

A Guide through Macroeconomics for the Busy Policymaker



THE BROOKINGS INSTITUTION WASHINGTON, D.C.

CONTENTS

INTRODUCTION 1

PART BACKGROUND 11

MEMORANDUM 1
The Supply and Demand for National Output 13

memorandum 2

Supply, Demand, and the Importance of Knowing the Difference 27

memorandum 3

The Nation's Income and Output: The Basic Structure 35

MEMORANDUM 4

National Saving and Investment: Why Are They Important? 45

PART 2 MANAGING DEMAND 55

MEMORANDUM 5
What Causes Recessions and Booms: An
Overview 57

MEMORANDUM 6
The Behavior of Consumption Spending 65

MEMORANDUM 7
The Behavior of Investment 73

MEMORANDUM 8

Interest Rates as a Stabilizing Force—and Why They Are Not Always Sufficient 86

MEMORANDUM 9

Exports, Imports, and International Investment 96

MEMORANDUM 10

'Exchange Rates, the Trade Balance, and the U.S. Economy 107

MEMORANDUM 11

Inflation: History, Measurement, and Economic and Political Costs 120

MEMORANDUM 12

The Causes of Inflation and the Inflation-Unemployment Trade-off 129

MEMORANDUM 13

The Stubbornness of Inflation and Its Consequences 142

MEMORANDUM 14

Unemployment: Who, How Long, Why 153

MEMORANDUM 15

The Full-Employment Level of Unemployment 160

MEMORANDUM 16

Monetary Policy: The Tools of the Federal

Reserve 172

Memorandum 17
Monetary Policy: What It Can and Cannot
Do 183

MEMORANDUM 18
Fiscal Policy: The Federal Budget and Its
Stabilizing Features 196

MEMORANDUM 19
Fiscal Policy: Using the Budget to Influence
GNP 207

PART 3 INCREASING SUPPLY 217

MEMORANDUM 20
The Supply of GNP: The Fundamentals of Long-Term Growth 219

MEMORANDUM 21
The Sources of Economic Growth and How Important Each One Is 227

MEMORANDUM 22

Saving, Investment, and Capital Formation 236

MEMORANDUM 23
Raising National Saving and Investment: A
Target for the 1990s 247

MEMORANDUM 24
Increasing National Saving and Investment:
Some Guiding Principles 255

MEMORANDUM 25
Raising National Saving and Investment I: The
Economic Consequences 268

memorandum 26

Raising National Saving and Investment II: Tax Changes and Their Effects 278

MEMORANDUM 27 Education 290

MEMORANDUM 28
Technological Advance 299

PART 4 SUMMARY 307

MEMORANDUM 29

A Summary of These Memos and How They
, Differ from What Others Might Have Told
You 309

Index 325

Tables

- 2-1: Promises and Performance 32
- 3-1: Shares of GNP 41
- 9-1: Components of the U.S. Balance of Payments, Current Account Balance, 1979, 1990 98
- 14-1: Alternative Measures of Unemployment, Third Quarter, 1990 155
- 14-2: Selected Characteristics of the Unemployed, October 1990 157
- 16-1: How the Federal Reserve Creates Money 175
- 18-1: The Different Kinds of Government Spending 197
- 18-2: The Major Types of Federal, State, and Local Income Taxes, 1990 202
- 20-1: GNP Growth since 1870 223
- 21-1: Sources of American Productivity Growth, 1929-82 230
- 22-1: Capital Stock and Investment in the United States, 1989 238

- 22-2: Uses of U.S. Business Investment, 1987-90 245
- 23-1: Federal Budget Overall Deficits, 1992, 1997 250
- 23-2: A National Saving Target for the 1990s 252
- 24-1: Meeting the National Saving Target 266
- 27-1: Income Disparity by Years of Schooling 291
- 28-1: Sources of Support for U.S. Nondefense Research and Development by Type 300
- 28-2: Government Support for Civilian Research and Development, 1987 304

Figures

- 1-1: Potential and Actual GNP, 1965-90 20
- 1-2: Potential and Actual GNP, 1870-90 24
- 4-1: The Collapse of National Saving, 1959-90 46
- 4-2: The Components of the Collapse in National Saving, 1959-90 47
- 4-3: The Relationship of National Saving and Investment 48
- 4-4: Adjusting to a Lower Saving Rate, 1959-80, 1989-90 50
- 5-1: The Average Volatility of GNP and Its Components 61
- 6-1: The Behavior of Consumer Spending and Saving, 1950-90 66
- 6-2: Consumption and the 1987 Stock Market Crash 71
- 7-1: The Volatility of Investment 75
- 7-2: Actual versus "Permanent" Sales 77
- 8-1: Change in Short-Term Interest Rates before and after Business Cycle Peaks 88
- 9-1: U.S. Exports, Imports, and Trade Balance as a Percent of GNP, 1948-90 97
- 10-1: Interest Rate Differentials and the Exchange Rate for the Dollar 110
- 11-1: Inflation and the Change in Unemployment One Year Later, 1960-90 121
- 11-2: Consumer Price Inflation, 1946-90 122

- 11-3: A Change in Inflation versus a One-Shot Price Increase 124
- 11-4: Annual Average Inflation versus Average Variation of Inflation, Selected OECD Countries, 1961-90 127
- 12-1: Major Elements in the Process of Inflation 132
- 12-2: Unemployment in the United States and Europe, 1960-90 136
- 12-3: Inflation and Energy Prices, 1970-90 137
- 14-1: The U.S. Unemployment Rate, 1948-91 154
- 15-1: Unemployment versus the Help-Wanted Index, 1971-89 165
- 15-2: Excess of the Total Unemployment Rate over the Rate for Prime-Age (25-54) Male Workers, 1948-90 167
- 15-3: The Actual and Full-Employment Level of Unemployment 169
 - 17-1: Real Interest Rates, 1951-90 191
 - 17-2: Changes in Real Short-Term Interest Rates in the 1980s 192
 - 19-1: Alternative Measures of the Federal Budget Deficit 208
 - 20-1: Two Kinds of Changes in Productivity 222
 - 20-2: The Growth of Real Wages and Family Income, 1955-90 225
 - 22-1: The Effect of a Rise in the Investment-GNP Ratio 240
 - 22-2: Capital Accumulation and Productivity Growth among OECD Countries, 1950–79 242