

# Voice

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# Supply-Side Economics: Its Role in Curing Inflation

Remarks by

**Lyle E. Gramley, Member  
Board of Governors of the Federal Reserve System  
Washington, D.C.**

before

**Community Leaders in Seattle  
Seattle, Washington**

**September 11, 1980**

During the past several years, a profound revolution has been occurring in the thinking of many of our nation's leaders concerning the proper role of fiscal policy in helping to maintain the health of our economy. For more than 30 years, our Government tried to use fiscal policy as a means of smoothing out fluctuations in business activity. Tax rates were cut, and expenditures increased, when recessionary forces were pervasive. Growth in expenditures was restrained—and on one occasion, tax rates were increased—to cool off inflation.

Deep disillusionment has set in regarding the results of those efforts. As the prestigious Joint Economic Committee stated in its recent Midyear Report on the economy, a review of the postwar period shows that "government attempts to short-

en the duration or reduce the intensity of recessions... have been ineffective." Economic policy for the future, the JEC argues, "must focus on the supply side of the economy, on the long-term capacity to produce..."

Supply-side economics is an exciting doctrine. Its central tenets are not entirely new, but they certainly are relevant. Our principal economic problem today is inflation. A long-term strategy is needed to deal with it.

Supply-side economics in fiscal policy is a logical complement to the way in which monetary policy is currently being conducted. Last October the Federal Reserve announced that it was changing its methods of implementing monetary policy in ways that would improve its control over the expansion of money and credit. Under this new monetary policy strategy, prospects have been enhanced that growth of money and credit will slow over the long run to rates that are consistent with a moderation of inflation, and eventually a restoration of price stability. If fiscal and monetary policies both aim at reducing inflation over the long run, the prospects for success in this effort will surely be greater.

How much help can we really expect from supply-side economics in curing inflation? As I think about that question, I cannot help but remember the enthusiasm with which economists of my generation embraced the old fiscal doctrines 30 years ago. We spent a large part of our energy elaborating the theory of aggregate demand management, as it was so often called, and testing its conclusions against the facts. We tried our best to make fiscal policy work in ways that would



reduce unemployment and idle capacity, keep the economy operating close to its full-employment potential, and yet avoid periods of excess demand that create fresh inflationary forces.

In retrospect, our principal mistake was a failure to recognize the severe limitations of aggregate demand management in an economy as complex as ours. We tried to achieve results that simply could not be realized.

The same danger exists now, I believe, with supply-side economics. Steps to increase the potential output of our economy and to improve productivity can make a vital contribution to dealing with inflation. However, unless we recognize the limits of supply-side economics, and design our economic policies accordingly, we could end up making our inflation problem worse instead of better.

What do we mean by supply-side economics? Conceivably, a wide range of things could be included—energy policy, manpower training, Federal support for higher education, and other programs that might increase the growth of supply or enhance productivity. I propose to focus today on three principal areas in which public discussion of supply-side economics has centered in the past several years: first, tax reductions on earned income—that is, on wages and salaries—to increase incentives to work; second, tax incentives to businesses to increase the rate of capital formation and thereby to improve productivity; and third, tax reductions on investment income to encourage a larger volume of private savings.

In discussing these three ways to increase aggregate supply, I do not propose to break any new ground. My objective is merely to make some common-sense observations on the potential contribution of this fiscal policy approach to solving our inflation problem.

### **Tax reductions on earned income**

Tax reductions for wage and salary income, if they contributed to the fight against inflation, would certainly have the enthusiastic support of a large number of our citizens. The average American gives up about one-fifth of his income in the form of direct tax payments to government; upper-bracket rates are, of course, much higher—up to 70 percent for the Federal personal income tax. Reducing these tax rates significantly might increase the willingness of individuals to work, and

it could do so in a variety of ways—by increasing hours worked per day or per week, inducing larger numbers of women to enter the labor force, encouraging postponements of retirement age, or making people willing to work harder. Is it possible that the aggregate supply of labor, and hence the output of goods and services, would rise substantially as a consequence of such tax reductions?

A bit of thought and introspection should raise some doubts in our minds. Work hours tend to be set by institutional arrangements as much as by individual decisions. Objectives for working, moreover, are complex and varied; many of us work for reasons other than simply the income we earn. Moreover, it is difficult to predict whether a completely rational economic man would work more or less if taxes were lowered. Lower rates of taxation increase the take-home pay that can be earned from an additional hour of work or a second job, but they also make it possible to attain any given standard of living with less work.

Studies of the effects of taxation on the available supply of labor both in the United States and in other countries are numerous, but their conclusions are ambiguous. Even in countries where tax rates are considerably higher than in the United States, such as the United Kingdom, it is not clear that labor supply would increase if taxes were lower. In a summary of the available evidence two years ago, the Congressional Budget Office concluded that labor supply probably would increase if taxes on earned income in our country were reduced. The effect, however, would be small; total hours worked might increase by perhaps 1 to 3 percent for each 10-percent rise in after-tax wages.

Reductions in taxes on wages and salaries stimulate demand as well as supply. Estimates of the increase in demand that would result from such tax reductions are also controversial. Nonetheless, the available evidence indicates that the increase in aggregate demand would be substantially larger than the increase in aggregate supply, possibly 5 or 10 times as large, or maybe more.

Tax reductions on wage and salary incomes, therefore, are not the most promising way to cure inflation. Indeed, unless the effects on aggregate demand were neutralized by raising other taxes or cutting budgetary expenditures, such tax reductions—if undertaken on any substantial scale—could make our inflation problem worse.

This does not mean that our Government should



be insensitive to the burden of taxation that Americans are bearing. Certainly, our chances for healthy economic growth will be greatly enhanced if the share of our national resources devoted to Federal uses is reduced and the rate of taxation is lowered. But it does suggest that the principal contribution that supply-side economics can make to fighting inflation lies elsewhere.

### **Investment incentives and productivity**

Providing tax incentives for business investment is another form of supply-side economics, one that we know more about. On several previous occasions during the postwar period, incentives to business capital formation have been increased through accelerated depreciation or an investment tax credit or a reduction in corporate profits tax rates. We therefore have some basis on which to judge their efficacy in stimulating capital formation and productivity growth.

A number of proposals have been put forward recently to stimulate investment through tax incentives. For example, in the Administration's recently announced fiscal program, allowable depreciation rates for new plant and equipment would be increased by 40 percent, and the investment tax credit would be liberalized somewhat. The cost of these incentives, in terms of loss of Federal revenues, would initially be small but would reach \$25 billion per year by fiscal 1985. Corporate tax payments in that fiscal year would be reduced by approximately 17 percent as a result of the new tax incentives.

It has been estimated that these investment incentives would increase the long-term growth rate of productivity in our economy by about 0.4 percent per year—not right away but after several years. Judging by studies of the effects of investment incentives introduced in the past, this is a fairly generous estimate, but a reasonable one. To put this amount of improvement in perspective, we might note that productivity in the past five years has been rising on average at about 1 to 1½ percent a year. With an improvement of 0.4 percent, the trend would be up to 1½ to 2 percent. If improvements in productivity growth occurred for other reasons as well, we might hope to regain the 2½-percent average annual rise that characterized the first two decades of the postwar period. To put it another way, an improvement of 0.4 percent in annual productivity growth would lead,

over the course of a generation, to an increase of 10½ percent in the potential output of our economy. Such an increase would make possible a welcome improvement in standards of living, in addition to its potential contribution to moderating inflation.

### **Tax incentives to increase savings**

Increased investment expenditures, however, must be financed by increased savings. Otherwise, they, too, may add to inflation rather than reduce it. Let me turn next, therefore, to the third area of supply-side economics that I mentioned earlier: Are reductions in taxes on investment income an effective way to increase savings?

Unfortunately, in this area, too, we do not know as much as we need to know to justify bold action. Like reductions in taxes on earned income, tax reductions on investment income cut two ways. By raising the after-tax earning power of every dollar saved, they increase the benefit to the consumer of postponing purchases today in order to increase buying power tomorrow. But because of that, they reduce the amount that a consumer has to save to assure his ability to achieve a given living standard later on.

No one knows for sure which edge of the blade cuts more deeply. Some studies have concluded that if our tax structure were changed in ways that reduced the taxation of investment income, and raised the level of taxes on other forms of income, there would be no effect at all on private saving. Others suggest beneficial effects on private savings. This state of affairs should not prevent us from experimenting cautiously with changes in the tax structure that might encourage more saving. In light of the uncertainties, however, it is hard to imagine that tax incentives to foster savings can play more than a minor role in our battle against inflation, at least in the relatively near future.

Fortunately, there is a surer way of increasing the amount of savings available to finance a higher rate of business investment. It is an old-fashioned method, and one that has not been used much in the past two decades. It is to reduce the deficit in the Federal budget through restraint on Federal spending as rapidly as economic conditions warrant, and eventually eliminate it altogether. Surpluses in the Federal budget, used to retire debt, would return funds to financial markets that could finance the additional business investment needed



to improve productivity growth. That is also the way to increase the prospects that improved productivity growth will actually result in lower inflation. Let me turn to that issue next.

### **Productivity and inflation**

Increasing productivity growth through tax incentives for business investment appears to me to be the most promising route for moderating inflation through supply-side economics. But will it work? And how well?

Unfortunately, there is no guarantee that improved productivity will automatically reduce inflation. Indeed, among the major industrial nations of the world, rates of inflation during recent years have not been closely correlated with rates of productivity increase. From 1974 to 1979, for example, manufacturing productivity rose faster in France than in any other major industrial country. Yet, the rate of inflation in France during that period was higher than that for the United States and Canada, and far above that for Japan and West Germany.

How much an improvement in productivity contributes to reducing inflation depends on the responses of businesses and workers. If businesses do not, or cannot, increase their profit margins, the slower rise in costs that higher productivity brings will show up in smaller increases in prices. If workers then accept smaller wage increases because inflation is moderating, costs would rise still more slowly and the inflation rate would come down further. The inflation rate might ultimately decline by two to three times as much as the initial increase in productivity.

The potential reduction in inflation made possible by a higher rate of advance in productivity will be realized, however, only if conditions in labor and product markets promote the necessary response in wages and prices. Product markets must be sufficiently competitive so that businesses are motivated to pass reductions in their costs

through to lower prices. Markets for labor must be sufficiently slack so that workers are encouraged to accept smaller wage rate increases as the rise in prices moderates. That is why prudent monetary and budgetary policies—policies that aim for slower growth of money and credit and for movements of the Federal budget toward surplus—are a necessary adjunct to supply-side economics. Unless these two work hand in hand, the promise that supply-side economics holds for reducing inflation could easily be lost.

Let me try to pull the threads of my argument together. Tax incentives to stimulate business capital spending appear to be the surest way of increasing our aggregate capacity to produce. At a cost of about \$25 billion annually by 1985, in terms of revenue loss to the Treasury, we might reasonably expect productivity growth to increase by about 0.4 percent per year. Under favorable economic conditions the inflation rate might be brought down by about 1 percentage point, or perhaps a little more, through this means. These are, I believe, realistic estimates of the costs and benefits of going the route of supply-side economics.

If the cost is that high, you may ask, is it worth it? I would respond: What better alternatives are there? Certainly, it is preferable to use tax policy to increase productivity and our capacity to produce than to try to squeeze out inflation by relying solely on highly restrictive fiscal and monetary policies, with the inevitable losses of jobs and real output that would be entailed.

Supply-side economics is obviously no cure-all for inflation. But the problem of inflation is so intractable that no single measure to deal with it will suffice. Our only hope for making substantial progress against inflation over the next several years lies in keeping the fight against inflation at the forefront of every economic policy decision. If we recognize its limitations as well as its strengths, supply-side economics can play an extremely useful role in that endeavor.



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### **New member banks**

First City Bank-North Belt, N.A., Houston, Texas, a newly organized institution located in the territory served by the Houston Branch of the Federal Reserve Bank of Dallas, opened for business October 1, 1980, as a member of the Federal Reserve System. The new member bank opened with capital of \$750,000 and surplus of \$750,000. The officers are: Edwin Finn, Chairman of the Board; Norma Galloway, President; Vernon Pool, Senior Vice President and Cashier; James Kerby, Vice President; and Josephine Cisneros, Administrative Officer.

Alvin Community Bank, N.A., Alvin, Texas, a newly organized institution located in the territory served by the Houston Branch of the Federal Reserve Bank of Dallas, opened for business October 7, 1980, as a member of the Federal Reserve System. The new member bank opened with capital of \$750,000 and surplus of \$750,000. The officers are: J. W. Lander, Jr., Chairman of the Board; Davis L. Llenos, Vice Chairman of the Board; B. J. Corley, Jr., President; and Chas. A. Thomas, Vice President and Cashier.

American National Bank of Plano, Plano, Texas, a newly organized institution located in the territory served by the Head Office of the Federal Reserve Bank of Dallas, opened for business October 15, 1980, as a member of the Federal Reserve System. The new member bank opened with capital of \$1,000,000 and surplus of \$1,000,000. The officers are: Jerry D. Stiles, Chairman of the Board; John A. Bryant, President; Lynn Barton, Executive Vice President and Cashier; and Connie L. Clark, Assistant Vice President.

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# “Fed Quotes”

Brief Excerpts from Recent Federal Reserve Speeches, Statements, Publications, Etc.

“When American bankers look back upon the decade of the 1970’s, they can add up a number of impressive achievements. American banks have innovated vigorously, both abroad and at home. Abroad they have played a pioneering role in the financing of developing countries and particularly in the recycling of OPEC funds. At home new techniques of lending, of raising funds, and particularly of serving the consumer have been developed. Through the bank holding company device, banks have been able to break out of their geographical confinement at least in limited fields such as consumer and mortgage financing. They overcame the difficulties of 1974-75 which incidentally provided a positive test of the effectiveness of American institutional arrangements for dealing with a major bank failure.

“At the same time, American banks have experienced trends that are less constructive and call for careful analysis. Large American banks have embarked on a program of heavy lending to developing countries, which carries them into an only partially charted risk area. As a group, these banks nevertheless have fallen behind in the race against foreign competitors for market shares worldwide. Domestically, the share of banks in the total supply of credit has diminished. The dependence of particularly the largest banks on purchased funds of a volatile character has increased. The value assigned to the largest banks by the stock market has fallen to levels at which it becomes very difficult for them to issue new stock. Meanwhile their capital has not kept up with the rise in their assets.

“These generalizations, to be sure, apply to different U.S. banks in very different degree. It is principally the money center banks that have experienced the problems just noted, and in lesser degree the large regional banks. Small local banks have been affected far less.

“These differences are crucial to an evaluation of the American banking scene. Local banks, with assets of up to perhaps \$100 million, typically have had good earnings, of the order of one percent on assets or more, compared to one-half to three-quarters of one percent for the money center banks. Their capital averages 8 percent of assets, contrasted with 4 percent or less for the money center banks. Their stock typically sells at a sizable premium over book value, contrasted with a discount from book value for many money center banks that has begun to be corrected in a few cases only recently. Considerable regional differences are observable in the experience of small banks during the 1970’s, and it is conceivable that increasing competition, especially with thrift institutions and perhaps with larger banks more aggressively deploying innovative techniques, may change the picture for small banks during the 1980’s.”

Henry C. Wallich, Member, Board of Governors of the Federal Reserve System (At the Roundtable on Credit Systems in the 1970’s, Perugia, Italy, September 5-7, 1980)



"In this regard, the Board continues to have strong reservations about the use of the discount rate for indexing permissible loan rates because, among other reasons, it imposes what is a short-term rate on markets that usually involve long-term lending, and movements among short-term and long-term rates often diverge substantially. In addition, we feel it is unwise to single out a tool of monetary policy for a purpose—such as indexing—that is not directly policy related. We therefore again urge Congress to find a more appropriate formulation."

Frederick H. Schultz, Vice Chairman, Board of Governors of the Federal Reserve System (Before the Small Business Oversight Subcommittee, U.S. House of Representatives, September 23, 1980)

"The United States probably has become the country where a given rate of inflation does more damage than anywhere else.

"We have allowed inflation to have its full impact on saving and on investment, outside the real estate sector. We have allowed inflation grossly to dilute business profits, to the extent where many of the dividends paid are in effect liquidating dividends that ought to be nontaxable to the recipient if inflation-adjusted accounting were permitted for tax purposes. Some areas of the economy have in effect been indexed against inflation, such as wages, interest rates, the government sector, and single-family homes. Other areas, especially saving and business profits, have not had this kind of protection. The result has been a calamitous drop in productivity gains. We might be better off if we recognized the damage, allowed realistic inflation accounting, and, to the extent that we fail to reduce inflation, adjust our tax and financial system to minimize the damage."

"Because we are dealing principally with a structural rather than a cyclical problem, our measures should be shaped to that situation. Tax reform is urgently needed. But a premature tax cut that drives up the budget deficit and interest rates without reducing the size of the public sector can be very damaging. We would be moving toward a fiscal/monetary mix of easy budgets and tight money, exactly the opposite of what our economy needs if productivity is to recover."

"We seem to have difficulty realizing that interest rates must be evaluated not only after inflation, but after taxes. On reasonable calculations, it becomes evident that at the short-term end interest rates after inflation and taxes have been negative 60 percent of the time since 1960 and at the long-term end 65 percent of the time. Negative real interest rates both distort and overstimulate the economy. Countries that have successfully dealt with inflation generally have managed to avoid both mistakes. A stable rate of growth of the money supply, which in effect leaves the determination of interest rates to the market, offers the best prospect that negative real rates will be avoided most of the time, although some fluctuations in nominal interest rates probably are unavoidable.

"Positive real interest rates look high in nominal terms and may have some tendency to slow economic expansion in the short run. This is the obverse of the familiar proposition that one can always, in the short run, stimulate the economy by making money a little cheaper and printing more of it. But in the longer run, negative real interest rates are a drag on the economy, just as past efforts to keep stimulating the economy have turned out to be. Expansion promoted by negative real interest rates would be artificial and short-lived."

Henry C. Wallich, Member, Board of Governors of the Federal Reserve System (At the 1981 Business Outlook Conference sponsored by The Conference Board, New York, New York, September 25, 1980)



# Differences in Unemployment Incidence and Duration Produce Differences in Unemployment Rates

*By James E. Pearce*

Few economic statistics receive as much attention as the aggregate unemployment rate. Policymakers follow it to monitor utilization of the nation's productive capacity, and many forecasters find it helpful in predicting changes in the rate of inflation. Unfortunately, the emphasis on these functions has somewhat overshadowed the information the unemployment rate provides about the prospects facing the individual jobholder. The changes in economic activity that produce most of the variation in unemployment affect the working population in many ways, but the principal concerns of the typical worker include the chance that he might become unemployed in the near future and the amount of time he can expect to remain out of work if that should occur.

This article examines the relationship between the unemployment rate and the incidence and duration of unemployment. The measure of incidence used is the percentage of workers unemployed at least one week during the year in question. The measure of duration is the mean number of weeks of unemployment these workers accumulated in all spells of unemployment that year. The article briefly covers the behavior of incidence and duration over time for the entire labor force and also identifies the source of the high

and variable unemployment rates characteristic of particular occupation and demographic groups.

The evidence indicates that the increases in unemployment that occur during economic recessions reflect rises in both incidence and duration in about equal shares, but the rising trend in the natural rate of unemployment appears to be due primarily to an increase in the percentage of workers who become unemployed. Differences in the unemployment rates of various labor force groups are, in most cases, due to differences in incidence. The difference in unemployment for blacks and whites is an exception to this rule, however, as greater duration contributes heavily to the higher unemployed rate observed for blacks.

## **Variation over time**

This investigation covers the behavior of incidence and duration between 1967 and 1977. The changes in unemployment during this period were due to a rising trend in the equilibrium, or "natural," unemployment rate as well as to variation in the overall level of economic activity. The macroeconomic disturbances included the economic expansion that accompanied expenditures for the Vietnam War and the Great Society program, the mild



**Cyclical increases in unemployment of full-year workers  
reflect jumps in incidence and duration**

| Year     | Unemployment rate <sup>1</sup> | Percent of labor force unemployed |               | Duration of unemployment <sup>2</sup> |  |               |
|----------|--------------------------------|-----------------------------------|---------------|---------------------------------------|--|---------------|
|          |                                | At least 1 week                   | Over 26 weeks | Mean (Weeks)                          | Percent distribution of unemployed workers<br>1 to 4 weeks | Over 26 weeks |
| 1967 ... | 2.2                            | 8.0                               | 1.0           | 14.0                                  | 24.0   | 12.5          |
| 1968 ... | 1.9                            | 7.3                               | .8            | 13.5                                  | 27.0   | 11.5          |
| 1969 ... | 2.1                            | 8.0                               | 1.0           | 13.5                                  | 27.0   | 12.5          |
| 1970 ... | 3.3                            | 10.9                              | 1.7           | 15.5                                  | 19.0   | 16.0          |
| 1971 ... | 3.9                            | 11.7                              | 2.4           | 17.5                                  | 17.0   | 20.5          |
| 1972 ... | 3.5                            | 10.6                              | 2.1           | 17.0                                  | 18.5   | 19.5          |
| 1973 ... | 2.9                            | 9.7                               | 1.5           | 15.5                                  | 20.5   | 15.5          |
| 1974 ... | 3.6                            | 11.8                              | 1.9           | 15.5                                  | 19.0   | 16.5          |
| 1975 ... | 5.7                            | 15.5                              | 3.7           | 19.0                                  | 14.5   | 24.0          |
| 1976 ... | 5.2                            | 14.8                              | 3.4           | 18.0                                  | 15.5   | 23.0          |
| 1977 ... | 4.6                            | 13.6                              | 2.8           | 17.0                                  | 17.0   | 20.5          |
| Mean ... | 3.5                            | 11.1                              | 2.0           | 16.0                                  | 20.0   | 17.5          |

1. (Weeks unemployed/weeks in labor force) x 100.

2. Figures rounded to the nearest 0.5.

SOURCES: U.S. Bureau of the Census.  
Federal Reserve Bank of Dallas.

recession of 1970-71 that accompanied the subsequent reduction in military spending, and the more severe recession of 1974-75 that followed the sharp rise in the price of oil in late 1973.

The data in the accompanying table and charts are based on work experience information from the Current Population Survey conducted each March by the U.S. Bureau of the Census. The analysis is confined to unemployment of workers who remain in the labor force the year round. (Other studies have shown that the unemployment data for part-year workers contain weaknesses and ambiguities that complicate analysis of their labor force activity.) The unemployment series for full-year workers lies a considerable distance below the unemployment series for the entire labor force. The difference reflects the greater stability of year-round workers, who change jobs much less frequently than people who withdraw from the labor force part of the year. A more detailed description of the data and the considerations dictating the choice of the sample and the estimators is provided in the Appendix.

The recessions caused pronounced increases in both dimensions of unemployment. Incidence—the percentage of workers unemployed one or more weeks during the year—rose approximately 50

percent in the course of peak-to-trough movements in economic activity over the 1969-71 and 1973-75 periods. Duration—the mean accumulation of unemployment—rose about one month in each case, as the incidence of long-term unemployment, shown in the third column in the table, increased about 150 percent.

The estimates suggest that changes in incidence and duration contributed about equally to the increases in unemployment in the recessions. If mean duration had remained at its 1969 value of 13.5 weeks in the next two years, the rise in the percentage of people becoming unemployed that occurred through 1971 would have added about 1 percentage point to the unemployment rate. A similar calculation indicates the rise in incidence between 1973 and 1975 added about 1.5 percentage points to unemployment.

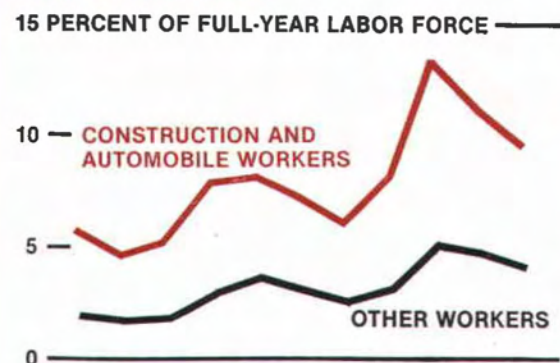
These figures imply that wider incidence accounted for somewhat more than half of the rise in the unemployment rate in the two recessions. The work experience survey's truncation of spells that overlap calendar years, discussed in the Appendix, probably causes the understatement of mean duration to be greater in periods when more spells of unemployment are long, however. Consequently, changes in incidence alone likely account



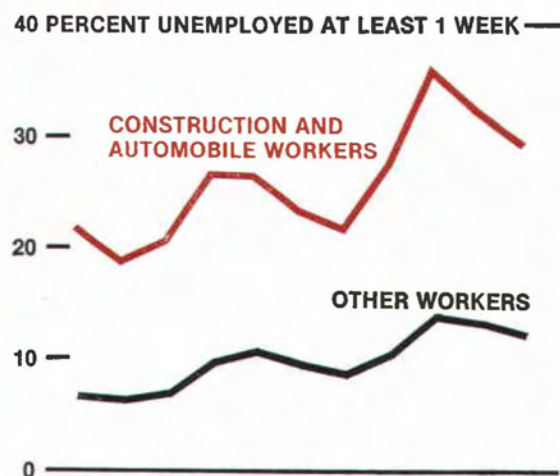
## CHART 1

**High incidence is responsible for the high unemployment of construction and auto workers . . .**

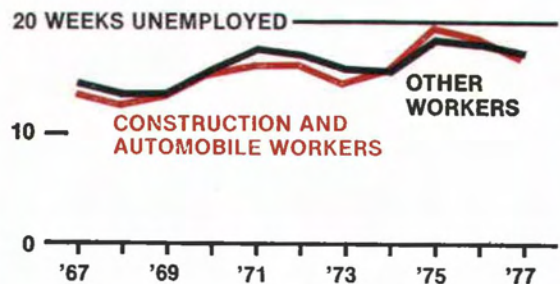
### UNEMPLOYMENT RATE



### INCIDENCE



### DURATION



SOURCES: U.S. Bureau of the Census.  
Federal Reserve Bank of Dallas.

for no more than half of the cyclical changes in the unemployment rate, and their actual contribution may even be slightly smaller than 50 percent.

The composition of the secular increase in unemployment differs markedly from the composition of cyclical variation. Comparisons of incidence and duration for years in which the business cycle was in similar phases—such as 1970 and 1974 (recession years in which unemployment was rising rapidly) and 1972 and 1977 (years when the economy was recovering from recession)—suggest that the rising trend in the unemployment rate is primarily attributable to the upward drift in the incidence of unemployment. Changes in aggregate economic ac-

**One out of nine full-year workers would spend at least one week on layoff or looking for another job in a year in which full utilization of resources prevailed. The average amount of time spent unemployed would be about four months.**

tivity appear to account for most of the variation in duration. The brief sample period and the dominance of short-run fluctuations limit the precision of any conclusions that may be drawn on this matter, but changes in duration appear to have contributed much less to the recent trend in unemployment than they have to cyclical changes.

The instability of the unemployment rate in this period makes it difficult to determine a set of unemployment figures that is consistent with full utilization of resources, but simple averages of the series in the table should provide adequate approximations for discussion. The mean of incidence indicates that one out of nine full-year workers would spend at least one week on layoff or looking for another job in a year in which full utilization prevailed. The average amount of time spent unemployed would be about four months, but the mean duration for the few full-year workers who accumulate more than six months of unemployment would be about nine months. Although the number of people in this group is small, its members account for about 40 percent of the total number of weeks of unemployment and, thus, play an important role in the determination of the unemployment rate.



## Accounting for high unemployment of particular groups

The above statistics may serve as useful guides to the job market conditions facing most workers, but the aggregate series do not describe the experiences of members of several atypical groups. The distinctive behavior of unemployment statistics for subgroups of the labor force that characteristically exhibit high and variable unemployment rates has always captured the attention of analysts, and the employment of workers in these groups has often been a major objective of economic policy. The charts here illustrate how the disparities in incidence and duration lead to higher unemployment rates for construction and automobile workers, young workers, and blacks.

Workers in the construction industry and motor vehicle manufacturing industry have relatively high average unemployment rates each year because the demand for their services changes from month to month. In addition, purchases of homes and new cars are sensitive to changes in interest rates, so the unemployment of these workers varies considerably from year to year. The unemployment rate for construction and auto workers was more than twice the unemployment rate for full-year workers in others industries throughout the 1967-77 period. Only in 1968 did the construction-auto unemployment rate fall below 5 percent—a level that the rate for other workers reached only in 1975.

The entire difference between these unemployment rates was due to higher incidence for workers in the construction and auto industries. Even in the late 1960's, the years of strongest demand, about 20 percent of the workers in these industries were unemployed at least one week; in the 1975-77 period, incidence for construction and auto workers was above or near 30 percent. Unemployment incidence for other workers remained below 10 percent in all years except those associated with economic recession. The difference in unemployment duration for the two groups remained small throughout the period covered by the data; the largest disparity was less than two weeks.

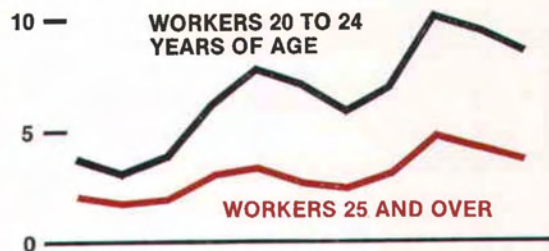
The unemployment series for young adults also lies above the aggregate unemployment series and exhibits greater cyclical variation. More young people are in transitional phases of their careers, so young workers account for a disproportionate number of job changes, which often involve interludes of unemployment. Since the typical young

### CHART 2

... and for the high unemployment rate of young workers ...

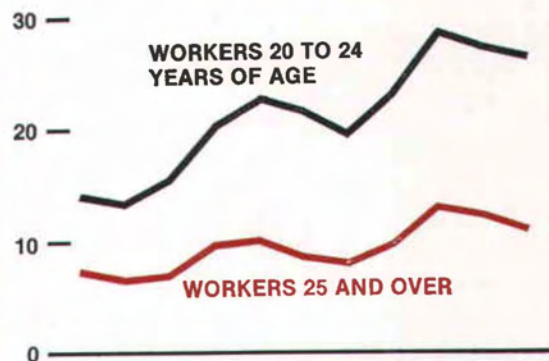
#### UNEMPLOYMENT RATE

15 PERCENT OF FULL-YEAR LABOR FORCE —



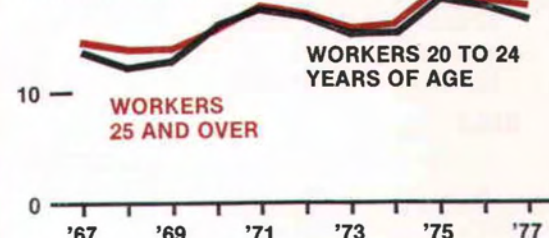
#### INCIDENCE

40 PERCENT UNEMPLOYED AT LEAST 1 WEEK —



#### DURATION

20 WEEKS UNEMPLOYED —



SOURCES: U.S. Bureau of the Census.  
Federal Reserve Bank of Dallas.



worker has accumulated little seniority, his employment is particularly susceptible to a decline in economic activity.

The data indicate that the unemployment rate for workers 20 to 24 years of age was about twice the unemployment rate for full-year workers older than 24, and the disparity widened during the years when unemployment was rising. Here again, a difference in incidence accounts for the entire difference in unemployment rates, as the durations for younger workers lie slightly below those of the over-25 group.

**The proportion of blacks experiencing some unemployment in a given year was about 4 to 5 percentage points higher, and durations for blacks were generally two to three weeks longer than for whites.**

In the final comparison, the data reveal that unemployment has been higher for blacks than for whites. Workers with relatively poor educations and little training and those employed in low-wage occupations generally have high unemployment rates, and this description fits more blacks than whites. Discrimination may also have contributed to black unemployment. The disparity of 2 to 3 percentage points between the unemployment rate for blacks and that for whites reflects differences in both incidence and duration. The proportion of blacks experiencing some unemployment in a given year was about 4 to 5 percentage points higher, and durations for blacks were generally two to three weeks longer.

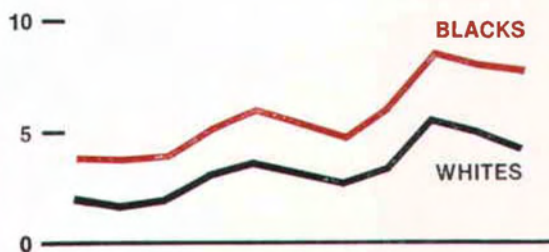
A widely held proposition maintains that unemployment of blacks is more sensitive to changes in economic activity than unemployment of whites. This claim is difficult to verify in the unemployment statistics for full-year workers because cyclical and secular changes in the difference between unemployment of blacks and whites cannot be distinguished easily. If the unemployment rate for blacks were more volatile than the unemployment rate for whites, the difference between the two should rise in recessions and fall in recoveries. Actually, the series diverged during years when unemployment increased, but they displayed little tendency to converge when the pace of economic

### CHART 3

**... but greater duration contributes to the high unemployment of blacks**

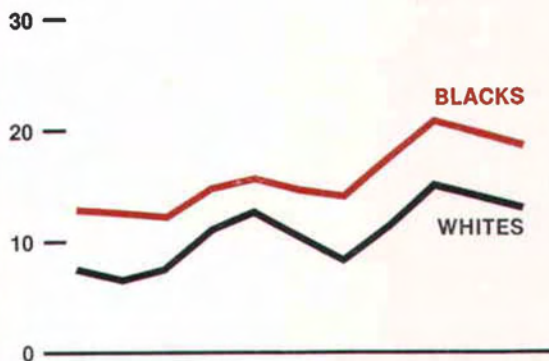
#### UNEMPLOYMENT RATE

15 PERCENT OF FULL-YEAR LABOR FORCE —



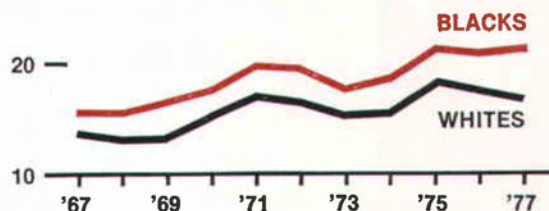
#### INCIDENCE

40 PERCENT UNEMPLOYED AT LEAST 1 WEEK —



#### DURATION

30 WEEKS UNEMPLOYED —



SOURCES: U.S. Bureau of the Census.  
Federal Reserve Bank of Dallas.



activity revived. Consequently, while the gap between the unemployment rates for blacks and whites widened over the 1967-77 period, the source of the divergence cannot be classified as cyclical or secular from the data here. Both incidence and duration followed this pattern, so the behavior of the separate unemployment dimensions contributes no additional information that would help make this distinction.

### Concluding remarks

Accounts in the press often refer to the unemployed as people who *cannot find jobs*, implying that episodes of unemployment typically continue indefinitely and impose extreme hardship on affected households. The evidence in this article suggests that the unemployed are better described as those who *have not yet found jobs*. For most people, unemployment in a nonrecession environment is a disruptive but not catastrophic experience. In an average year, five out of six year-round workers who spend some time on layoff or looking for work accumulate less than six months of unemployment; the average accumulation for this group is about three months.

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**A higher percentage of workers 20 to 24 years old have interruptions in their employment, but there is no indication that they have more difficulty acquiring new jobs.**

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The evidence also suggests that the current limitations on the number of weeks any one individual may be eligible for unemployment insurance benefits are about right. Most states allow receipt of benefits for a maximum of 26 weeks except in periods of high unemployment, when the eligible unemployed may draw benefits up to 39 weeks.

### Appendix

The data used to estimate unemployment incidence and duration were obtained from the March Current Population Surveys for 1968 through 1978. The Current Population

These constraints would cover the total annual accumulation of unemployment for over 80 percent of those who become unemployed. The case for extending the maximum weeks of eligibility to 52 or more, as was done in the 1974-75 recession, is weak.

The importance of incidence in accounting for most of the differences in the behavior of unemployment rates for different labor force groups has some interesting implications. High unemployment of young adults has caused considerable concern among some observers, who have regarded it as a manifestation of the inability of young workers to find employment. The evidence here indicates that a higher percentage of workers 20 to 24 years old have interruptions in their employment, but there is no indication that they have more difficulty acquiring new jobs.

A similar conclusion does not hold in the case of high unemployment of blacks. Greater duration contributed substantially to the higher black unemployment rates from 1967 to 1977, and the difference between mean duration for blacks and that for whites widened over the period. This accounted for much of the divergence in the black and white unemployment series, which must be regarded as a conspicuous failure of U.S. economic policy in the past decade.

Finally, the consequences of analyzing data for full-year workers only must be noted. People in the labor force the year round account for only half of all unemployment. Thus, the behavior of some labor force series cannot be explained by examining the experience of members of this group. The unemployment of teenagers, particularly black teenagers, is perhaps the most obvious example. On the other hand, the behavior of the unemployment series examined above has closely paralleled the behavior of the corresponding official unemployment statistics, which are computed using samples that include part-year workers. Therefore, most of the conclusions reached from analysis of the limited sample can probably be safely extended to the more general case.

Survey (CPS) is a household survey conducted monthly by the U.S. Bureau of the Census and is the source of the data the Department of Labor uses in computing official



Table 1

## COMPOSITION OF FULL-YEAR LABOR FORCE

| Year     | Percent distribution of ages |          |             | Percent of labor force |        |
|----------|------------------------------|----------|-------------|------------------------|--------|
|          | 20 to 24                     | 25 to 54 | 55 and over | Females                | Blacks |
| 1967 ... | 12.4                         | 66.4     | 21.2        | 34.3                   | 10.8   |
| 1972 ... | 15.6                         | 65.0     | 19.4        | 35.7                   | 10.0   |
| 1977 ... | 17.1                         | 65.8     | 17.1        | 38.3                   | 10.4   |

SOURCES: U.S. Bureau of the Census.  
Federal Reserve Bank of Dallas.

unemployment statistics. The March interview contains some supplemental questions about the respondents' labor force activity in the previous year, including the number of weeks worked and weeks unemployed.

The work experience interview has two weaknesses that may bias the estimates. First, people who work 50 or 51 weeks are not asked if they were unemployed during the survey period. This may preclude the reporting of many one- and two-week spells and, if it does, will make unemployment appear more protracted than is actually the case. Second, the survey questions refer to a specific year, so the amount of unemployment experienced by people with spells beginning in one calendar year and ending in another will be understated. The biases from these two sources will offset one another, but which dominates is not known. The resulting error is believed to be insignificant, but the situation should be kept in mind when reviewing the findings.

A source of possibly serious error is the questionable reliability of information obtained in response to questions that require

recalling details about activities as far in the past as 15 months. Although the accuracy of the data is difficult to verify, the consistency of work experience data with official unemployment statistics has been examined. This research indicates that for people who are routinely in the labor force, the unemployment reported in the work experience interview is consistent with official unemployment statistics.<sup>1</sup> People who divide their time between work for pay and work in the home or work in school report less unemployment in the work experience interview than in the monthly CPS interview. In order to make the estimates here more consistent with official statistics, the sample was restricted to workers who were at least 20 at the time of the March CPS interview and reported spending at least 40 weeks of the previous year in the labor force.

1. Richard D. Morgenstern and Nancy S. Barrett, "The Retrospective Bias in Unemployment Reporting by Sex, Race and Age," *Journal of the American Statistical Association* 69 (June 1974):355-57.



Table 2

## UNEMPLOYMENT RATES FOR MALES 25 TO 54

| Series  | 1967 | 1968 | 1969 | 1970 | 1971 | 1972 | 1973 | 1974 | 1975 | 1976 | 1977 |
|---|------|------|------|------|------|------|------|------|------|------|------|
| Official unemployment rate <sup>1</sup> ..... | 1.9  | 1.7  | 1.6  | 2.8  | 3.5  | 3.1  | 2.5  | 3.1  | 5.7  | 4.9  | 4.3  |
| Work experience estimate <sup>2</sup> .....   | 1.9  | 1.6  | 1.8  | 2.8  | 3.2  | 2.7  | 2.2  | 3.0  | 4.7  | 4.3  | 3.6  |

1. Percent of civilian labor force.

2. Mean of (weeks unemployed/weeks in labor force)  $\times$  100.

SOURCES: U.S. Bureau of the Census.

U.S. Department of Labor.

Federal Reserve Bank of Dallas.

The tables show characteristics of the sample. Table 1 displays demographic information. The most notable points there are the widely publicized rising trends in the ratio of young workers to older workers and the ratio of women to men. Table 2 contains the official annual average unemployment rate for prime-age males and the comparable statistic computed from the work experience data, which is the annual percentage of weeks in the labor force that male workers in the 25-54 age group spent unemployed. The two series are close to one another in most of the years, but they diverge somewhat during the recessions. Still, their consistency is sufficient for the sample data to be regarded acceptable for some broad inferences about the composition of changes in the official unemployment rate.

The duration estimates reported here are considerably larger than those reported in previous research. Several factors may account for the discrepancy. First, most analysts estimate the mean duration of individual spells of unemployment, but the figures here are mean annual accumulations of weeks of

unemployment per unemployed worker. The two estimates will differ if some workers have more than one spell per year. Second, the sample excludes seasonal workers, who are more likely to abbreviate their episodes of unemployment by dropping out of the labor force. Recent research suggests that annual accumulation may be a more appropriate measure of duration than the lengths of individual spells because multiple spells per worker and spells terminated via withdrawal are both common.<sup>2</sup>

2. For example, Stephen T. Marston, "Employment Instability and High Unemployment Rates," *Brookings Papers on Economic Activity*, 1976, no. 1, pp. 169-203, and Kim B. Clark and Lawrence H. Summers, "Labor Market Dynamics and Unemployment: A Reconsideration," *Brookings Papers on Economic Activity*, 1979, no. 1, pp. 13-60, report high rates of labor force withdrawal for unemployed teenagers and adult women. George A. Akerlof and Brian G. M. Main, "Unemployment Spells and Unemployment Experience," *Special Studies Papers*, no. 123 (Washington, D.C.: Board of Governors of the Federal Reserve System, Division of Research and Statistics, October 23, 1978), discuss the problem of recurrent spells.



# Regulatory Briefs and Announcements

## **NOW Accounts: Eligible Holders, Advertising Policy, Ceiling Rate Announced**

The Depository Institutions Deregulation and Monetary Control Act of 1980, enacted March 31, authorizes depository institutions (except credit unions) nationwide to offer interest-bearing accounts upon which transferable or negotiable orders of withdrawal may be drawn. Depository institutions are authorized to make NOW account services available beginning December 31, 1980.

Under the act, NOW accounts are available only to individuals and to qualifying organizations that meet two separate tests of eligibility. To be eligible, an organization must be operated primarily for religious, philanthropic, charitable, educational, or other similar purposes and must not be operated for profit. The categories of depositories designated by the Federal Reserve Board as *eligible* to maintain NOW accounts at member banks are:

1. Individuals
2. Sole proprietors
3. Husband and wife operating unincorporated businesses
4. Local housing authority
5. Residential tenants' security deposits
6. Independent school districts
7. Redevelopment authority
8. Escrow funds (provided the entire beneficial interest is held by individuals or qualifying organizations)
9. Labor unions
10. Trust and other fiduciary accounts (provided the entire beneficial interest is held by individuals or qualifying organizations)
11. Pension funds
12. Trade associations

The Board has also issued a list of depositories generally found *ineligible* to maintain NOW

accounts at member banks. These depositories include:

1. Realty or real estate investment trusts
2. Credit unions
3. Blue Cross/Blue Shield and similar plans
4. Military exchanges and purchasing cooperatives
5. Hospital districts
6. State and local governmental units (except those qualifying above)
7. Partnerships operated for profit
8. Professional corporations
9. Business corporations
10. Trustees in bankruptcy (unless the entire beneficial interest in the bankrupt's funds is held by individuals or qualifying organizations)
11. Political parties or campaign committees

The Board has adopted a policy statement concerning the advertising of NOW accounts. The policy states that institutions may engage in advertising and promotional programs prior to December 31 and may offer accounts that will be converted to NOW accounts on that date, but such programs must accurately describe the nature of NOW account services. In promoting checking accounts that will be converted to NOW's, it should be made clear that interest cannot be paid on the accounts before December 31. Any terms or conditions to be imposed on the accounts should also be disclosed in the promotion or advertisement.

The Depository Institutions Deregulation Committee has established an interest rate ceiling of 5<sup>1</sup>/<sub>4</sub> percent on NOW accounts, effective December 31, 1980, at all types of depository institutions authorized to offer such accounts. These include commercial banks, mutual savings banks, and savings and loan associations.



## **Deregulation Committee Adopts Some Final Rules**

The Depository Institutions Deregulation Committee has issued several final rules regarding time and savings deposits held at federally insured depository institutions.

One rule, effective October 30, 1980, establishes a ceiling rate of interest for a new category of time accounts—time deposits under \$100,000 with 14 days as the minimum maturity. Depository institutions that are members of the Federal Reserve System may pay interest on any time deposit of less than \$100,000 with an original maturity or notice period of 14 days or more, but less than 90 days, at a rate not to exceed  $5\frac{1}{4}$  percent. Since no ceiling rate exists for time deposits of \$100,000 or more with an original maturity (or notice period) of 14 days or more, a rate may be negotiated between the bank and the depositor.

The committee has also ruled that premiums—whether in the form of merchandise, credit, or cash—to depositors will not be regarded as payment of interest if:

1. The premium is given only when a new account is opened, an existing account is renewed, or funds are added to an existing account;
2. No more than two premiums per account are given within a 12-month period;
3. The value of the premium or the total cost of the merchandise does not exceed \$10 for deposits of less than \$5,000 or \$20 for deposits of \$5,000 or more.

The committee has defined a finders fee as a payment of interest to the depositor involved (subject to the applicable interest rate ceiling for the deposit), and such a fee is to be paid only in cash. Both the premium and finders fee rules become effective December 31, 1980.

Another rule that becomes effective December 31 prohibits the prepayment of interest to depositors, in either cash or merchandise, on all deposits subject to interest rate ceilings. However, depository institutions may pay interest at maturity or as it is earned. If merchandise is given in lieu of cash, its cost must be certified by an executive officer.

Inquiries from members of the Federal Reserve System may be directed to Consumer Affairs, Bank Supervision and Regulations Department, Federal Reserve Bank of Dallas, (214) 651-6171.

## **Regulation E: New Amendments Adopted, Proposed Amendment Issued**

The Board of Governors of the Federal Reserve System has adopted several amendments to Regulation E. One exempts certain family transfer plans from the Electronic Fund Transfer Act and the regulation. Another amendment permits institutions that ordered or purchased certain automated teller machines (ATM's) before February 6, 1980, to omit a unique account identifier from the terminal receipt. The other amendments modify two periodic statement requirements. The first of these permits financial institutions to omit the state in which a terminal transfer took place when the transfer occurs within 50 miles of the institution's main office. The second deletes from the regulation a requirement that a certain receipt code be printed on the customer's periodic statement. The amendments became effective October 6, 1980.

The Board has issued for public comment an amendment to Regulation E that would exempt certain overdraft checking plans from the compulsory use prohibition of the EFT Act. The overdraft plans that are the subject of this proposal generally require an agreement to debit a minimum payment each monthly or other payment period from available or advanced funds. Comments were received through November 5, 1980.



## **“Bankers’ Banks” Defined**

The Federal Reserve Board has issued an interpretation of Regulation D (Reserve Requirements of Depository Institutions) that defines “bankers’ banks” and sets forth the criteria under which bankers’ banks may act as pass-through agents for the reserves of other institutions. Under the Monetary Control Act of 1980, bankers’ banks are exempt from Federal reserve requirements.

In its interpretation the Board ruled that an institution qualifies as a bankers’ bank if it is organized solely to do business with other financial institutions and not the general public and if 75 percent or more of its capital is owned by the financial institutions with which it conducts business.

A bankers’ bank may act as a pass-through agent for the reserves of other institutions if it enters into an agreement with the Federal Reserve to accept responsibility for correctly maintaining passed-through reserves and if the Federal Reserve is satisfied with the quality of the management and financial resources of the bankers’ bank.

## **Consolidation Required for Pass-Through Accounts in Eleventh District**

A correspondent handling pass-through reserve accounts in the Eleventh Federal Reserve District is required to consolidate in a single account the reserve balances of all its respondents whose main offices are located in more than one territory of the Eleventh District.

The pass-through correspondent should designate the specific Federal Reserve office in the Eleventh District (Dallas, El Paso, Houston, or San Antonio) in which the account is to be maintained. On the agreement form the pass-through correspondent should also indicate whether the pass-through account for its respondents is to be commingled with its own reserve account or is to be held as a separate commingled account for all the respondents.



# Now Available

Recently issued Federal Reserve circulars, speeches, statements to Congress, publications, etc., may be obtained by contacting the Bank and Public Information Department, Federal Reserve Bank of Dallas, Station K, Dallas, Texas 75222, unless indicated otherwise.

## Circulars

- Election of Directors: Report of Nominations—Voting Procedures.** 19 pp. Circular No. 80-184 (October 1, 1980).
- Regulation Z—Truth in Lending: Official Staff Interpretation.** 7 pp. Circular No. 80-185 (October 1, 1980).
- Public Information Statement: Community Reinvestment Act.** 6 pp. Circular No. 80-187 (October 2, 1980).
- Policy Statement on Advertising of "NOW" Accounts.** 3 pp. Circular No. 80-189 (October 2, 1980).
- Legal Agreement for Establishing Pass-Through Accounts at the Federal Reserve Bank.** 1 p. Circular No. 80-190 (October 1, 1980).
- Federal Reserve Services.** 30 pp. plus questionnaire on use of Federal Reserve services. Circular No. 80-191 (October 9, 1980).
- Revised Bulletin 5 [Currency, Coin and Food Coupons].** 11 pp. Circular No. 80-192 (October 15, 1980).
- Revised List of OTC Margin Stocks.** 20 pp. Circular No. 80-193 (October 8, 1980).
- Regulation E—Electronic Fund Transfers: Proposed and Final Amendments.** 13 pp. Circular No. 80-194 (October 15, 1980).
- Questions and Answers on the Monetary Control Act.** 1 p. Circular No. 80-195 (October 14, 1980).
- Title 12—Chapter XII—Interest on Deposits: New Ceiling Rate for 14-90 Day Time Deposits Under \$100,000; Ceiling Rate for NOW Accounts; Premium and Finders Fees Rules; New Prohibition of Prepayment of Interest on Time Deposits.** 19 pp. Circular No. 80-199 (October 23, 1980).
- Regulation K—International Banking Operations: Notice of Final Rulemaking Relating to Interstate Banking Restrictions for Foreign Banks.** 12 pp. Circular No. 80-200 (October 27, 1980).
- Final Revision to Regulation J [Collection of Checks and Other Items and Transfer of Funds].** 18 pp. Circular No. 80-202 (October 29, 1980).

**Results of Election.** 1 p. Circular No. 80-204 (October 23, 1980).

**Questions and Answers on the Monetary Control Act.** 19 pp. Circular No. 80-205 (October 27, 1980).

**Deferral of Reserve and Reporting Requirements.** 2 pp. Circular No. 80-206 (October 24 or 27, 1980).

## Pamphlets, Brochures, and Reports

**The Depository Institutions Deregulation and Monetary Control Act of 1980.** Reprinted from the *Federal Reserve Bulletin*. 10 pp. June 1980.

**The Federal Reserve Discount Window.** Published by the Board of Governors of the Federal Reserve System. (A booklet describing the programs under which Federal Reserve credit is advanced) 13 pp. October 1980.

## Speeches and Statements

Remarks by **Paul A. Volcker** ("The Burden of Banking Regulation") at the **Annual Convention of the American Bankers Association**, Chicago, Illinois. 13 pp. October 14, 1980.