, and for several countries the ratio now exceeds 50 percent. In the Netherlands, for example, it is hoped that during the years ahead the rise in public outlays can be limited to not more than 75 percent of the rise in national income. The large

²*Inflation: The Present Problem* (O.E.C.D., 1970), p. 37.

³See John T. Dunlop, *Statement Before the Subcommittee on Production and Stabilization of the Senate Committee on Banking, Housing and Urban Affairs*, February 6, 1974, p. 31.

deficits do tend to impede the management of monetary policy, and tax rate increases produce fiscal push inflation as both individuals and businesses resist the prospective reductions in take-home incomes—either resisting higher tax rates or compensating for them by higher wages and prices.⁴

If governments are quite explicit about the path along which these policies will be moving, they will have served notice on those responsible for wage and price decisions that there will be top-side discipline. And if governments stay with this strategy—as during an interim period some wage and price increases are “too large” for the market to accommodate, and this can be expected to occur—the conviction will grow that this discipline is a reality with which prices and wages must come to terms. If we are ultimately to regain lower rates of inflation and unemployment, it is, of course, essential that the managers of economic policy be prepared to stand firm in their demand management strategy even as further slack develops in the economy.

Here some contemporary arithmetic has been troublesome. The logic goes something like this. Inflation is running at a 6 to 7 percent rate. We also want, say, a 4½ to 5 percent increase in real output in order to absorb projected increments in the work force and to reduce somewhat further the unemployment rate. The objective of demand management policies, therefore, should be an increase in nominal GNP at something like an 11 to 12 percent rate. Or a slightly more ominous formulation is to urge that we be willing to accept yet some further rise in the rate of inflation in order to achieve a lower rate of unemployment. We then profess mystification that somehow it all works out so that we seem to be stuck at the current rate of inflation. “When we lack the will to see things as they really are,” Irving Kristol once wryly observed, “there is nothing so mystifying as the obvious.”⁵

The literature laying out the theoretical analysis for expecting that the end result of this strategy would be an outward-looping Phillips-type relationship leading to high rates of both inflation and unemployment is extensive and needs no belaboring here. What is indisputable is that, in fact, we have arrived at a situation in which the “discomfort index” (the sum of the rates for inflation and unemployment) is moving along levels that a decade or so ago would have been thought highly improbable.

⁴Cf. G. Warren Nutter, *Growth of Government in the West* (American Enterprise Institute for Public Policy Research, 1978).

⁵Irving Kristol, *On the Democratic Idea in America* (New York: Harper and Row, 1972), p. 90.

Now if a strategy of at least accepting the current rate of inflation as a point of departure, or *de facto* being willing to accept yet a little more inflation so as to make what we hope will be some progress against unemployment, has landed us in a situation of unacceptably high rates for both unemployment and inflation, simple logic would suggest that reversing our policies might be the route to reversing the direction of our movement along this outward-looping Phillips relationship. It might, in short, be the path leading to lower inflation and lower unemployment. This means demand management policies that permit a decreasing rate of expansion in the nominal volume of economic activity. Moreover, policies must persist on that course, forcing the price-cost level to come to terms.

This was the logic of the report to the Secretary General of the O.E.C.D. by an international committee of economists: “. . . governments should make it clearer when framing, explaining and executing their policies, that they will not—and in the end, cannot—pursue policies which will permit or accommodate high rates of inflation. . . . Somewhat paradoxically, therefore, we believe the route to sustained full employment lies in recognizing that governments cannot guarantee full employment regardless of developments in prices, wages, and other factors in economic life.”⁶ This, to repeat, is a strategy for unwinding the looping cycle of sustained high rates for both inflation and unemployment that have been, however unintended, the result of the strategies that many industrial countries have been following.

History provides some support for the view that such a strategy in fact will work. It has been central to the disinflationary process by which the U.K. government has brought the rate of inflation down from the 25 percent zone to well under 10 percent. The industrial countries who through this period have pursued moderate demand management policies seem now to be in the best position for a sustained expansion. In the United States during the early part of this decade demand management policies which did not accommodate the accelerating inflation, which had it continued would have brought the rate of inflation to the 8 to 10 percent zone in 1971, in fact halted the acceleration and started an irregularly declining movement in the price level (well before the imposition of wage and price controls).

For this strategy to work, however, there must be a time dimension in our judgments about policy. Policies must be judged in terms of whether they ultimately bring the economy to a condition of lower inflation and

⁶*Towards Full Employment and Price Stability* (O.E.C.D., 1977), pp. 184-185.

unemployment, not in terms of the economy's immediate responses. Policies must, in short, be evaluated in terms of the "present value" of their future results over a more extended period of time. Here skepticism would be easy to come by because of the short-term horizon imposed by the election calendar, and no one who has been involved in the actual processes of government is apt to forget this. There are, however, some favorable omens. The citizenry has learned to be suspicious of short-term favorable results from policies that carry a high probability of producing longer-term problems. And the time has long since passed when rhetoric, cosmetics, and posturing can be expected to have any credibility. Governments are now taking a more medium-term view in their management of economic policies.

There is, in short, growing recognition that tackling the problems frontally is both the only effective strategy and perhaps the politically better procedure. The U.K. government's disinflationary program was not the usual recipe for political popularity, but it may have turned out to save the Labor Government politically. The president's Budget Message now does contain five-year projections, providing greater capability for an analysis of the longer-run implications of fiscal programs. In international discussions, governments are at least discussing the requirements of policy within the context of a medium-term horizon.

This longer time dimension for the evaluation of economic policy is an imperative for a good economic performance. If policy is to be judged only in terms of its initial effects, we shall remain on the outward-looping path that maintains high inflation and high unemployment—this because the interim effect of overly expansive policies will be expanded output and employment, followed then by higher inflation and unemployment as these pressures move on through to the price level. Conversely, the initial result of demand management policies that do not give way before price-cost pressures is apt to be the emergence of more slack in the economy. The magnitude of this slack is apt to be related to the duration of the inflation and the resulting firmness with which expectations of further inflation are held. The present value of future economic slack and unemployment, however, will be reduced by this policy of nonaccommodation to inflation, and managers of economic policy seem to be coming to this view.

The government that is not willing to accept more immediate slack in the economy as the route to an ultimate condition of lower unemployment and a more stable price level is, in fact, choosing to live with chronically high inflation and high unemployment.

Within this general framework for macro-policies, major scope remains for an active agenda of programs to improve the economy's adjustment and response mechanisms, thereby reducing the period required to re-establish the basis for lower inflation and unemployment. In the period ahead much of the analytical resources and capability should properly be devoted to so-called micro-programs. Whether Wordsworth had power of attorney to speak for On High may be debatable, and he was not at that moment really giving a lecture on economics, but he did capture the essence of economics when he declared:

. . . high Heaven rejects the lore
Of nicely calculated less or more.

Micro-analysis is the essence of our discipline. If a time card were kept by the Council of Economic Advisers, including the chairman, it would show that most of the man hours and effort expended by advisers on economic policy is on so-called micro-problems. And that, to repeat, is as it should be—not only because micro-theory and micro-analysis are the essence of economics, but because therapeutic actions here can contribute substantially to a better performance of the economy in terms of unemployment and inflation.⁷ And the growing literature providing the results of research and analysis on these matters will increasingly influence the direction of public policy. We are all familiar with Keynes's observations about the ultimate power of ideas, but Marshall put the whole matter in perspective when he observed:

. . . it is worthwhile to notice that the full importance of an epoch-making idea is often not perceived in the generation in which it is made: it starts the thoughts of the world on a new track, but the change of direction is not obvious until the turning point has been left some way behind. . . . Thus it is that each generation seems to be chiefly occupied in working out the thoughts of the preceding one; while the full importance of its own thoughts is as yet not clearly seen.⁸

By definition, the list of micro-problems whose solution would contribute to a better macro-economic performance is unending, but two sets of concerns deserve specific comment here. First, public policy urgently needs more solid theoretical and analytical work on how to make labor markets

⁷Ibid., ch. 9.

⁸Alfred Marshall, *Principles of Economics*, 8th ed. (New York: Macmillan), pp. 170-171, note.

work better. One dimension of this has to do with the optimum agglomeration of power in labor markets. No one would pretend that either the theory or the present state of policy regarding agglomerations of power in product markets has reached perfection, and it may even be that these policies are now at war with themselves.⁹ There is, however, at least a theory of product markets to indicate in principle the direction in which policy should be moving to improve market performance. When it comes to agglomerations of economic power outside product markets we are without a theory, without a policy, and even without much courage for the intellectual work which must be antecedent to good policy. While strongly focused interest-group pressures would certainly make movement on these matters hard to achieve in the political arena, those in political life can reasonably observe that the competition of ideas which constitutes the vigorous intellectual work that must be antecedent to public policy decisions has been scanty. It is interesting to note that in the United Kingdom, a more laboristic society than ours, there is a vigorous intellectual discussion of this issue.¹⁰ Lacking this, governments are driven to exhortations for restraint, a vacuous effort predictably devoid of results.

We must also recognize that endeavors to implement through a compression of income differentials society's concerns about the proper distribution of income have had a capricious distribution effect, and they have also tended to give us higher unemployment and inflation relative to basic aggregate demand pressures. There is substantial agreement among economists, for example, that an escalating minimum wage increases youth unemployment and the rate of inflation. Skill wage differentials are now often too small to assure the supply of skilled labor required to achieve the economic expansion needed for low unemployment rates among the unskilled. The fact is that efforts to use the pricing system for redistributing income are apt to produce the twin vexations of an arthritic pricing system and a capricious program of income redistribution.

Another set of micro-developments that has been crowding the rate of inflation upward relative to the level of unemployment has to do with the whole array of programs and regulations channeling resources into uses that do not increase measured output. Denison estimates that regulations regarding pollution, environment, and safety and the rise in dishonesty and crime had by 1975 reduced the annual gain in output per unit of

⁹ Cf. Robert H. Bork, *The Antitrust Paradox* (New York: Basic Books, Inc., 1978).

¹⁰ Cf. Peter Jay, "Employment, Inflation, and Politics," Sixth Wincott Memorial Lecture (Institute of Economic Affairs, 1976); also the series of papers, particularly that of Lord Robbins, in *Trade Unions*, International Economic Association, 1978.

input by 0.5 percent, relative to rules of the game a decade earlier, and that the reductions have been rising rapidly in the 1970s.¹¹ This is broadly consistent with the analysis by the Council of Economic Advisers in their annual report, finding that private nonfarm productivity since 1968 has been rising (on a cycle-adjusted basis) at the rate of 1.6 percent per year compared with 2.5 percent for the period 1950-1968.¹²

Clearly, government has become the source for a new administered inflation, and it is of major proportions. This will require a much more careful cost-benefit analysis to avoid programs and regulations, in the aggregate by now of substantial economic significance, whose social costs exceed benefits. To the extent that the social benefits are deemed to be worth the economic costs, institutional arrangements must reflect this decision of society. If these costs show up as higher prices for output, for example, incomes cannot then be adjusted upward by the full extent of a price index that reflects these costs. We need, to be specific, a purified price index measuring the increase in prices relevant to cost-of-living escalators in wage agreements, and it ought to exclude changes in the price level because import prices rise, because sales and excise taxes are increased, or because higher product prices are reflecting mandated increases in costs, and it seems clear that we must be thinking in terms of an improvement factor roughly a full percentage point lower than the 2½ percent per year that we have assumed to be our economic birthright.

In any case, it has become clear that government actions themselves have become a major source of administered inflation in the quite meaningful sense of actions that directly push costs and prices to higher levels. Demand management policies that by brute force would endeavor to hold the general price-cost level stable in the face of these programs would then find this government-administered inflation producing for us an unpalatable combination of unemployment and distortions in the use of economic resources.

VI

All of us are acutely aware that there is an international dimension to our present unsatisfactory economic condition, as already discussed briefly earlier. Here there is a clear interface between the industrial and the developing economies. In their report, the O.E.C.D. committee of economists,

¹¹ Edward F. Denison, "Effects of Selected Changes in the Institutional and Human Environment Upon Output Per Unit of Input," *Survey of Current Business*, January, 1978, pp. 21-44.

¹² *Economic Report of the President, 1978*, pp. 146-147.

to which I have already alluded, estimated that trade restrictions which would sharply reduce the rate of increase in O.E.C.D. imports from developing countries could reduce growth rates of these lower-income countries by 1½ to 2 percentage points per year. Since this would be \$15-20 billion per year of output and income for them, continued access to markets of the industrial countries is far more important than aid from the mature economies.¹³ (Aid, however, may be more important to the bureaucracies of these countries than the widely diffused additional income from added exports.)

The current international disequilibrium does complicate the problem of achieving higher operating rates for the work economy, and it is a systemic problem, not just a weak dollar problem, for the United States to fix. It is obviously not simply reflecting the fact that an intransigent Congress has failed to pass the president's energy plan. Passage of the president's energy plan would not have altered 1977 oil imports in a significant way. Indeed, the plan was deficient on the basic issues of higher prices for natural gas and oil and on the objective of developing alternative energy sources to supplant oil imports. In any case, the rise in non-oil imports during the last two years accounted for 60 percent of the increase in total U.S. imports. And U.S. exports last year would have been \$20 billion higher (two-thirds of the merchandise trade deficit) if the rising trend in U.S. exports as a percentage of GNP had not reversed itself after 1975.

This points to one aspect of the problem that the U.S. administration has correctly emphasized: the sluggishness of most industrial economies relative to that for the United States. Unemployment is higher in most of these countries than in the recession year of 1975. And, as pointed out earlier, the O.E.C.D. Secretariat has projected, with unchanged policies, only a 3½ percent growth rate for the area in 1978 (decelerating through the year), a full percentage point below the 4½ percent that would be required to avoid a further rise in unemployment.¹⁴

Moreover, it is other countries, not the United States, whose rate of domestic expansion has fallen far short of their own projections a year ago.

¹³Cf. O.E.C.D., *Towards Full Employment and Price Stability*, pp. 228-229. From 1965 to 1974 O.E.C.D. imports of manufactured products from developing countries increased about 20 percent per year, and by 1974 were equal in volume to ¾ of a percent of O.E.C.D. industrial production. If these trends continued, their share might rise to 1½ to 2 percent by 1985. If these imports were, instead, to grow at only 6 percent per year, the growth rate of these countries could be reduced by 1½ to 2 percentage points per year.

¹⁴*Economic Outlook* (O.E.C.D., December, 1977), p. 19.

That these differential rates of expansion would tend to produce for the United States relatively strong imports and weak exports is not surprising. That such a pattern of trade would move the exchange rate of the dollar lower would certainly also be in accord with economic principles.

Table 1
National Forecasts and Realized
GNP Growth for 1977

| <u>Country</u> | <u>Change from</u> | <u>Early 1977 Forecast (percent)</u> | <u>Realized (percent)</u> |
|----------------|----------------------------|--|-------------------------------|
| United States | Fourth qtr. to fourth qtr. | 5¼ - 6 | 5¾ |
| Canada | Year to year | 3 - 4 | 2¼ |
| France | Year to year | 4.6 | 2¾ |
| West Germany | Year to year | 4½ - 5 | 2½ |
| Italy | Year to year | 2.6 | 2 |
| Japan | Fiscal year to fiscal year | 6.7 | 5 |
| United Kingdom | Year to year | 1.2 | ½ |

Source: *Economic Report of the President, 1978*, p. 107. Some of these "realized" figures have subsequently been revised, but the basic point remains.

One has the feeling, however, that what we have been seeing at work here is broader than what is implied by these specific arguments. There does still seem to be a systemic problem. With the shift to a managed-floating system, the International Monetary Fund has endeavored to provide some common sense "rules of the game." Actions to adjust should be symmetrical as between surplus and deficit countries. Deficit countries should free resources for more exports by restraining domestic demand. Surplus countries should assure a stronger expansion of domestic demand. And appropriate adjustments in exchange rates must be a part of the adjustment process.¹⁵ Yet it is equally clear that if these are the rules of the game, then nations are playing some other game.

The conclusion cannot be avoided that the processes which were supposed to accommodate international differences in rates of growth, in rates of inflation, and in a myriad of other factors have not functioned well.

Professor Marina v. N. Whitman summarized this issue well:

The shift in the exchange-rate regime from pegged rates to managed floating was successful in introducing greater

¹⁵ See *Annual Report for 1977*, International Monetary Fund, p. 12.

automaticity into the payments adjustments mechanism. But much of the operational asymmetry of the Bretton Woods system, arising from the key-currency role of the dollar, remains. And the insulation flexible rates provided against external disturbances is more limited than many had anticipated.¹⁶

We face here a three-way choice. We can develop the stronger “rules of the game” that will apparently be needed to make the floating rate system effective. We can return to a fixed rate system. Or we can let matters drift, which will probably mean continuing disequilibria and a retreat toward direct controls as governments attempt to deal with external payments imbalances. We are, in fact, close to being on that third track now.

VII

These comments have ranged over a wide area, and the time has come for some concluding remarks. The indispensable requirement for a more orderly world economy is for the industrial economies to arrive at a condition of lower unemployment and inflation. About this there would be little dissent. Is it reasonable to expect that this condition can be achieved? History is at least moderately encouraging. From 1900-1929 the U.S. unemployment rate averaged 4.7 percent and the consumer price index rose at the average rate of 2.5 percent per year. The figures were similar for the years 1948-1966: 4.8 percent and 1.7 percent, respectively. In the final analysis our success in regaining a better performance will depend on whether we are willing to persist with policies that do not accommodate to inflation, and whether directly administered increases in the cost-price level by government can be moderated. In both areas the managers of economic policy could use some help from economists.

¹⁶Marina v. N. Whitman, “Coordination and Management of the International Economy: A Search for Organizing Principles,” in William Fellner, ed., *Contemporary Economic Problems, 1977* (American Enterprise Institute for Public Policy Research, 1977), p. 290.