The Levy Economics Institute of Bard College

Summary

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The Levy Economics Institute of Bard College, founded in 1986, is a nonprofit, nonpartisan research organization devoted to public service. Through scholarship and economic research it generates viable, effective public policy responses to important economic issues that profoundly affect the quality of life in the United States and abroad.

The *Summary* is published three times a year (Winter, Spring, and Fall) and is intended to keep the academic community informed about the Institute's research. To accomplish this goal, it contains summaries of recent research publications and reports on other activities.

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PUBLICATIONS AND PRESENTATIONS

LETTER FROM THE PRESIDENT

To our readers:

This issue begins with two policy notes by Distinguished Scholar Wynne Godley under the state of the U.S. and world economies program. He reviews the Levy Institute's comprehensive stock-flow model and concludes that the United States risks a prolonged growth recession unless exports rise faster than full-employment imports. He questions whether the U.S. government and public are prepared for a large rise in taxation and cuts in public services, and he notes that global imbalances require a global solution, such as a new international order.

Under the distribution of income and wealth program, Senior Scholar Edward N. Wolff and Research Scholars Ajit Zacharias and Hyunsub Kum find that the median LIMEW shows a hefty increase in well-being during the 2000–2002 period as a result of lower taxes and higher transfers that contrasts sharply with the official measures. Nevertheless, overall inequality was higher in 2002 than in 1989 according to all measures of well-being. A working paper by Wolff finds that retirement wealth had a considerably weaker offsetting effect on wealth inequality in 2001 than in 1983, despite the proliferation of defined contribution pensions. The main equalizing effect of retirement wealth for all age groups comes from Social Security, not private pensions, he says.

A working paper by Research Associate Sephanie Seguino under the gender equality and the economy program looks at South Korea and Taiwan and finds that foreign direct investment (FDI) and trade liberalization reinforce job segregation and lower women's wages. The evidence suggests that the gender-wage ratio is inversely related to trade.

The program on economic policy for the 21st century begins with the 15th Annual Hyman P. Minsky Conference, held at the Institute in April. There was general consensus that the U.S. current account deficit is unsustainable, economic growth will continue in the near term, further dollar devaluation is necessary, and interest rates will rise along with global reflation. The participants were unsure of the timing and the economic, financial, and political costs of unwinding the global imbalances in light of uncertain exchange rates relative to the dollar, future mortgage rates, the continuation of China's high capital investment and growth rate, the role of the Fed and the replacement of chairman Alan Greenspan, investor behavior, and the role of creditor nations and policymakers.

A policy note by Research Associate Korkut A. Ertürk advocates steep dollar devaluation and speculates that attempts to establish regional economic and financial networks will bypass the United States. A second working paper by Seguino finds that FDI has a negative effect on wage and productivity growth in developing economies and that there can be a low wage–low productivity trap when capital investors gain too much bargaining power relative to that of workers. A working paper by Ertürk studies the macroeconomics of asset-price speculation based on Keynes's insights and finds that asset-price expectations are more relevant today than changes in interest rates to reach desired macroeconomic outcomes. A working paper by Research Associate Jörg Bibow asserts that the European Central Bank's (ECB) macroeconomic policy has failed and that its leaders have rejected an inflation-targeting approach. The bank's approach has been costly, and policymakers should reform euroland's structural problems and correct the key flaws in central banking institutions, he says. A second working paper by Bibow warns that the euro and the Economic and Monetary Union could fail as a result of policy blunders by the ECB. A third working paper by Bibow reviews the analytical framework of Keynes's liquidity preference theory and concludes that the framework offers insights that are relevant today.

A working paper by Panos Konstas of the Federal Deposit Insurance Corporation (FDIC) outlines a plan that would make it more cost efficient for banks to replace insured deposits with uninsured deposits by placing an intermediary in the credit-flow chain between the initial lender (saver) and borrower (bank).

Under explorations in theory and empirical analysis, Research Scholars Claudio H. Dos Santos and Gennaro Zezza present a simplified "stock-flow consistent" post-Keynesian model that sheds light on classic macroeconomic issues. Resident Research Associate Greg Hannsgen tests the viability of incorporating nonpecuniary costs of borrowing into standard rational-choice models and concludes that economists must seek tools to answer questions that mix morality and economics.

I am very pleased to welcome Senior Scholar Caren A. Grown, who is the new codirector of the gender equality and the economy program.

As always, I welcome your comments and suggestions.

Dimitri B. Papadimitriou, *President*

Program: The State of the U.S. and World Economies, and Strategic Analysis

Imbalances Looking for a Policy

WYNNE GODLEY
Policy Note 2005/4
www.levy.org/pubs/pn_4_05.pdf

Distinguished Scholar Wynne Godley reviews the Levy Institute's comprehensive stock-flow model and concludes that the continued deterioration of the U.S. current account deficit will have to turn around, but he doubts whether there can now be a market solution to this problem. The state of aggregate demand in the United States is precariously based, he says, as private debt and borrowing cannot continue to provide the motor for expansion for more than a couple of years, particularly if interest rates continue to rise. The risk is a return to recession, and there is no remedy this time in the shape of a fiscal expansion.

Godley observes that, although the dollar has depreciated by 17 percent during the last three years, the terms of trade have improved only slightly, a trend in sharp contrast to the mid-1980s. Non-oil import prices have hardly risen relative to overall domestic price levels, so, with strong private expenditure, imports have continued to soar. If U.S. output grows at 3.5 to 4.0 percent per annum, there will have to be a 12-percent annual average increase in the volume of exports sustained over four years (a growth rate rarely achieved in the past) to get any significant improvement in the overall balance, he says. Godley also observes that the expansion of total demand has been powered entirely by a renewed increase in private expenditure relative to income, and private net saving has fallen back decisively into negative territory, which also happened in the Goldilocks period of the 1990s. The result is that the growth of debt owed by the nonfinancial private sector has been reaccelerating and the growth of lending (and debt) is financing a raging boom in housing.

Godley states that no one has a clear idea about what can actually be done, by whom, and when. With the exception of the Levy Institute, ideas are formulated without the benefit of a comprehensive stock-flow model. He believes that the largest creditors of the United States (the Pacific rim countries) wish to continue building a mighty industrial machine more than preserving the value of their dollar assets, so market forces may be subverted for, perhaps, years. He surmises that any lasting solution will probably require a new international order.

Some Unpleasant American Arithmetic

WYNNE GODLEY
Policy Note 2005/5
www.levy.org/pubs/pn_5_05.pdf

The deficit of the general government is equal to the current account deficit plus the private sector balance. Distinguished Scholar Wynne Godley notes that if the U.S. current account deficit remains the same (6 percent of GDP) while output growth is sufficient to stop unemployment from rising and the private sector balance recovers halfway to normal (i.e., to zero), the general government deficit must rise to 6 percent. If the private sector balance were to return to its long-term average (plus 1.8 percent), the government deficit would have to rise to nearly 8 percent of GDP.

Neither of these figures for the budget deficit is credible, says Godley, given the Bush administration's commitment to cut the federal deficit in half during the next four years. Without renewed fiscal stimulus, the United States will encounter a prolonged growth recession under the stated assumptions about international trade and the private sector balance.

Godley observes that sustained and balanced growth (without recession) requires that exports rise faster than full-employment imports. However, the obstacles to sufficient export growth are daunting because the value of imports is now 57 percent higher than exports. Using a range of assumptions, he finds that any credible configuration requires a sustained rise in the volume of exports at a rate well in excess of 12 percent per annum, which is faster than during any previous four-year period. Moreover, a 3-percent improvement in the current account balance as a share of GDP would require significantly reduced private consumption and investment. Are the U.S. government and public prepared for the large rise in taxation and cuts in public services that are implied? Global imbalances require a global solution, notes Godley.

Program: Distribution of Income and Wealth, and the LIMEW

Interim Report 2005: The Effects of Government Deficits and the 2001–02 Recession on Well-Being

EDWARD N. WOLFF, AJIT ZACHARIAS, and HYUNSUB KUM

Levy Institute Measure of Economic Well-Being, May 2005

http://www.levy.org/pubs/limew0505.pdf

The economic well-being of the average U.S. household was significantly higher in 2000 (the end of the 1990s boom) than in 1989 (the end of the 1980s boom). However, official measures of well-being show deterioration for the average household during the 2000–2002 period. According to Senior Scholar Edward N. Wolff and Research Scholars Ajit Zacharias and Hyunsub Kum, the median LIMEW shows a hefty increase in well-being of 5.6 percent during the 2000–2002 period that contrasts sharply with official measures. Nevertheless, overall inequality was higher in 2002 than in 1989 according to all measures of well-being.

By construction, the average values of the LIMEW are higher than gross money income (MI) and the U.S. Census Bureau's most comprehensive measure, extended income (EI). The authors note that EI does not adequately capture the economic advantage from wealth and ignores public production of services (e.g., education) and provisioning within households (e.g., child care). They also note that the LIMEW allows them to estimate the hours spent on total work (paid work plus housework) by the average household. While the hours of paid work by men were 3 percent lower in 2002 compared to 1989, hours of paid work by women rose 7 percent during the same period, reflecting increased labor-market involvement.

The growth in household well-being was similar in the LIMEW and EI between 1989 and 2000, as both the base income and income from wealth components were the main contributors to growth. However, the drag of net government expenditures was offset in the LIMEW by a positive contribution from household production.

The different rates of change in the Levy and official measures of well-being are primarily a reflection of differences in their components and in the components' makeup. According to the LIMEW, lower taxes and higher transfers contributed the most in the growth of well-being for the middle class (the third quintile) in the 2000–2002 period. In contrast, middle-class well-being declined according to EI as a result of a downward pull related to the income-from-wealth component.

Between 2000 and 2002, the mean values of the LIMEW and EI shifted in opposite directions: the LIMEW grew by 2.2 percent, while EI shrank by 4.8 percent. The negative impact of falling base income and income from wealth in the LIMEW was offset by dramatic growth in net government expenditures and in the value of household production. The authors note that the tax and transfer components in the LIMEW are aligned with their National Income and Product Accounts (NIPA) counterparts, unlike EI, and transfers in the LIMEW include several programs that are not included in EI. The considerable gap between the sizes of the tax cuts implied by the two measures reflects the divergence between the bureau and the NIPA in estimating aggregate federal personal income taxes.

The results of the decomposition analysis of Gini coefficients suggest that the greater increase in LIMEW inequality from 1995 to 2000 stemmed primarily from the growing share of income from wealth and its greater concentration among the upper quantiles of the distribution. Similarly, the decline in inequality between 2000 and 2002 was largely a result of a reduction in the share of income from wealth.

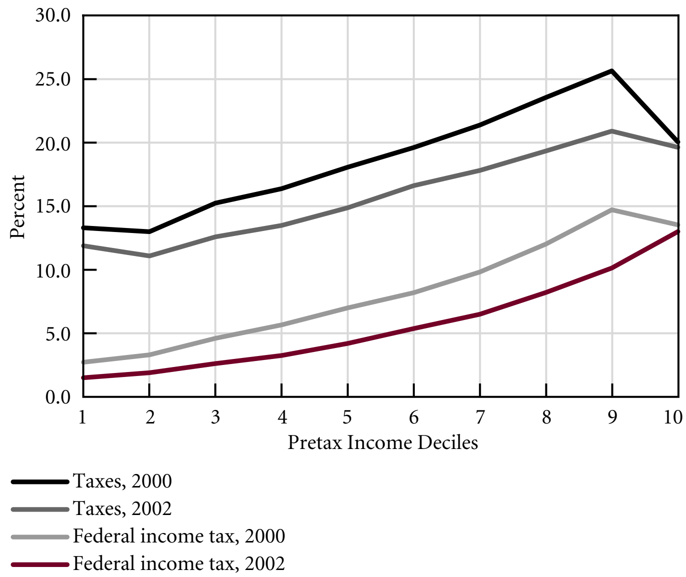
The LIMEW suggests that the relative weakening of macroeconomic performance between 2000 and 2002 led to a notable decline in inequality, while EI shows a somewhat smaller decline and MI very little change. The share and amount (in real terms) of income from nonhome wealth fell in the LIMEW and EI. The decline in LIMEW inequality was checked by the positive contribution from taxes, whereas the smaller decline in EI was checked by positive contributions from base income and taxes.

Taxes contributed to increasing inequality because their share in the LIMEW declined from 18.3 percent in 2000 to 15.5 percent in 2002, whereas that share remained stable in EI. Given changes to the tax system since 2000, the authors compare the distribution of the tax burden in 2000 and 2002 (Figure 1). There is an apparent lack of progressivity from the ninth to the tenth decile in 2000 as a result of a decline in the effective total tax rate and the federal income tax rate. However, the change in the effective total tax rate is negligible in 2002 and is attributable to the income from nonhome wealth component, which fell significantly between 2000 and 2002 (due to losses from falling stock prices). The degree of progression between successive deciles from the bottom to the ninth decile appears to have worsened throughout the distribution in 2002 vis-a-vis 2000 for the various tax schedules.

The authors also examine the incremental effects of different components of the LIMEW and EI on 2002 levels of overall inequality (Figure 2). The incremental effects on inequality of base income and income from nonhome wealth are strikingly different in the LIMEW and EI. Base income has a large positive effect in EI and a small negative effect in the LIMEW; and income from nonhome wealth has a large positive effect in the LIMEW, but a much smaller effect in EI. The notion of economic inequality as being shaped by earnings inequality may be misleading: wealth inequality also plays an important role. Furthermore, the incremental effects of taxes and expenditures are different in the two measures. The LIMEW shows that government expenditures have a markedly higher incremental effect than taxes on reducing inequality.

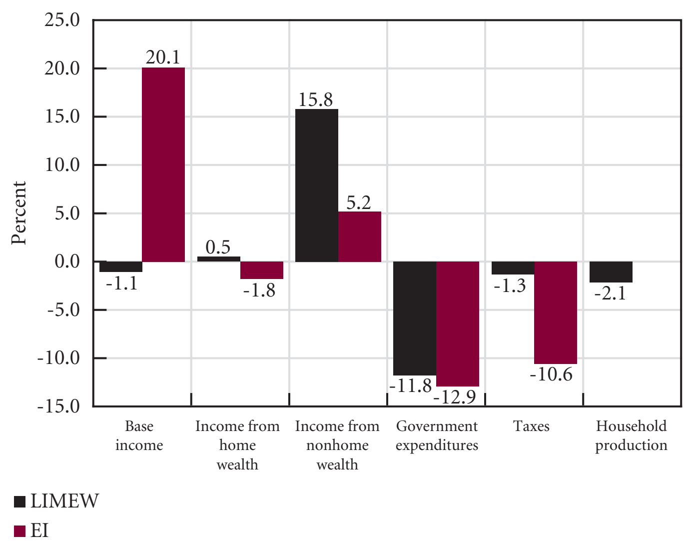
In their review of population subgroups, the authors found that there was no reduction in the relative disadvantage of single female–headed families relative to married-couple families between 1989 and 2002. They also found that the well-being of the elderly relative to the nonelderly was lower as a result of a decline in the relative value of income from wealth and, to a much lesser extent, government transfers. These results are relevant for social policy, say the authors.

Figure 1 **Total Tax Rates and Federal Income Tax Rates by Pretax Income Deciles, 2000 and 2002**



Source: Authors' calculations

Figure 2 **Incremental Effects on Inequality by Measure and Component, 2002**



Source: Authors' calculations

Is the Equalizing Effect of Retirement Wealth Wearing Off?

EDWARD N. WOLFF

Working Paper No. 420, March 2005

www.levy.org/pubs/wp420.pdf

A dramatic change in the retirement-income system over the last two decades is the substitution of traditional defined benefit (DB) pension plans with defined contribution (DC) pension plans. Senior Scholar Edward N. Wolff of New York University analyzes the effects of substitution on the overall distribution of household wealth. He finds that retirement wealth (pensions and Social Security) had a considerably weaker offsetting effect on wealth inequality in 2001 than in 1983. Despite the proliferation of DC plans at a time when the stock market experienced one of its longest bull runs in history, general well-being did not improve. The main equalizing effect of retirement wealth for all age groups comes from Social Security, not private pensions.

Wolff uses data from the Federal Reserve Board's Survey of Consumer Finances for 1983, 1989, 1998, and 2001. The unit of observation is the household, which is divided into three age groups: under 47, 47 to 64, and 65 and older. Marketable wealth (or net worth) is defined as the current value of all marketable or fungible assets less the current value of debts (including the market value of DC pension plans). He imputes pension and Social Security wealth and notes that his estimates are based on reported earnings at a single point in time, which are likely to be overstated and inferior to estimates based on longitudinal work histories of individual workers.

The author documents robust growth in wealth during the 1990s. Mean pension wealth increased by 60 percent in real terms from 1983 to 2001, and mean retirement wealth increased by 16.5 percent, but median retirement wealth declined by 5.9 percent. The addition of retirement wealth to net worth reduced the overall Gini coefficient less in 2001 (0.164) than in 1983 (0.208). Wolff finds that Social Security wealth has a strong mitigating effect on overall wealth inequality, but it increased only 9.7 percent in real terms between 1983 and 2001. In 2001, the Gini coefficient for retirement wealth among all households was 0.49, compared to 0.34 for Social Security wealth, 0.80 for pension wealth, and 0.83 for net worth.

The percentage of all households covered by either a DC or DB plan increased from 54 to 66 percent between 1983 and 2001. While the share of households with DC pension accounts skyrocketed from 11 to 52 percent, the share of DB pension accounts fell from 53 to 34 percent. The average value of DC pension accounts increased more than tenfold (from $3,900 to $53,700 in 2001 dollars), while the average value of DB pension accounts declined 26 percent (from $55,400 to $41,200). Although median pension income more than doubled (from $4,900 to $10,900), much of the gain was a result of increased pension coverage. Despite the gain, many households had very small amounts of pension wealth.

DC pension accounts rose from 1.5 percent to 12.3 percent of total assets between 1983 and 2001, which offset the decline of liquid assets and appears to have allowed households to substitute tax-free pension accounts for taxable savings deposits, rather than increasing overall family savings. Among all households, the Gini coefficient for total pension wealth increased from 0.749 to 0.800, and the increase was most striking among pension wealth holders. Thus, the switch from DB to DC pension plans resulted in an upsurge in pension wealth inequality.

The size distribution of pension wealth substantially widened between 1983 and 2001, particularly among middle-age and elderly households, as the largest growth of pension wealth (and private accumulations) occurred at the top of the pension-wealth distribution. A comparison of trends in private accumulation and net worth, excluding DC plans, suggests that households dipped into their private savings to finance their 401(k) and other DC plans. The main news here is a sharp rise in the inequality of retirement wealth among all households.

Wolff notes that there are important differences in the estimation of DB and DC pension wealth and Social Security wealth, and he attempts to put them on an equal footing. The issue is how to treat future employee contributions to DC plans and future wealth accumulation. He finds that his main conclusion—that the increase of inequality over the 1983–2001 period was greater when retirement wealth was included in the wealth definition—remains largely unchanged when excluding the present value stream of future employer contributions, considering new measures of wealth inequality, or including the effect of future tax liabilities on pension wealth.

Program: Gender Equality and the Economy

Gender Inequality in a Globalizing World

STEPHANIE SEGUINO

Working Paper No. 426, July 2005
www.levy.org/pubs/wp426.pdf

Liberalization and global economic integration affect macroeconomic policies and development strategies. These approaches have slowed economic growth rates, increased firm mobility, and contributed to financial and economic volatility. Furthermore, these policies do not appear to improve social development in terms of health, education, and human security.

Research Associate Stephanie Seguino of the University of Vermont looks at South Korea and Taiwan, which have created a dynamic comparative advantage in technologically sophisticated industries. These countries intervened in markets (e.g., imposing import tariffs and quotas) and selectively restricted imports in order to nurture their domestic capabilities and compete internationally. They also socialized some of the risks of investment in order to expand capacity in strategic industries with large capital investments. Both countries recognized that they face different challenges than countries, such as Japan, that industrialized earlier.

Seguino observes that South Korea and Taiwan engaged in strategic economic openness, a flexible-policy approach tailored to achieve the domestic goals of industrialization and stable economic growth while acquiring advanced technologies. The approach promotes structural changes by demanding a quid pro quo from firms (e.g., export and investment targets) in exchange for government subsidies (e.g., subsidized interest rates by state-owned banks). They also took a "managed market" approach that restricts foreign direct investment (FDI) and strengthens the government's ability to manage the economy (e.g., domestic firms with limited access to capital can be disciplined by the state). These approaches enabled South Korea and Taiwan to avoid the negative effects of increased competition among low-wage export producers for a limited market share, she says.

A key component of South Korea and Taiwan's strategy was a reliance on low-cost exports, primarily produced by women, to generate the foreign exchange that in turn financed technology imports. While women's wages and incomes grew in absolute terms as female employment in manufacturing expanded, employment conditions made it difficult to close the gender-wage gaps (e.g., limited bargaining power, the Asian financial crisis, and the shift to more informal work arrangements).

There is evidence that the gender-wage ratio is inversely related to trade, observes Seguino. The increased mobility of capital due to relaxation of FDI rules in Taiwan has widened the gender-wage gap. The experience of South Korea and Taiwan shows that FDI and trade liberalization reinforce job segregation and lower women's wages. FDI is also inversely related to wage growth in other semi-industrialized countries and is more likely to affect women whose employment is concentrated in mobile industries. Other indicators of well-being show that women's relative economic status can worsen in spite of rapid growth, so there is a need to ensure that increases in output will remedy existing gender inequalities, says the author.

Seguino outlines four areas where policy can improve women's well-being and promote gender equity: expansionary macroeconomic policy; financial market regulation; regulation of trade and investment flows; and gender-sensitive public-sector spending. She emphasizes that there is no one-size-fits-all approach, since economic structure will determine the parameters of policy that close gender gaps. She notes that tight monetary and fiscal policies associated with neoliberal macroeconomic policies have been harmful, since they lead to a deflationary bias (slow growth and high unemployment) that harms more women than men. She also notes that the IMF's emphasis on low inflation is too great and fails to account for the costs of unemployment, including long-term growth effects.

Seguino suggests a refocus away from an excessive emphasis on inflation targeting to a restoration of the central bank's role in macroeconomic management, which includes gender-equitable goals and investment in strategic sectors to stimulate productivity growth. The government must be an active participant in the growth and development process and be able to shift resources to mitigate supply bottlenecks, she says. Industrial policy should move away from low-wage, labor-intensive commodities, and labor-market policies should limit firm mobility, regulate capital flows to avoid excessive volatility, and use labor standards to raise the wage and employment conditions of workers in export industries. She concludes that the national government represents a critical locus of resources to promote gender equity and trade and that FDI policies must promote development and expand well-being.

Program: Economic Policy for the 21st Century

The 15th Annual Hyman P. Minsky Conference, "Economic Imbalance: Fiscal and Monetary Policy for Sustainable Growth"

As part of its research program on economic policy for the 21st century, the Levy Institute organized a conference, held on April 21–22, 2005, at Blithewood in Annandale-on-Hudson, New York, to exam-

ine the strength of the U.S. economic recovery following a short-lived recession. The recovery, primarily the result of the swift and significant change of the federal fiscal policy stance and low interest rates, is still uncertain. The positive high growth rates accompanied by accelerating deficits and rising levels of debt in the internal and external sectors indicate bad times ahead, especially as interest rates and inflation rise. Participants discussed their viewpoints, policy guidelines to be considered within the context of current economic trends, and the implications for national and international economies. They addressed the question, What are the monetary and fiscal policy prescriptions for growth, employment, and price stability? Summaries of the speakers' remarks are given here.

Welcome and Introduction

Levy Institute President DIMITRI B. PAPADIMITRIOU finds several signs that the U.S. growth rate will decline from a rate exceeding 4 percent in 2004. His most recent coauthored Strategic Analysis (March 2005) entitled "How Fragile Is the U.S. Economy?" warns that, if rising interest rates and debt burdens continue, debt-service-to-income ratios will become unsustainable and lead to a jump in personal bankruptcies and a sharp drop in consumer spending. An overview of his paper appears in the Spring 2005 *Summary*, pp. 4–6.

Speaker: SANDRA PIANALTO

The U.S. economy has expanded for the past few years, but it could face some challenges from fiscal and trade deficits. Sandra Pianalto, president and CEO of the Federal Reserve Bank of Cleveland, explained how central banks can meet the challenges and promote economic prosperity—by maintaining price stability or maintaining low and stable rates of inflation. She noted that these were her views and not necessarily those of the Federal Reserve system.

Pianalto outlined three aspects of her message: (1) there is a global consensus that central banks should pursue price stability; (2) large budget deficits do not need to undermine success in maintaining price stability; and (3) a firm commitment to price stability is the best contribution that monetary policy can make toward resolving the challenges posed by external account imbalances. She noted that, historically, when governments become involved with money, economies suffer under an inflationary policy, which results in costly economic distortions and uncertainty (e.g., spiraling inflation in the 1970s). She further noted that growing public support for a return to low inflation around the world resulted in the inflation rate falling from 9 to 2 percent in industrialized countries and from 30 to 6 percent in developing countries.

Dramatic reductions in inflation were accompanied by improved economic performance in a postinflation era termed the "Great Moderation" by Federal Reserve Board Governor Ben Bernanke. Overall, central banks should promote sustained economic growth by maintaining low and stable inflation rates, she said.

Pianalto observed that current budget deficits are well within the boundaries of historical experience, in spite of growing concerns from the public about fiscal discipline. She warned, however, about demographic changes in the United States and Europe, where entitlement liabilities are growing faster than the tax base—a serious issue that should be addressed as soon as possible. Although it is not the job of monetary policymakers to resolve fiscal imbalances, their implications should not be ignored, she said. The stance of monetary policy depends on the equilibrium real interest rate (i.e., the interest rate that matches the supply and demand for funds, assuming markets are working efficiently), and it is not unreasonable to expect that persistent government deficits and the effects of fiscal imbalances will eventually place upward pressure on the rate. However, the equilibrium real interest rate, which could be, but need not be, the source of inflationary pressures, cannot be readily estimated. The prospect of inflation arises only if the central bank ignores or resists any rise in real interest rates. A central bank that is committed to price stability and addresses budgetary imbalances in a timely manner can avoid that prospect, she said.

Pianalto noted that the current account deficit as a share of GDP is at record postwar levels, and that these levels are unsustainable. She further noted that the more commonly expected scenario is that foreign savings in the United States could decline and drive up interest rates, thereby inducing households to save more and spend less. If there is a substantial turnaround in the current account deficit, which results in higher equilibrium real interest rates, the federal funds rate target would need to be adjusted to prevent a change in the Federal Open Market Committee (FOMC) policy stance. Moreover, a decline in the exchange value of the dollar could create upward price pressures. The central bank's responsibility is to ensure that these pressures do not feed into higher inflation expectations in the long run. A clear commitment to price stability is the best contribution the central bank can make to the adjustment process toward more sustainable external account positions.

Pianalto believes that a gradual and orderly transition toward smaller current account deficits is the probable outcome. She does not think that the FOMC should take preemptive measures to address the current account imbalances, but that it should bring the federal funds rate target to a level that is consistent with maintaining price stability in the long run. A credible monetary policy will help smooth the adjustment to any economic circumstances that arise. An environment of low inflation and stable inflation expectations is the contribution that the Federal Reserve can deliver and the contribution that she intends to pursue as a policymaker.

Session 1. The State of the U.S. and World Economies

The session was moderated by Levy Institute President DIMITRI B. PAPADIMITRIOU. Presentations were made by STEVEN B. KAMIN, Federal Reserve Board; JAMES W. PAULSEN, Wells Capital Management; and FRANK A. J. VENEROSO, Dresdner RCM.

STEVEN B. KAMIN noted that the U.S. current account deficit has been growing increasingly larger and is now in record territory. A concern is that a "disorderly correction," which means a sharp decline in the dollar, a run on U.S. bond and stock markets, and a contraction of U.S. GDP, is imminent. This scenario is unlikely, he said, but it is possible. However, industrial countries may be less vulnerable than emerging market economies to disorderly current account corrections. A rise in interest rates and a fall in stock market prices, by themselves, do not imply a disorderly correction. These events must be sufficient to depress economic activity.

Kamin addressed several questions that are relevant to the disorderly correction scenario: (1) Is the disorderly correction scenario plausible on theoretical grounds?; and (2) What is the historical precedent for the disorderly correction scenario in industrial economies? His discussion drew on research with colleagues in the international finance division of the Federal Reserve. He noted that these were his own views and not necessarily those of the Fed.

Disorderly markets mean that financial markets cease to function effectively. When the dollar fell both in the mid-1980s and more recently, markets operated smoothly. Whether a market becomes disorderly depends on the behavior of investors in response to a fall in the dollar—will they act rationally, or will they have more extrapolative expectations that drive up interest rates and depress stock prices? There is no theoretical evidence that a current account adjustment will be contractionary. Kamin's macroeconomic models suggest that in the event of future depreciation of the dollar the expansionary effect on the U.S. economy would outweigh the contractionary effect, but the result depends on assumptions about the response of interest rates and stock prices.

Kamin analyzed the historical data of current account adjustments in industrial economies and their resemblance to the disorderly correction scenario. He identified 23 episodes of adjustment where the current account deficit exceeded 2 percent of GDP before reversal and the deficit was reduced substantially and for a sustained period. The maximum mean average current account deficit (in year 0) was 3.86 percent of GDP, which improved to 1.45 percent in two years. The median value peaked at about 5 percent of GDP and improved to 1.73 percent. An examination of GDP growth rates before and after adjustment showed a decline that remained positive. Inflation rose somewhat after the start of adjustment, before falling again. Real long-term interest rates rose gradually, while there was some decline in real stock prices in the first year after adjustment. For all episodes as a whole, there was a minor decline in growth.

Kamin grouped the individual episodes according to the seven highest (expansion episodes) and lowest (contraction episodes) growth rates. The contraction episodes had a much greater deterioration in current account deficits before adjustment than the expansion episodes. An interesting observation is that the contraction episode growth rates were very high before adjustment, suggesting overheating. Conversely, the expansion episode growth rates were low (about 1 percent), suggesting recovery. The output gap rose substantially prior to adjustment for the contraction episodes, but it fell for the expansion episodes.

Inflation fell gradually during the expansion episodes, but popped up for the contraction episodes. In terms of real exchange-rate behavior, there was a substantial fall in real currency values for the expansion episodes, but, surprisingly, strengthening exchange rates for the contraction episodes. This result is inconsistent with the disorderly correction scenario. Another inconsistency is that in the contraction episodes real long-term interest rates fell before and after adjustment. In addition, interest rates went up for the expansion episodes.

In terms of trade performance, real exports continued to rise significantly before and after adjustment for both types of episodes. Imports for the expansion episodes continued to rise and accelerate after adjustment, which is consistent with faster growth. However, for the contraction episodes imports soared before adjustment and fell thereafter because of cooling economies rather than changes in exchange rates. A scatter plot of all episodes showed that higher real exchange-rate appreciation resulted in lower economic growth. In addition, the more real long-term interest rates rose from before to after an adjustment, the more GDP growth increased. Higher interest rates led to higher, not lower, economic growth rates.

In sum, Kamin did not find much evidence of, or historical precedence for, the disorderly correction scenario. Episodes where exchange rates depreciated resulted in accelerated growth. He cautioned that the mainly foreign evidence did not prove that an adjustment of the U.S. current account deficit would be orderly and benign, since the U.S. economy is unique in many ways: (1) it is the largest economy in the world and has the most capacity to affect foreign economies; (2) it is less open than other economies in the sample; (3) it issues the key reserve currency in the world, so debts are denominated in dollars and balance sheets are protected in the event of devaluation; and (4) U.S. product, labor, and financial markets are flexible.

Points of concern raised by Kamin are that all expansion episodes started with very low growth before adjustment, so low growth might be required for current account adjustment; and that the U.S. current account deficit is larger than the average of all episodes in his sample, so the difference may be problematic.

JAMES W. PAULSEN presented an economic and financial market outlook for the United States. He focused on growth and inflation in the near term and concluded that both of these indicators would be higher than expected and that the cycle would play out over a couple of years.

Paulsen outlined the reasons behind the view that the U.S. economy is slowing: a slowdown is likely as we enter the fourth year of recovery; high oil prices; and Fed tightening. He believes, however, that the United States is in a very expansionary policy environment, as interest rate policy remains highly stimulative because no one has stepped on the brakes. Although short-term interest rates are up, they are still very low by historical standards and long-term rates, which matter, have not budged. Although the United States may have slowed the growth in the money supply, there is no liquidity shortage, especially in the corporate sector, so interest rates have not increased, and the dollar is weak. The process may have started to change, but there is a long way to go.

Paulsen noted that income growth, profits, and corporate balance sheets are as strong as those in the early 1960s. S&P 500 companies have been growing at a rate of 11 percent per year, and margins are very wide. However, there is no confidence in the recovery of the business sector; growth, which is already sufficient, could get much higher if the mood becomes more positive. The Achilles heel is the consumer sector, but this sector has kept spending in spite of events that could have caused it to retreat. Although the consumer has a debt problem, Paulsen observes, there is no problem with current mortgage rate levels. The only way to raise mortgage rates is to increase payroll numbers, because there is a huge relationship between payrolls and what happens in the bond market. The consumer—the biggest swing factor for growth—can handle higher mortgage rates as long as job growth increases at the same time. It remains to be seen how this situation plays out.

According to Paulsen, the most impressive aspect of the U.S. real trade deficit is not its size ($600 billion or over 6 percent of GDP) but its record-setting duration (13 uninterrupted years with chronic trade worsening), which explains a lot about the miracle of the 1990s (real growth without inflationary consequences). The United States exported inflationary pressure and imported deflationary pressure. When the deficit starts to turn around, the relationships will change, and the world will feel different. It is amazing that the unemployment rate is about 5 percent, yet the United States is losing 6 percent of total demand each year, said Paulsen. He noted that if the trade deficit and spending remain the same this year then real GDP will jump up to the rate of domestic spending growth without any change in spending trends. If the trade deficit improves along with 5 percent real growth in spending, real GDP will jump from 3.9 to 5.2 percent without any change in spending trends.

Paulsen presented the ratio of real U.S. imports to exports since 1975 and noted that imports are currently 60 percent above exports, and the trade-weighted dollar exhibits a two-year lead time against the U.S. real trade ratio. It is time that the deficit turns around, he said. He also noted that half of the U.S. $600 billion deficit is with countries under fixed exchange rate regimes, so trade improvement would occur with countries where there has been considerable currency movement (e.g., Japan and Canada). Paulsen expected that larger trading partners with fixed exchange rates will be forced to revalue (e.g., China) and that trade will improve two years hence. He also expected that there would be currency-floating with countries such as Mexico and Brazil in order to correct trade imbalances.

Another piece of the trade puzzle relates to U.S. interest rates. Paulsen disaggregated the trade deficit between intrasensitive (durable goods and financial items) and nonintrasensitive (nondurable goods and services) portions. He observed that the trade deficit explosion occurred after a large drop in mortgage rates in the early part of this decade, when there was a surge in the intrasensitive portion of the trade deficit that went overseas. He conjectured that low mortgage rates are responsible for a positive housing and consumer sector and a negative trade sector, so raising mortgage rates might help to reduce the trade deficit.

In terms of inflation, Paulsen believes that there is a large disconnect between attitudes held over from the 1990s and today's economic reality. While there was deflationary policy between 1988 and 1998, today's fiscal and dollar policies are very inflationary. Moreover, the yield curve and lower negative real interest rates are extraordinarily expansionary. In addition, there was an explosion in supply growth in the U.S. economy in the 1990s (part of the disinflation story), but now supply is contracting, and productivity is showing signs of slowing down. Furthermore, the real federal funds rate based on the annual core consumer price inflation rate is still negative overall.

Paulsen observes a close relationship between periods of trade improvement in the United States and core price inflation problems and the possibility of rising core price inflation with no improvement in trade. He believes that the cyclical inflation and growth rates will be significantly underestimated, with inflationary and interest rate consequences.

FRANK A. J. VENEROSO outlined his case for China's inevitable investment bust. With extensive experience as an advisor and crisis specialist to developing economies, he sees China as an example of one of the worst potential episodes. Its economy has an investment ratio of 50 percent (net of trade), which is equivalent to 8 percent of GDP, while consumption is at 42 percent. History has never seen an economy like this, so it must revert someday, he exclaimed. A decrease in investment along with accelerator and multiplier effects will result in negative growth and a hard landing.

Some people believe that the Chinese economy is a different model with a different solution from the norm. They believe that China's economy is not overheated, but rather experiencing problems of resource misallocation (e.g., duplication of investment in steel, aluminum, and cement), including an excess of high-priced real estate. Veneroso outlined examples of manufacturing capacity that are almost equal to world demand and involve trade: air conditioning, cell phones, and high-tech products (e.g., semiconductors). He noted that prices are falling, and countries (including China) have to cut production. The end result will depend on how the resource misallocation is financed, he said.

The Asian model of development is debt intensive along with high household savings and investment. High savings rates, where banks are the channel of intermediation, lead to little equity issuance and the need for markets guided by government, which can absorb the shocks and make it work, observed Veneroso. He noted that China has a large proportion of state-owned enterprises, including the banks, which is a key factor.

The Chinese model of development includes large plants, narrow margins, and highly indebted enterprises that lead to financial fragility. It is unlikely that the consumer will pick up the baton when the investment ratio adjusts, because the consumer is very risk-averse and has no safety net. There is no real consumer finance except mortgage finance, and auto financing, which is currently shrinking, is 65 percent in arrears after only three years. There is no way that China's financial system of intermediation can transfer demand, concluded Veneroso.

Veneroso believes that an internal financial crisis is unlikely because of China's state-owned banking system and heavily controlled economy. He surmises that there would be massive socialization. He noted that the debt-to-GDP ratio, which averaged 15 percent historically, has increased to 38 percent in a couple of years. He further noted that the National Academy of Social Sciences's survey of households in Shanghai and Beijing found that the debt-to-income ratio has risen from practically zero ten years ago to 150 percent today. The financial system is deteriorating, he said.

In terms of global imbalances, the United States is facing a tsunami of goods, especially as China's current account surplus increases to, perhaps, 10 percent of GDP this year. This is the reason why the United States has a growing current account deficit. And since the U.S. deficit is large and other world economies are weak, the situation has to end soon. An example is Senator Schumer's (D-NY) bill for a significant revaluation of the Chinese yuan in lieu of the imposition of a high tariff.

Veneroso warned that China has the makings of a classic Asian crisis: excessive debt and investment, and speculation in real estate. He said that the usual Asian pattern of exchange rate depreciation and increased exports is not possible in today's world, as a result of the U.S. current account deficit and weak economies in Europe and Japan.

Veneroso also warned of a credit bubble in interest rate spreads, which are vulnerable because many leveraged bets are related to what happens in China. If a piece of the correlated bets on China fails, then spreads will widen, house prices may weaken, and there may be a kind of rolling readjustment reminiscent of a Minsky episode.

Speaker: DAVID D. HALE

David D. Hale of Hale Advisors LLC addressed the question, "Will Republicans need a trillion dollar current account deficit to retain the White House in 2008?" and concluded that the answer is "yes." If the next Fed chairman actively devalues the dollar and gets a current account adjustment over the next two to three years, the federal funds rate would rise to 7 percent and wreck the housing market, which would weaken domestic consumption. Since Americans don't like falling house prices or falling domestic consumption, the low-risk strategy for the Bush administration is a trillion-dollar current account deficit. With that strategy, the federal funds rate can stay below 5 percent, the housing boom can continue, and there will be no need to have a recession in domestic consumption in the next three years.

Hale outlined a number of issues and statistics that define the economic backdrop affecting the exchange rate of the dollar. The U.S. current account deficit will probably exceed $700 billion or 7 percent of GDP this year, an historically awesome number. A lesser-known fact is that emerging-market countries had a current account surplus of $330 billion last year, compared to a $100 billion deficit about eight years ago. Compared to the direction of financial change in the United States, it is the polar opposite. Moreover, the emerging-market surplus will be $400 billion by the end of 2005 and could continue rising before declining. In addition, a few industrialized countries have large current account surpluses (e.g., Japan and Germany). With the exception of Canada, the deficits in the industrial world are mostly seen in English-speaking countries.

Another interesting fact, Hale pointed out, is the performance of bond markets in recent times. Very low bond yields are a global phenomenon (e.g., bond yields in Britain are at the lowest levels since the founding of the Bank of England). Moreover, U.S. bond yields are still low (4 percent) in spite of a very weak currency and a huge current account deficit. The result is asset inflation in the real estate market (e.g., a record real house price gain of 35 percent [$5 trillion] during George W. Bush's first term in office), which explains how Bush was reelected in spite of being the first president in 60 to 70 years to lose employment.

Hale outlined three major points of view about the outlook for the U.S. current account. The conventional view is that the current account deficit is unsustainable, so there will be a significant dollar depreciation in order to reduce the deficit. A second, contrary view is that there is a new emerging exchange rate system comparable to Bretton Woods but regional in scope. East Asian countries do not want currency appreciation against the U.S. dollar and are prepared to intervene indefinitely to maintain stable exchange rates. Hale notes that these countries now have $2.5 trillion of foreign exchange reserves (66 percent of the world total) that was caused initially by the East Asian financial crisis, which made them very conservative. A third view, articulated by Ben Bernanke, is that the U.S. current account deficit is not caused by domestic factors, like budget deficits and low household savings rates, but is the counterpart to a large surplus of savings and foreign exchange reserves in the developing countries. The only real solution to the current account problem is to produce a big capital-spending boom in the developing countries, which run current account surpluses and have foreign exchange reserves as well as pent-up spending potential. A critical issue is the exchange rate policies of countries such as Japan and China that spend very heavily to maintain currency stability. For example, a large appreciation of the yen (e.g., 10 to 15 percent) would magnify Japan's deflation problem, so it is likely that Japan would resist a major dollar depreciation against the yen.

China has a number of very important economic challenges, such as its huge banking system (150 percent of GDP), which is full of bad debt (15 to 30 percent of loans are nonperforming). The risk is very high as a result of dramatic loan growth to finance its great capital-spending boom. China's low interest rate policy combined with credit controls was not successful, so an imbalance persists, and bank lending grows by 14 to 15 percent per annum. Low interest rates, a huge imbalance between nominal GDP growth and very low deposit yields (2 percent) and inflation rates of 5 percent are causing a dramatic growth in China's underground financial system (where interest rates are 15 to 20 percent), which is probably 30 to 35 percent of GDP. Money and credit growth is understated, as lending occurs outside the financial system. A precedent for this situation is Korea about 30 to 40 years ago.

Hale noted the difficulties of the Chinese government in making important policy changes. For instance, when China raised interest rates by 25 basis points in October 2004, there was no meeting of the monetary policy committee and no central bank decision. The decision was driven by a private dinner party conversation. The simple answer to the question, "Why can't the Chinese government change their exchange rate policy?" is that they find it very hard to arrive at a consensus. At a critical moment in Chinese history, the new leaders are indecisive, and the government is consensus-driven. And the exchange rate question is a big decision, since a 15 to 20 percent appreciation could wipe out profit margins and jeopardize employment (the global export boom has created 8 million new jobs in manufacturing over the last four years). Concerns about employment security and social stability result in a reluctance to jeopardize the employment gains. Therefore, there is a reluctance to change China's exchange rate policy.

The mechanism for change in the year ahead would be further dramatic growth in China's foreign exchange reserves, which are $640 billion (up $200 billion from a year ago) and could easily increase by $300 billion this year (a total of $1 trillion in 12 to 18 months). Combined with $50 to 60 billion of foreign direct investment, a $100 billion trade surplus, and a further $100 billion of speculative (hot) money, the growth rate of reserves could accelerate. The government would have no choice but to raise interest rates and to slow the growth rate. Hale believes that the trend to higher interest rates would happen slowly and gradually and that interest rates could be 100 basis points higher by the end of the year. He speculates that China may decide that it is time to adjust its exchange rate by the middle of next year.

The degree of adjustment would depend on the economic environment at the time. If there is a collapse in capital spending, China's current account surplus could skyrocket to $200 billion as the investment-to-GDP ratio declines from 45 to 35 percent. The prospect of a hard landing makes the Chinese reluctant to revalue because it would jeopardize the export-led growth sector. There may be another $250 billion of intervention by China to maintain stable exchange rates in the next 12 to 15 months, said Hale. Moreover, the increase in commodity prices has created a new demand for dollars in developing countries that produce commodities. One of the secondary effects of the China boom has been a transfer of income to commodity-producing countries, which will persist for at least another 12 to 18 months.

Hale noted that U.S. manufacturing investment has declined, so the United States does not have adequate manufacturing capacity to fundamentally reduce its large current account deficit by more than 50 percent. If the current account deficit were cut by only 25 percent, the capacity utilization rate would increase from 79 to 86 percent, a level that is dangerously inflationary, so the federal funds rate would rise. The rise in mortgage rates would cripple the housing boom, increase the domestic private savings rate, and slow domestic consumption. And these effects would set the stage for a current account adjustment through export growth and a slowdown in domestic growth and consumption within 12 to 18 months.

What happens will depend very heavily on some key decisions in Washington in the next 9 to 12 months regarding the dollar policy in the Bush administration and the replacement of Alan Greenspan. The candidates to replace Greenspan—Marty Feldstein, Glenn Hubbard, and Ben Bernanke—would affect the dollar exchange rate in profoundly different ways. According to Hale, while Feldstein thinks a large current account deficit is wrong and talks the dollar down, Hubbard has no view on the dollar (the market will drive it somewhere), and Bernanke does not think that the current account deficit matters. If Feldstein gets the job, the dollar is likely to fall quickly. If Hubbard or Bernanke gets the job, the market does not know how to react because neither candidate has a well-defined view. Since a Republican presidential candidate in 2008 would not want to be campaigning against a backdrop of weak house prices and falling domestic consumption, the low-risk strategy for the Bush administration is to go for a trillion-dollar current account deficit, which allows the housing boom and high levels of consumption to continue.

Session 2. Monetary Policy in the U.S. Economy

The session was moderated by Resident Research Associate GREG HANNSGEN. Presentations were made by BRUCE C. KASMAN, JPMorgan Chase; ALBERT M. WOJNILOWER, Craig Drill Capital Corporation; and Senior Scholar L. RANDALL WRAY, University of Missouri–Kansas City.

According to BRUCE C. KASMAN, the U.S. economy and the corporate sector are healthy and currently in balance in terms of growth, and the end of easy money has arrived. He noted that U.S. households are in good shape and believes that a consumption minicycle is at hand, along with a rebound in growth outside the United States (e.g., Japan). Kasman's major theme was global reflation after two decades of falling nominal growth. He expects global headline inflation to fall, but U.S. core inflation to move decisively above 2 percent in 2005, while the federal funds rate increases to 4.5 percent (2 percent real) early next year.

U.S. external balances and interest rate policy, as well as global dynamics in general, will be driven by global reflation rather than by policymakers or the next Fed chairman, said Kasman. The drive stems from the institutional structures of the Fed and other governments, such as China and Japan. The reflationary dynamic and unwinding of imbalances will require a broad shift in policy arising from the central banks, currency appreciation in Asia, a U.S. recession in the next 2 to 4 years, and a federal funds rate in the range of 6 to 7 percent.

Kasman noted that policymakers correct global problems and that their policies, along with financial market support, are still in place. He also noted that the U.S. economy gets into trouble when incomes become imbalanced (i.e., when corporate income is squeezed by Fed tightening) and households have bargaining power. The U.S. economy is healthy and resilient when both households and businesses are benefiting from recovery, a situation that is happening now. Wage and salary income and profits are growing at a solid pace, so the current economic expansion will continue.

Kasman pointed out that average hourly earnings reflect only wage and salary income of individuals who punch a clock, rather than other payments from employers to workers. Adjusting the personal income report, he found that hourly income was increasing at a rate exceeding 4 percent (close to 5 percent if self-employed income is included). Overall growth and nominal income has been increasing at a rate of 6 percent over the past two years. It is important to understand that the U.S. economy has been labor driven by household demand, said Kasman, and that very sharp swings in headline inflation and real purchasing power have significantly affected the business cycle. As household purchasing power is squeezed, there will be a temporary economic slowdown (i.e, if energy prices do not keep increasing).

Kasman did not foresee a return to 1970s-style inflation, but a steady upward shift that would raise global core inflation rates by at least a percentage point. Policymakers are not responding to economic expansion in the same way as they did in the 1980s and 1990s because their biases are more focused on growth and the idea that inflation can be too low. As a result, policymakers allow risks that create some upward pressures. An equally important factor is the role of Asian economies in the global cycle. Asia grew more rapidly than the rest of the world for two decades prior to the mid-1990s before the financial crisis and Japan's slide into deflation depressed supply, demand, commodity prices, and manufacturing purchasing power. These events set the stage for no capacity additions in the goods-producing sectors (aside from the tech sector) during the last 7 to 8 years. Asia is starting to normalize, driven by easy policies on the currency side, and prices are responding. China, Japan, and Korea cannot control their real currency values, so if values are kept low, they will affect prices.

In the 1990s the United States grew supply (in terms of capacity and labor) at a phenomenal pace, but there has been a fundamental shift in terms of tradeoffs, which work slowly but powerfully, said Kasman. The unemployment and industry operating rates are changing at a more rapid pace than in the 1990s in spite of lower relative growth rates. Labor is not growing as rapidly as jobs—participation rates have stopped rising, and the labor supply and working-age population have slowed sharply, due to a shift in immigration. Whereas 184,000 additional jobs per month stabilized the unemployment rate in the latter half of the 1990s, the number of jobs per month today is 120,000. There was a jobless recovery after the last recession, and the downward pressure on labor compensation costs is muted by a rise in benefit costs. The bulge in productivity growth is unwinding as firms hire, pricing power returns, unit labor costs rise, and the cost base remains sticky.

The dynamic on inflation is shifting, and the most dramatic tradeoff shift is on the external side, that is, on the relationship between capacity utilization and the goods-pricing dynamic as reflected in intermediate producer prices. This change clearly indicates the shift from a global disinflationary environment to a global reflationary environment. Inflation is already apparent at the consumer level on the goods side, and the stage is set for a turn in core service prices (i.e., unit labor costs and wage inflation). In addition, the impact of service price inflation will contribute to an upward movement in U.S. core inflation to a level that is 60 basis points higher than the Fed's forecast, said Kasman. Aggressive Fed tightening back to neutral, however, will not put a brake on the growth rate in the near term.

Kasman observed that higher real interest rates will direct activity toward commodity and manufactured goods producers. He asserts that the forces of reflation are powerful and will not be stopped by policymakers or governments. These forces, however, are directing the United States and global economies on a constructive path in the near term. He foresees more fundamental adjustments in terms of the U.S. external and domestic positions when the Fed perceives core inflation to rise above 3 percent. There is time to reflate the global economy constructively and generate world growth where it is needed, stated Kasman.

ALBERT M. WOJNILOWER observed that the Fed has never understood the mentality and culture of financial market participants. Central banks think in terms of statistical quantities that measure a country's economic welfare, while market professionals gamble for personal profits and prestige. The Fed wants a smoothly growing economy, but the securities industry thrives on volatility that generates trading volume and profits. Therefore, the Fed and financial markets are adversaries, not allies.

Based on experience, Wojnilower finds that the level of short-term interest rates has little business-cycle impact on the U.S. economy. For example, in the past year, short-term rates have risen steadily and at a predictable pace, yet long-term rates have declined, and credit has grown rapidly. The effect of changes in long-term interest rates is also limited: rate increases have to be substantial to make a real difference, especially during the present time of greater demand. Moreover, long-term rates are not significant compared with growth and profit incentives that motivate business investment in equipment and research. Therefore, noninterest limits to credit growth are necessary to prevent runaway expansions.

Rate differentials rather than rate levels are the most important influence on interest rates because of their effect on the profits of financial firms, noted Wojnilower. He also noted that the Fed has virtually guaranteed that the spread in favor of long-term rates will not vanish without substantial advance warning, a policy that has substantially reduced the risk of "carry" trades. Although the Fed wants the rising federal funds rate to lead to higher long-term rates that keep the economy from overheating (e.g., mortgage rates and the real estate market), the financial sector will continue to expand its assets aggressively if long-term rates remain above short-term rates. Narrowing the carry-trade spread will not slow credit expansion.

Wojnilower agreed that the Fed should tolerate some inflation in preference to restrictive steps that slow U.S. demand and may trigger a worldwide recession. The near-term danger of runaway inflation is small, he said, but the Fed's task of dealing with a bloated credit and asset-price bubble will not be simplified by raising the federal funds rate now. Its routine short-rate increases have habituated the market and the public to ignore its actions.

Monetary policy is only effective if credit is widely unavailable at any price. Rather than raise general interest rates and potentially trigger a crisis, it is better to employ selective measures and reasonable safeguards early on in order to rein in the economy. The main question about the next Fed chairman is whether he recognizes the raison d'être of central banks—to safeguard the monetary and financial system. The principal task of monetary policy is to prepare the way for essential compromises and trade-offs among prejudices and self-interests needed to preserve the life of vital institutions.

Senior Scholar L. RANDALL WRAY observed little evidence of actual or expected wage or price inflation and concluded that the Federal Reserve's action to raise interest rates is, at best, premature. He outlined the flaws in the Fed's thinking that have led to frequent policy mistakes and concluded that the Fed's philosophy is convoluted. It is time for a new approach to monetary policy, he said. Wray's presentation was based on Levy Institute Public Policy Brief Nos. 79 and 80. An overview of those briefs appears in the Spring 2005 *Summary,* pp. 12–14.

Session 3. Financial Instability in a Global Economy

The session was moderated by Resident Research Associate W. RAY TOWLE. A presentation was made by ROBERT A. LAWRENCE, Harvard University and the Institute for International Economics; and there was a submission by EDWIN (TED) TRUMAN, Institute for International Economics.

ROBERT A. LAWRENCE presented the results of his research with Martin N. Baily concerning the impact of financial instability on the U.S. labor market, particularly manufacturing employment where there has been an extraordinary loss of jobs (2.8 million) since 2000. He noted that employment growth since the trough of recession has been especially weak compared to other recovery periods, and many Americans have blamed this trend on trade and outsourcing. While there has been a recovery in aggregate employment in the last year, manufacturing employment remains at a very depressed level, and its share has continued to decline.

In terms of sectors of the U.S. economy, most job losses in the 2000–2003 period were in manufacturing, but other sectors showing contraction were wholesale and retail trade and professional and business services. These sectoral declines led people to give trade great prominence as an explanation of job losses, but their perceptions are inaccurate, said Lawrence. Production workers experienced huge losses (-1.9 million), and so did management (-1.1 million), so job losses affected both white- and blue-collar workers.

The recession was driven by weakness in investment, according to Lawrence, which is an important alternative explanation for weakness in the manufacturing sector. There was a huge slump in the high-tech sector of the U.S. economy. There were very weak exports during the upturn in the business cycle, but imports were only slightly weaker than average, so the story is export weakness as the more significant side of the deficit. While the manufacturing trade deficit grew toward the end of the 1990s, it expanded dramatically between 2000 and 2003. Given the size of the deficit, it is not surprising that many people blame trade for the manufacturing recession, while others pointed to the role of offshoring.

Lawrence analyzed the causal relationships between trade and manufacturing, and trade and offshoring. The greatest job losses occurred in computer and electronic products (more than 0.5 million, or 30 percent of total employment in the sector), machinery (0.3 million), and fabricated metal products (0.3 million). He noted the close connection between capital goods spending and sectors that produce capital goods. To simply look at trade deficits is inadequate, he said. Manufactured exports embody value added from other sectors, such as services and primary commodities, so export data will overstate the number of manufacturing jobs created by exports. Trade in nonmanufactured goods and services embodies value added from the manufacturing sector and impacts employment change in that sector. Furthermore, goods produced in the United States contain imported inputs; ignoring this fact would overstate the number of jobs created by U.S. exports or displaced by U.S. imports.

Lawrence used the input/output matrix to derive job-equivalent numbers and relate job changes by industry to exports, imports, and domestic use. For example, people in the steel industry complain about international trade and direct competition in steel, but the most important determinant of the demand for steel filtering through trade is U.S. exports of machinery that contain steel. The primary metals industry (e.g., steel) is directly dependent on domestic demand rather than on trade. Another important issue is how to view productivity growth. For example, labor productivity in manufacturing increased by 5 percent annually between 2000 and 2004, so demand output must grow at least 5 percent annually to hold employment constant.

Many of Lawrence's results were surprising. Most of the job losses attributed to trade is due to a slump in exports, not to increased imports. Domestic use (and weakness in domestic demand) contributed 85 percent of the decline in employment in the manufacturing sector, while the trade effect was only 15 percent. In the trade sector, export performance contributed a job loss of 0.74 million, but imports contributed a job gain of 0.43 million. Because the import gain was far less than productivity growth, the import content was much lower. The big driver here is productivity, he said, and job losses are coming from the weaknesses in exports. Although there was export growth between 2003 and 2004, the same weaknesses are evident (i.e., the United States is trading out of a tremendous slump in equipment investment in domestic spending). Another surprise is that the apparel industry is one of few industries (along with chemical products) where the trade effect was positive.

Import growth between 2000 and 2003 was slower than GDP growth, while exports fell; these rates are not keeping up with the 15-percent pace required to keep employment constant (and imports have actually been declining as a share of the U.S. goods market). Lawrence observed that the GDP numbers show the same trend as the input/output numbers, as do the updated 2004 numbers. Large deficits with China are offset in other areas, so, in aggregate, import growth is not a drain on the economy, contrary to pronouncements by the media. More significantly, exports are stalled at 20 percent (from 23 percent) of domestic production of goods. The reason for the export slump is that the United States has lost its competitiveness.

The main reason for export weakness has been the strong dollar, which is still too high, and the importance of lagged impacts. Service offshoring to India has been tiny relative to overall U.S. service employment. While it has hurt computer-programming employment, overall computer-service sector employment has held up well, despite the technology bust, said

Lawrence. He suggested that expanded service-sector offshoring represents a new trade opportunity for the United States, as it lowers costs and raises productivity.

Lawrence concluded that weak U.S. job growth has been the result of a number of factors: (1) rapid productivity growth with which demand has not kept pace; (2) an overhang of investment in high-tech and nonresidential structures; (3) a stock market correction and corporate scandals that subdued investment; (4) worsening job growth, as consumers face weak income growth and job fears; (5) oil price increases; and (6) no new policy stimulus for the U.S. economy.

According to a paper submitted by EDWIN (TED) TRUMAN, there is scant evidence that policymakers are preparing for substantial adjustment in the U.S. current account balance. He advises policymakers to design policies on the assumption that the U.S. current account balance will narrow to about 3 percent of GDP ($375 billion in 2005) over the next 3 to 5 years. The growth of U.S. domestic demand will slow by at least a percentage point from its recent rate, and U.S. economic growth will also slow if the narrowing of the balance is not handled properly. Truman urges immediate action on the U.S. budget deficit, including efforts by the Federal Reserve to slow the growth of domestic demand. He warns that the absence of symmetrical accommodative policies outside the United States will lead to higher economic, financial, and political costs of global adjustment.

Truman points out that the U.S. current account deficit is affected by public policies and economic and financial choices by private agents worldwide. However, policymakers have few incentives to adjust their policies and influence the U.S. external deficit, which contributed about 1.7 percent to GDP in the rest of the world from 1999 to 2004. The status quo is maintained because the adjustment process is likely to be politically, economically, and financially painful. This era of codependence will not only have to end, but must be reversed, he says.

Truman reviews evidence that the U.S. current account position is unsustainable and unlikely to continue at its current rate of nearly 6 percent of GDP. He outlines the implications of an external adjustment, including a substantial terms-of-trade loss that would be felt by most consumers. He offers several alternative scenarios of exchange rate adjustments that would need supporting policy actions and proposes that the United States, the euro area, and Japan encourage the diversification of substantial additions to international reserves.

The wide range of views about the U.S. current account position is explained by three factors: (1) it is an endogenous variable; (2) it is not a target of U.S. policy; and (3) there is a lack of consensus on the appropriate analytical framework. Truman identifies four major analytical strands: the trade balance view; the saving and investment view; the aggregate demand view; and the portfolio balance (capital account) view, and he believes that a proper analysis should include all four strands. He also identifies six views about what constitutes a sustainable U.S. current account position. Although there is a great deal of uncertainty about the size and timing of the U.S. current account adjustment, an adjustment is inevitable, he says.

The consequences of a continuation of unsustainable U.S. current account deficits include a rise in protectionism, geopolitical implications ("the balance of financial terror"), and a lack of confidence in U.S. financial policy, which increases the risk of crisis. Truman notes that external financial crises are more common after the process of adjustment is underway, but that the chances of a disorderly correction are low. He also notes that the U.S. external adjustment will require an adjustment of U.S. saving and investment. For example, a reduction in the U.S. current account deficit by 3 percent of GDP would boost expected U.S. long-term interest rates by 75 basis points, which would reduce the rate of investment, lower the rate of growth of the capital stock, and slow the growth rate of potential GDP. The data suggest that the United States faces an extended period of stagnation of real incomes. (Declining real wages has been associated with improvement in the trade balance.)

The core economic policy issue is the low rate of domestic saving. The most reliable method of increasing national saving is to reduce the fiscal deficit (which contributes to lower interest rates and may be associated with a weaker currency) and raise net government spending through expenditure reductions or tax increases. (The long-run impact will raise growth and living standards.) The proper measure is not the actual deficit (which has been declining), but the structural deficit (which has been deteriorating). Truman believes that the Fed has not acknowledged that monetary policy has a role to play in managing the balance between supply and demand (i.e., slowing the growth of aggregate demand relative to the growth of aggregate supply) and therefore risks slamming on the brakes in the name of containing inflation and restoring credibility.

Truman does not believe that the United States should deliberately seek to weaken the dollar. However, exchange rates are likely to be a central element of the adjustment process that forces other policy adjustments. The dollar will depreciate by another 20 percent on average in nominal terms, Truman says. The depreciation will have to be broadly based, and most currencies will have to appreciate by at least 15 percent. The question is how this process will unfold, particularly for currencies pegged to the dollar (e.g., the Chinese yuan). The preferred approach is an immediate and substantial appreciation of the yuan (15 to 25 percent) and greater exchange rate flexibility, along with a coordinated adjustment of Asian currencies.

Some cautionary observations are that foreign official assets accounted for only 14 percent of all foreign assets in the United States in 2003 and U.S. dollar financial liabilities are highly substitutable in most portfolios. In addition, private capital inflows into the United States were 2.5 times official inflows in the first quarter of 2004, so recorded reserve patterns have little to do with the pattern of trade surpluses. Furthermore, the reserve-management policies of monetary authorities are an area of substantial inertia in the international financial system. Truman's preference is that monetary authorities adopt a longer-term view of portfolio management and that they diversify currency assets.

Aside from official exchange rate and portfolio policies, the central economic policy issue for the rest of the world is whether other economic and financial policies adjust appropriately to smooth the U.S. external adjustment (e.g., increasing investment at home or reducing saving). Truman suggests using exchange rates as the preeminent device for facilitating expenditure switching in the United States (i.e., boosting exports and slowing the growth rate of imports) and for slowing the growth of domestic demand. He notes that increasing the growth rate of the rest of the world has historically had a relatively small effect on the U.S. trade balance.

Session 4. The Macroeconomic Prospects for the U.S. Economy

The session was moderated by Research Scholar AJIT ZACHARIAS. Presentations were made by LAKSHMAN ACHUTHAN, Economic Cycle Research Institute; Senior Scholar JAMES K. GALBRAITH, University of Texas at Austin; and RICHARD W. PEACH, Federal Reserve Bank of New York.

The principle challenge to short-term forecasting is improving the methods for predicting upper turning points of economic cycles, said LAKSHMAN ACHUTHAN. Comovement of key coincident measures of the economy (production, employment, income, and sales) occurs at turning points and is at the root of the classical definition of the business cycle, which still applies today. The challenge is to recognize when the cycle is about to turn.

The consensus forecast, which is mainly based on econometric models, is one of the most accurate forecasts, especially during periods between turning points. The monetarist approach complements econometric forecasts by focusing on events at the turning points—the cyclical highs and lows of the cycle—so it is a valuable aid in decision-making.

Achuthan reviewed the background leading to the classical definition of business cycles and the composite index of leading economic indicators, including the approaches of Wesley Mitchell, Arthur Burns, Geoffrey Moore, and Julius Shiskin. He noted that Moore developed a list of leading indicators of revival and recession in 1950, tested a leading index in the 1970s, and developed separate leading indicators for employment and inflation in the 1980s. Moore's work developed eight leading indicators, including sensitive commodity prices, new orders, stock prices, new incorporations, and business failure liabilities. Achuthan noted that the important feature is the lead time, which averages about four months at the peak and trough of the business cycle. Leading indicators would have correctly predicted turning points in the period from the U.S. Civil War through the second half of the 20th century in spite of profound structural changes in the U.S. economy, and these indicators are robust in other diverse economies (e.g., the G6 countries, South Korea, New Zealand).

Three key cyclical aspects of an economy are economic growth, employment, and inflation. Achuthan outlined the state of the art of monitoring cycles in market economies. Future inflation gauges are designed to capture the key drivers underlying inflationary pressures (e.g., real home prices) and to forecast turning points in the inflation cycle. In forecasting the overall employment cycle, it is important to capture such nuances as the leading indexes of nonmanufacturing and manufacturing employment. In terms of domestic and overall growth, various sequential indicators include a long-leading index (about a year), a week-leading index and a short-leading index (a couple of quarters), and a coincident index (no lead time). He noted that it is important to study particular sectors of the economy (e.g., indexes for services, financial and nonfinancial services, manufacturing, and construction) as well as the overall business cycle. This approach allows the study of individual movements of the U.S. economy and the incorporation of analogous indicator groupings for international economies (i.e., exports, imports, and trade). This monitoring mechanism is a major evolution of the cyclical approach, said Achuthan.

In terms of current growth prospects, Achuthan pointed out that the indicators have been drifting up or have stopped falling. Therefore, economic growth and stability are likely to prevail during the next few quarters. While the inflation gauge components denoted significant imported disinflation in the 1990s, there has been an inflation-cycle upturn in the 2001–05 period. However, inflation is not running away in spite of a spike in oil prices. As a coincident indicator, employment is on target, but manufacturing (11 percent of employment) has collapsed since the last recession. The weak employment index is the result of a structural shift rather than a cyclical event. The decline in manufacturing, however, appears to be over.

Senior Scholar JAMES K. GALBRAITH reviewed a recent paper entitled "Budget Deficits, National Saving, and Interest Rates" (September 2004) by William G. Gale and Peter R. Orszag, both of the Brookings Institution and the Urban-Brookings Tax Policy Center. The paper outlines the widely accepted case for treating current and future U.S. budget deficits as the most urgent economic policy priority. Gale and Orszag argue that "sustained budget deficits reduce national saving and raise interest rates by economically and statistically significant quantities." Galbraith finds that the authors' theory is built on a very poor understanding of the theory of economic output and growth, that their econometric work does not support their case, and that the perspective of John Maynard Keynes has been left out.

Gale and Orszag identify three "principal perspectives," or models, of the effect of deficits on the macroeconomy: the Ricardian equivalence hypothesis, the small open economy view, and the conventional view. Their paper is a brief for the conventional view—deficits raise interest rates and lower "national saving," national investment, capital stock, and national income.

Galbraith stated that it is inappropriate to use Ricardian equivalence (which proposes that a cut in taxes will have no impact whatever on aggregate consumption expenditure) as a starting point for a discussion of fiscal policy. The authors' underlying growth theory is that the future size of real GDP depends solely on the size of the real capital stock, which depends solely on the physical quantity of new capital investment (full employment of labor is assumed). Since resources are shifted from saving and investment to consumption, they argue that budget deficits have no effect on current GDP. Keynesians take exception to the notion that tax cuts, which are 50 to 80 percent spent in the first year, have no effect on current GDP, said Galbraith. To postulate that a fiscal shift of 3.5 percentage points of GDP ($420 billion) has no stimulative effect on GDP or inflation is truly improbable. The authors' theory does not allow for fluctuations of aggregate effective demand, nor does it account for changes in unemployment.

According to Galbraith, another problem with the authors' theory is its total reliance on growth of capital stock to explain growth in real output. He argues that it is not true that future real GDP is always enhanced by more investment (e.g., free-market capitalism at the peak of the "dot com" boom did not have that effect) and that GDP growth relies mainly on new capital investment (e.g., there is the Solow residual, or "technical change," as well as productivity growth to consider). According to Keynesian theory: (1) it is not possible to stimulate nominal GDP through fiscal policy without experiencing some expansion of nominal GDP; (2) the economy does not characteristically operate at full employment and capacity, and some growth of real GDP is therefore a characteristic response to fiscal stimulus; and (3) when demand for real output presses on the supply of labor, induced productivity growth tends to occur. The fears that Gale and Orszag express about future budget deficits are plainly overstated because they ignore the Keynesian effects on total output, said Galbraith.

In regard to international aspects of the authors' position (i.e., the flow of capital from overseas and the repayment in the future as a result of borrowing from abroad today), Galbriath maintains that today's imports do not necessarily imply tomorrow's exports. Reliance on the dollar internationally means that foreign countries have limited leverage over U.S. interest rates. In response to Gale and Orszag's third model, which links budget deficits and real interest rates (and where banks play no role), Galbraith notes that in no way is it legitimate to derive an interest rate from a marginal-product-of-capital calculation (i.e., capital stock is not homogeneous, so it is measured as a valuation in financial terms, which depends partly on an exogenous rate of interest). Further, he says, there is no consistent relationship between the "capital intensity" of production, in aggregate, and the interest rate.

Galbraith's critique of the authors' interest-rate regressions is that there is no stable empirical relationship between rising deficits or federal debt and some measure of the interest rate; the authors' estimates apply only to forward and not to actual interest rates, and according to their own estimates, the effects on the current borrowing cost of the federal government or private sector could be zero. Moreover, their calculation of the effect of deficits on savings and asset ownership has nothing to do with the channel of effect through the interest rate. Furthermore, present deficits are not causing an investment shortage.

Galbraith suggests that people who oppose the drift of the United States under Bush and Cheney should stop hiding behind platitudes of public finance and look for more coherent economic programs that address real problems, such as jobs, health care, energy, global warming, and the risks and costs of war.

RICHARD W. PEACH addressed the question of whether or not there is a housing bubble in the United States. He noted that the views expressed were his own and not necessarily those of the Federal Reserve. His coauthored paper with Jonathan McCarthy used price-index data for the 1976–2004 period from the national home price series for the U.S. economy issued by the Office of Federal Housing Enterprise Oversight (OFHEO), a government agency that supervises Fannie Mae and Freddie Mac. He also noted that the current real appreciation in the national home price index is unique and has led to claims of a housing bubble, unrealistic expectations of future price appreciation, and a surge in purchases of investment properties. These supposed effects are claimed to be the result of excessive ease by the monetary authorities, he said.

Peach disagrees with the notion that the value of residential real estate should be assessed using the OFHEO home price index because its repeat-sales home price series is not a constant quality index. He outlined other national home price series, such as the median price of existing homes sold, published by the National Association of Realtors, and the median price of new homes sold, as well as the constant-quality new home price index, published by the Census Bureau. The constant-quality new home price index incorporates additional information about the physical and locational characteristics of homes. Peach noted that the process of deriving the deflator for residential investment is also supervised by the Bureau of Economic Analysis.

In the period from 1977 to mid-2004, the constant-quality new home price index rose 215 percent, whereas the repeat-sales index rose 353 percent (roughly equal to the change in the median price of new homes sold). The repeat-sales index is questionable because the size and amenities of new home construction have risen rapidly over time. Peach presented additional evidence that the repeat-sales home price index is not a constant-quality index. When the standard measure of home price valuations (home price divided by median family income) is replaced by the constant-quality index or the rent-to-price ratio, the ratios are not high or low, respectively, by historic standards.

Using the latest data from the American Housing Survey (2003), the authors disaggregated single-family homes by percentile and examined rates of change of home prices relative to income, length of occupancy, and the ratio of median home values to median income. They found that rates of home price appreciation and housing stock turnover rates are rising more rapidly in the top half of the distribution, a feature in line with the income distribution. Therefore, transaction-based home price series have an upward bias. The median-value-to-median-income ratio has risen for all points in the distribution, but it is higher further up the distribution, so there is an income elasticity of demand for housing that is greater than one. Based on national home price statistics, Peach concludes that it is debatable whether or not home prices are seriously overvalued.

He finds that a review of home prices by state in the period from 1999 to mid-2004 showed that faster income growth leads to faster home price appreciation. However, many states outside California and the Northeast have comparable rates of income growth, but much lower rates of home price appreciation. Furthermore, in aggregate, buyers do not have particularly high expectations of future price appreciation in the housing market, a view confirmed by the University of Michigan's consumer confidence survey. Peach also found that the number of investment properties has declined to13 percent of all occupied single-family homes in 2003, a result of an ongoing shift from rental to owner occupancy.

Speaker: PAUL DAVIDSON

The topic addressed by Paul Davidson, editor of the *Journal of Post Keynesian Economics* and visiting scholar at New School University, is whether a declining dollar is good for the U.S. or global economies. He maintains that, while it is true that the physical volumes of exports and imports increase and decrease, respectively, as the value of the dollar declines, this response does not mean that there will be a reduction in the trade deficit. (Although the volume of imports may decline, higher prices could result in more spending on imports.) The Marshall Lerner condition that is necessary for dollar depreciation to improve the trade balance may not be applicable to the U.S. trade pattern. Davidson noted that U.S. policymakers are encouraging speculators to bet against the dollar. The question is not whether there will be an abrupt further dollar decline leading to a financial crisis, but, when will a crisis occur?

Davidson outlined the history of the dollar standard and noted that, under the Bretton Woods dollar-based payments system, the non-Communist world experienced the highest global rate of real economic growth and a better record of price stability. The reasons for growth and stability include the fixity of exchange rates and the notion that creditor nations accepted responsibility for curing current account imbalances. According to Davidson, today's global economy has two choices: defend the existing dollar standard, or abandon any international standard for the global payment system and accept that all currencies are free to float against one another. The bursting of the dollar standard, however, is potentially devastating for the globalized economic community, he warned.

Davidson noted that the post–Bretton Woods world has never been one of pure generalized floating, but floaters may be gaining over currency fixers, who were motivated by geopolitical rather than purely economic reasons after World War II. The euro nations recognize that fixed exchange rates among one another are preferred for macroeconomic stability and interregional trade expansion. The most vocal advocates of floating are predominantly Americans operating under the ideological spell cast by Milton Friedman and Walras/Arrow/Debreu. The Asian decision to maintain a competitive fixity of exchange rates against the dollar and pursue export-led growth (and savings on their rapidly growing international accounts) permits consumers in the United States to live well beyond their means.

While most of the world relies on export-led growth for achieving real economic growth, the United States requires significant labor productivity growth. The conventional wisdom is that foreigners will not accept dollars without limit in the long run, so the U.S. current account deficit is not sustainable.

In light of growing trade deficits in spite of government fiscal surpluses, Davidson concludes that the fiscal budget deficit per se is not the cause of persistent U.S. current account deficits. He also recognizes that belt tightening on the part of large debtor nations would have deflationary repercussions for creditor nations (e.g., rising unemployment, falling aggregate incomes, and potential bankruptcies of export industries). Therefore, creditor nations would be foolish to suddenly stop their growing surplus dollar export earnings in favor of a free-floating exchange rate.

The current system of international capital flows combined with the options of developing nations with deficits (and IMF loans and Washington Consensus reforms that require policies that depress the nations' economies) lead to situations where indebted nations cannot free themselves from the increasing weight of hard-currency international debts (except by default). Davidson does not support Joseph Stiglitz's proposal of global greenbacks, known as special drawing rights (SDRs). Rather, he says, the cure lies in creating a new international financial architecture, which President Clinton called for after the Russian debt default in 1998.

Using Keynes's guidelines, Davidson proposes a new international financial architecture, outlined in his book *Financial Markets, Money and the Real World* (2002). Building on Keynes's proposal for an international clearing union, Davidson developed an eight-point system that produces the conditions to permit the establishment of a global golden age of economic growth in the 21st century. Whenever there is a persistent or large imbalance in current account flows, there must be a built-in mechanism that induces the surplus nation(s) to bear a major responsibility for eliminating the imbalance, he said. It is time to look at blueprints for a new financial architecture that will prevent recurrent financial crises and another international Great Depression.

Speaker: DONALD L. KOHN

The topic addressed by Donald L. Kohn, member of the Board of Governors of the Federal Reserve System, was imbalances in the U.S. and global economies, including their resolution and implications for policy. He emphasized that the views expressed were his own and not necessarily those of his colleagues on the Federal Open Market Committee.

Kohn noted that the United States has done well by most measures of overall economic performance. Accommodative financial conditions combined with healthy profits and cash flow and increasing incomes have led most forecasters to expect growth to remain solid. He expects that, barring further sizable increases in the prices of oil and natural gas, both core and headline inflation rates should moderate later in 2005.

Although the overall state of the economy is favorable, there appear to be a number of spending imbalances and unusual asset-price configurations: record levels of the current account deficit and net foreign indebtedness; a pronounced decline in saving proclivities of private and public sectors; and a rise in capital spending. Contrary to expectations that the pronounced imbalance between national saving and domestic investment would place substantial upward pressure on interest rates, nominal and real yields on short-term and long-term Treasury securities are low by historical standards. Investors appear to be sanguine about default risk and other types of uncertainty, and low interest rates have been a major force driving the run-up in residential real estate prices, as well as net worth. Kohn posed the questions: "Can the spending imbalances and possible asset-price anomalies continue without threatening macroeconomic stability?" and "If not, how will they unwind, and what role will government policy play in influencing the path of adjustment?"

Kohn noted that these sorts of imbalances are not new and that the U.S. economy continues to churn out high rates of productivity and income growth. However, the magnitude of imbalances is moving into unfamiliar territory, and projected funding shortfalls in Social Security and exploding Medicare and Medicaid costs without fiscal discipline mean a worsening long-run outlook for the federal budget balance. Therefore, the sustainability of large and growing imbalances would require behavior that is inconsistent with reasonable assumptions about how people save, spend, and invest. Current imbalances will likely give way to more sustainable configurations of income and spending, but their size and persistence risk a disruptive transition.

Important factors in the U.S. trade and current account imbalances include a rise in the net supply of saving in other countries, the perception that dollar assets (and a favorable relative return on U.S. investment) are a favorable vehicle in which to place that saving, and an increase in global financial integration that has facilitated the transfer of savings. In the aftermath of recession, the slow rebound in private aggregate demand meant that many central banks held real interest rates low to support real activity and keep inflation stable, which, in turn, bolstered asset markets and depressed the personal saving rate. In addition, a fiscal policy shift toward greater deficits and innovations in financial markets and other structural changes that facilitated household spending worked to lower national saving relative to domestic investment.

The Federal Reserve started a process of removing the unusual degree of policy accommodation about a year ago, and the process is not yet finished, said Kohn. The federal funds rate appears to be below the level that is consistent with the maintenance of stable inflation and full employment over the medium run. Rising interest rates should induce an increase in the personal savings rate and lessen one of the significant spending imbalances. However, it is difficult to forecast the path of the overall spending-to-production imbalance, but, at some point, the current account deficit should start to narrow. And it may be helped by an autonomous rise in domestic saving.

If current spending behavior is built on realistic expectations, the transition should be relatively orderly, said Kohn. However, if current expectations are distorted, then realignments can be abrupt, making it difficult for monetary and fiscal policy actions to keep the economy on track. Kohn outlined several observations about Treasury yields, risk premiums on private securities, investors, and private bond premiums and concluded that the likelihood of major credit problems seems limited in the current environment. In terms of the housing market, distortions would most likely unwind through a slow erosion of real house prices rather than a sudden crash. A gradual adjustment in spending would give offsetting policy actions time to work.

In terms of the exchange rate of the dollar, Kohn does not think that market expectations are substantially distorted. Financial markets are flexible and increasingly integrated around the world, so there is adaptation of capital flows to changing circumstances. The same goes for markets for goods and services that have been subjected to government actions to slow the process. It is likely that adjustments toward reduced imbalances in the United States and globally will not disrupt the overall performance of the U.S. economy, he said, but there must not be complacency in light of the large imbalances that are unusual from a historical perspective.

Kohn believes that sound public policies are essential to enhance the chances for a smooth transition. A permanent correction to spending imbalances must involve the restoration of fiscal discipline and long-run solutions to the financing problems of Social Security, Medicare, and Medicaid. He noted that the United States cannot count on an ever-increasing flow of global savings and there would be intensified pressures on interest rates. U.S. trading partner policies could help to adjust global current account imbalances by using macroeconomic policies and micro-oriented measures to stimulate domestic spending. Governments should strive to maintain and enhance the flexibility of markets, and strong financial institutions are needed when asset prices move unexpectedly or changes in short-term interest rates are necessary.

The Fed's mandate is concerned with monetary policy and with anything that threatens the stability of output and prices, said Kohn. Imbalances affect the forces of supply and demand, so they have consequences for price stability. In Kohn's view, the Fed's role is to anticipate the macroeconomic effects of imbalances and their correction and to respond to unexpected changes in asset prices and spending propensities. The Fed aims to achieve economic stability through such actions.

Financial Markets and Monetary Policy

Is the Dollar at Risk?

KORKUT A. ERTÜRK
Policy Note 2005/3
www.levy.org/pubs/pn_3_05.pdf

U.S. aggregate macroeconomic imbalances (i.e., the budget and current account deficits) have worsened along with an increase in the value of assets owned by foreigners and a decrease in net investment income. According to Research Associate Korkut A. Ertürk of the University of Utah, steep dollar devaluation, rather than a slow downward drift, would be better for the U.S. economy. The dollar and U.S. interest rates will increasingly be dictated by the interests of foreigners, he says, and the United States will find it increasingly difficult to maintain any real control over its financial and economic destiny.

Ertürk outlines three distinct scenarios: (1) a U.S.-led recovery; (2) a complete collapse of the dollar; and (3) whether those in a position to make or break the dollar are able to engage the United States "constructively." The first scenario, whereby the United States resumes being the engine of world growth and the importer of last resort, looks increasingly far-fetched. The housing bubble is the single most important obstacle the U.S. economy will face in the next couple of years, and the effect of it bursting could be worse than the bursting of the stock market bubble, he says. The second scenario would cause cataclysmic turmoil in financial markets worldwide, as world central banks are unable to stop the destabilization process of a run on the dollar and there is an abrupt rise in U.S. savings. Since the first two scenarios are chimeras, a third option is desirable.

The author notes that the economic and political costs of keeping the United States engaged on its own terms (with its neoconservative unilateralism intact) will continue to rise, so the world will have to wean itself from U.S. markets. The Asian governments will probably use their cache of dollars to acquire control over real resources around the world, so political tensions are sure to rise.

Ertürk speculates that once the dollar ceases to be a magnet, developing countries will reduce their vulnerability to international capital markets in the era of globalization. There will also be attempts to establish regional economic and financial networks (e.g., growing cooperation among the member countries of the Association of Southeast Asian Nations together with China, Japan, and South Korea). Furthermore, a loose alliance of countries may define their self-interest by creating a multipolar world that bypasses the United States (e.g., a Eurasian bloc is no longer unthinkable).

Is More Mobility Good?: Firm Mobility and the Low Wage–Low Productivity Trap

STEPHANIE SEGUINO
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Research Associate Stephanie Seguino of the University of Vermont explores the effect of foreign direct investment (FDI) flows on wages and productivity growth in developing economies. In contrast to previous studies, she finds that FDI has a negative effect on wage and productivity growth. Her evidence is consistent with the hypothesis that, if capital mobility reduces wage pressures, the push for firms to innovate also declines, leading to slower productivity growth. Seguino's results suggest that there can be a low wage–low productivity trap that countries fall into when capital gains too much bargaining power vis-à-vis workers.

Seguino investigates a set of 37 semi-industrialized economies for the period 1970 to 2000. She notes that the share of global inward and outward FDI directed to and out of developing economies has increased since 1970. Total FDI as a share of gross fixed-capital formation serves as a proxy indicator of capital's threat effect in negotiations over wages, employment taxes, and other factors that affect firm profitability, and the share has been rising for most regions of the developing world.

Seguino outlines a number of debates on the determinants of inward FDI and the impact of investment liberalization on developing economies that are, as yet, unresolved. While one group lauds the relaxation of constraints on corporate investment as a win-win outcome, another group argues that increased FDI flows result in an augmentation of corporate power that can contribute to downward pressure on wages and to greater wage inequality in both developed and developing economies. She surmises that the positive effect of wages on productivity growth may have technological limits when higher wages translate into permanent increases in unit labor costs, which result in higher prices and declines in demand and employment. She suggests that the relationship between labor productivity and wages is positive over some relevant range of wages and that the relationship may be linear, logarithmic, or strictly concave, depending on the industry. An empirical example of a positive relationship among wages, investment, and productivity growth is her study of South Korea in the period 1975 to 1995.

Seguino outlines channels through which mobility can slow wage and productivity growth, such as firm fragmentation (a production strategy to reduce costs through downsizing and outsourcing), globalization (financial liberalization emphasizes short-term profits), and subcontracting (flexible workers have less bargaining power). One scenario is that capital mobility holds down wage growth and reduces the pressure on firms to raise productivity, so productivity growth stagnates.

Seguino develops a framework for estimating the effect of firm mobility on wages and productivity growth. She tests the hypothesis of a negative effect of capital mobility on wages and the effect of firm mobility on manufacturing-labor productivity growth. Seguino expects the effects to be more pronounced in labor-intensive industries where wage costs are a larger share of total costs, such as wearing apparel, footwear, leather, and electrical machinery. FDI is defined as the increase in the equity position of a foreign firm that holds more than 10 percent of the shares of a host-country firm. Sequino outlines several important measurement concerns (e.g., countries that are tax havens) and cautions about cross-country data analyses and against heavy reliance on the size of coefficients.

Disaggregating total FDI into inward and outward FDI shows that each has a significant negative effect on wage growth, but the effect of outward FDI is larger. FDI exerts the strongest negative effect in wearing apparel, as well as a negative effect in footwear and leather. (There is no discernible effect in the electrical machinery industry.) Results from Seguino's reduced sample indicate that the negative effect of firm mobility on wages in wearing apparel is apparent in other subsectors. Her results are consistent with the argument that changes in firm mobility produce psychological effects on workers that cause them to attenuate wage demands.

In terms of the full sample, Seguino finds that GDP growth exerts a positive and significant effect on productivity growth (a 1-percentage-point increase in GDP growth is associated with a 0.635-percentage-point increase in the productivity growth rate), which is consistent with the Verdoorn hypothesis, and total FDI has a negative effect on productivity growth. Inward FDI exerts a significantly negative effect on productivity growth, while outward FDI, though negative, is not significant. The negative effects of FDI are most robust on wages and, in the disaggregated regressions, outward FDI has a more significant negative effect than inward FDI, as expected.

While the results are consistent with the hypothesis of a low wage–low productivity trap, Seguino tempers her conclusions due to measurement problems and the possibility of omitted variable bias. Also, FDI data at the subsector level does not separate vertical FDI (largely export industries) from horizontal FDI (capital-intensive industries). Seguino notes that other factors may play a role, such as macroeconomic stabilization policies, liberalization of financial flows, and privatization of publicly owned firms. She suggests that detailed case studies of country-specific factors would be a valuable next step for exploring the role of FDI in influencing trends in wage and labor productivity growth.

Macroeconomics of Speculation

KORKUT A. ERTÜRK

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www.levy.org/pubs/wp424.pdf

Despite Minsky's emphasis on the speculative character of investment decisions, he paid little attention to asset-price speculation per se, ignoring asset-price bubbles and their macroeconomic effects, notes Research Associate Korkut A. Ertürk of the University of Utah. Financial speculation in asset prices is growing in importance, evident in the rise and bursting of the high-tech stock market bubble in the United States, the persistence of the liquidity trap in Japan, and currency crises in emerging markets. Most mainstream economists do not acknowledge or know how to study the macroeconomics of asset-price bubbles in light of the influence of the efficient-market hypothesis since the 1960s, he says.

Ertürk revisits Keynes's *A Treatise on Money* (1930) for fresh insights into financial macroeconomics and where asset-price expectations and speculation (and financial circulation) play an integral role in a macroeconomic analysis of the trade cycle. The behavioral theory of finance seems to corroborate Keynes's arguments in the *Treatise*, along with his "beauty contest" analogy in *The General Theory of Employment, Interest, and Money* (1936). Ertürk presents an overview of Keynes's treatment of asset-price speculation in the context of business-cycle analysis and discusses the conditions under which speculation can be destabilizing. He develops a generic macroeconomic model to highlight how output determination might work with self-sustained biases in asset-price expectations in financial markets, and he captures the macroeconomic argument implicit in the *Treatise*.

Ertürk notes that monetary circulation in the *Treatise* has two components—industrial and financial—that are associated with the circulation of goods and services, and titles to financial wealth, respectively. He also notes that Keynes took the volume of cash deposits as a rough measure of industrial circulation, and savings deposits as a measure of financial circulation. Keynes defines four types of speculative markets in connection with different configurations of the bear position, and his approach in the *Treatise* is consistent with the modern "noise trader" (behavioral) approach to finance (i.e., there are no riskless arbitrage opportunities when actual prices deviate from true values).

According to Keynes, the rise of the bear position at a time when security prices are rising plays an important role in explaining the turning point of a business-cycle expansion. When profits fall short of expectations that underlie asset prices and the view that the market might be overvalued takes hold, a bear position develops, and interest rates are likely to rise above the natural rate.

The mainstream view among economists stems from Friedman (1953), who argued that destabilizing speculation would be unprofitable and unsustainable in the long run. Asset-price bubbles were considered highly unlikely in a "normally" functioning market. The intuition behind Friedman's argument rested on a simple view of arbitrage where smart traders know the true values, while noise traders do not. The assumption that smart traders know the true value is exceedingly unrealistic, says Ertürk, and it does not necessarily follow that the deviation of an asset's current price from its true value creates a riskless arbitrage opportunity.

The modern behavioral approach to finance holds that the effect of arbitrage can be severely limited, which is very close to Keynes's "beauty contest" analogy (i.e., speculators base their expectations of future asset prices not only on what they think the true values are, but, more importantly, on what they think the average opinion about the average opinion is). Noise is as important as information about true values in causing asset-price changes, rendering an uncertain resale price. Since no direct information exists on others' higher-order expectations, traders make inferences from market trends (i.e., the magnitude and direction of changes in current prices).

Stability depends on both the elasticity of expectations and the reaction speed, but speculation can become destabilizing once price deviations exceed in size and duration a certain threshold. In a similar manner, in his *Treatise* Keynes's discussion on how asset prices behave over the business cycle seems to presuppose that speculation can be stabilizing and destabilizing, depending on the phase of the business cycle. While speculation is stabilizing in the period when asset prices are driven by fundamentals, it is destabilizing in the period when asset prices are driven by speculation (during late expansion), giving rise to a bubble. Keynes's argument implies that the elasticity of expectations can vary endogenously over the business cycle.

Ertürk constructs a series of diagrams that incorporate his observations based on Keynes's insights and the behavioral theory of finance. One diagram shows that, if and when asset-price expectations exhibit a strong trend component, the influence (of expectations) can be very significant. Another diagram shows how desired macroeconomic outcomes can be affected by controlling asset prices through changes in the interest rate. While the latter diagram might be more applicable to a world characterized by financial regulation and tranquility, the former diagram is more relevant today, says the author.

Refocusing the ECB on Output Stabilization and Growth through Inflation Targeting?

JÖRG BIBOW

Working Paper No. 425, July 2005

www.levy.org/pubs/wp425.pdf

The consensus view among the eurozone's key policymakers is that there is no need to reform the European Central Bank (ECB). According to Research Associate Jörg Bibow of Franklin College, Switzerland, the ECB has failed dismally to manage domestic demand growth, and it has pushed inflation up at the same time that it has strangled growth. The evidence is clear that the ECB's macroeconomic policy has failed, he says. The ECB leaders are ignorant of economic theory, and they have rejected an inflation-targeting approach.

The author assesses the ECB's performance from within an inflation-targeting framework, looking at whether this framework might refocus the ECB toward output stabilization and growth (the bank's secondary mandate, according to the Maastricht Treaty). Bibow maintains that the ECB obfuscates its inflation-targeting approach and does not properly internalize the fiscal policy regime (i.e., the Stability and Growth Pact). As a result, since 2000 the bank has failed to meet its price-stability mandate.

Bibow observes that the ECB is firmly attached to Germany's Bundesbank traditions, which provided the blueprint for the structure of monetary policy in the Economic and Monetary Union (EMU). The traditions include an improperly managed economy, bank independence, an overall autocratic style, peculiar public relations, and a "two-pillar framework": the monetary pillar and the price-stability pillar. Within its monetary pillar, the ECB uses its reference value (M3 growth) in the same highly discretionary manner as the Bundesbank. Within its price-stability pillar, the ECB has a pronounced bias in its inflation-risk assessments and interest rate applications. The asymmetry in the ECB's approach is that it quickly slams on the (economic) brakes, but abstains from using the accelerator. The approach has been costly, as the ECB, including Germany, flirts with "stability-oriented" deflation. Europe's leadership, however, invents structural excuses for protracted domestic demand stagnation and blames its malaise on the rest of the world, says Bibow. Maintaining price stability is not enough when attempting to stabilize the economy.

The ECB's performance has featured a number of policy blunders: (1) a clash between the ECB and financial markets resulted in a marked depreciation of the euro; (2) its refusal to cut interest rates and boost growth resulted in a productivity slump that pushed up unit-labor costs; and (3) its refusal to cut interest rates and stimulate a recovery has prompted increases in indirect taxes and administered prices. These policy blunders have pushed inflation up and choked domestic demand through aggressive interest rate hikes.

Bibow observes that, while headline and core inflation rose, wage inflation remained low and stable, so employment gains did not materialize and protracted stagnation and rising unemployment caused budgetary problems. He also observes that without tax-push inflation, the ECB would not have failed its price-stability mandate over the last four years. The counterproductive interaction between fiscal and monetary policies has left the euro area stranded in stagnation and with inflation persistently above its set limit of 2 percent, which is probably too low.

A proper way to target inflation is to internalize fiscal policy, sustain growth and employment, and prescribe a forward-looking policy conduct. An inflation forecast takes center stage in the policymaking process and policy communication, and deviations in either direction are equally unwelcome. Inflation targeting means actively managing aggregate demand and employment and thereby inflation (i.e., fine tuning the economy by means of monetary policy). The Bank of England targets inflation through this approach. The United Kingdom is blessed with cooperation between monetary and fiscal policies, including wage increases in line with GDP growth. Rigid wage inflation should not be blamed for euroland's stagnation-cum-inflation persistence, asserts Bibow.

Policymakers should reform euroland's structural problems rather than single-mindedly push for labor-market liberalization. They should also correct the key flaws in central banking institutions, such as unbounded discretion, which is undemocratic and economically inefficient. Bibow suggests that one way to encourage such reform is to impose inflation targeting upon the ECB through a collaborative effort among ECOFIN, the European Commission, and the European Parliament. Another way is to select central bankers who can manage the economy and, thereby, inflation.

Liquidity Preference Theory Revisited: To Ditch or to Build On It?

JÖRG BIBOW

Working Paper No. 427, August 2005
www.levy.org/pubs/wp427.pdf

According to the classical economists, the rate of interest is a real phenomenon that is determined by the forces of productivity (the demand for funds for investment purposes) and thrift (the supply of savings). By contrast, Keynes argues that the theory of interest is properly dealt with at the level of portfolio decisions. His crucial point is that finance rather than saving is the precondition for entrepreneurial investment activity and that it precedes the actual investment and saving flows. Thus, Keynes undermined the assumption that productivity and thrift are the supposed real anchors of the interest rate. Research Associate Jörg Bibow of Franklin College, Switzerland, disagrees with the critiques of Keynes's liquidity preference theory. He argues that Keynes provides a suitable analytical framework for investigating the role of monetary policy and the financial system and for offering both theoretical and practical insights that are relevant today.

Bibow reviews Keynes's works, particularly *The General Theory of Employment, Interest, and Money* and *A Treatise on Money*, and notes that Keynes clearly shows that loanable fund theorists mistakenly focus on savers alone when they argue that a rise in thrift directly and immediately depresses interest rates. In the case of an unforeseen rise in thrift, sales revenues will be disappointing, so that saving leads to redistribution rather than a rise in wealth. By contrast in the case of an anticipated rise in thrift, "savings plans" will be disappointing in line with income expectations. Further adjustments in business and consumer behavior due to sales may influence subsequent developments. It is simply fallacious to consider saving as a source of funds that could finance investment, says Bibow. In monetary production economies, it is money that allows production of real things to go ahead.

Interest rates are, however, affected by the "Keynes mechanism," which may be triggered by a change in the scale of economic activity rather than a change in thrift. The Keynes mechanism is driven by the banks' profit motive and describes an indirect interest rate channel that could lessen the deflationary effects of increased thriftiness. Keynes stresses that, in general, the banking system holds the key position in the transition from a lower to a higher scale of activity. The finance motive highlights the importance of banking system behavior and shows that liquidity preference theory is also a theory of financial intermediation. The terms of finance determined by the financial system, in whatever ways, condition the levels of income and employment.

How should economic policy be organized and applied to deliberately manage the economy? According to Keynes, real world market economies are, in fact, managed economies, and the failure to achieve satisfactory macroeconomic performance is due to inappropriate policy arrangements and ignorance. Regarding monetary policy, Keynes advocated arrangements allowing authorities to exercise a sufficient degree of influence and control over financial institutions and markets.

Bibow outlines the interaction between monetary policy and financial market players, particularly banks, in setting the terms of finance and conditioning economic activity. The portfolio decisions of the general public and the banks, including expectations about future securities prices, are accounted for explicitly. In Keynes's liquidity preference theory, banks actively manage their balance sheets (balancing profitability and liquidity considerations), and the term structure of interest rates and asset prices are largely driven by bank behavior. Banks' active management of their asset portfolios involves both responsiveness to customer requirements and considerations of their own profitability and liquidity preferences.

Keynes provided the theoretical blueprint for steering market expectations in line with policy intentions as a key part of effectively conducting monetary policy. The question is whether the monetary authorities align market expectations with policy intentions and thus marshal the support of policy in the marketplace. Policy communication is the key to steering market expectations in line with policy intentions. Due to the insight that conventions play a key role in establishing the level of interest and asset prices at any time, Keynes was alert to the complexity of the influence of monetary policies on interest rates.

Keynes's theory of effective demand is that investment spending, in particular, is driving the system. If Keynes's vision needs updating, it is in the areas of consumer finance and consumption spending, but neither diminishes the relevance of his theory of effective demand, his analytical framework, or the applicability of liquidity preference theory, says Bibow. He notes that the developments in behavioral finance and the modern mainstream theory of monetary policy have made some important progress toward Keynes's vision.

Europe's Quest for Monetary Stability: Central Banking Gone Astray

JÖRG BIBOW

Working Paper No. 428, August 2005
www.levy.org/pubs/wp428.pdf

Euroland continues to be plagued by high unemployment, protracted domestic demand stagnation, and low economic growth rates. According to Research Associate Jörg Bibow of Franklin College, Switzerland, the fault lies with the supranational and highly independent European Central Bank (ECB). The euro is on track for failure, he says, and there is a serious risk that the Economic and Monetary Union (EMU) will break up in the medium term. The bank's performance is a series of policy blunders that have pushed inflation up and GDP growth down.

Bibow reviews the background, mandate, structure, organization, and track record of the ECB since the late 1980s. The governing ECB council includes the executive board members of the ECB and the govenors of the national central banks (NCBs). The council formulates monetary policy, including the decisions relating to intermediate monetary objectives, key interest rates, and the supply of reserves. The board implements monetary policy, but policy execution is left to the NCBs. This peculiar design of the euro system's structure reflects a balancing act between national interests and European aspirations that raises a number of issues, notes Bibow. For example, a single currency means a single monetary policy common to all member countries, but fiscal policy remains under national control. Therefore, conflicts can arise between system-wide responsibilities and national functions and interests, and there is the question of how to solve cross-border systemic problems. Furthermore, exchange rate policy is not clearly defined by the Maastricht Treaty.

Bibow believes that the council is too large (18 members) and that it is biased toward the NCBs (12 members). He questions the use of the "one person, one vote" principle and the propensity for governments to focus on nationality rather than merit when selecting members. He observes that the ECB enjoys unbounded discretion in term of both instrument and goal independence because it is outside any political control and there are no effective checks or real accountability on performance. Moreover, it is impossible for outsiders to know the policy debates underlying the bank's decisions or to assess the role of individual council members. This is a politically absurd situation and an economic paradox, says Bibow, and he concludes that the bank's operations depend too much on the personalities of its members.

The ECB's goal independence derives partly from the lack of a "price stability" definition and a conspicuous lack of a lower bound. There is also a lack of policy coordination; euroland's macroeconomic policy-mix is random rather than deliberate. Mainstream economists cannot make sense of the ECB's mantra that maintaining price stability in itself contributes to the achievement of output and employment goals, says the author.

Bibow outlines the ECB's two-pillar policy strategy (monetary and price stability) and the bank's endeavor to distance itself from inflation targeting and from fine-tuning its "stability-oriented" monetary policy. The ECB obfuscates its policies through an ill-designed strategy, and it is misguided by confused ideas and outdated doctrines, he says. Because of euroland's fiscal regime, monetary policy has to shoulder most of the stabilization burden. However, the ECB must recognize that its role is not to be the primary stabilization instrument, says Bibow.

Bibow also outlines a series of ECB policy blunders that resulted in a marked depreciation of the euro (because of aggressive interest rate hikes), a productivity slump that pushed unit labor costs up, and fiscal policy that pushed headline and core inflation higher. A sound monetary policymaker internalizes fiscal policy to combat protracted stagnation and rising unemployment, notes Bibow. Due to protracted stagnation, inflation has stayed above 2 percent, and the gap between headline inflation and market-determined inflation has widened since 2001 (by 0.7 percentage points at the end of 2004). Without "tax-push" inflation, the ECB would not have failed on its price-stability mandate the last four years, asserts Bibow.

Fiscal and monetary policies have prevented each other from achieving their primary goals of deficits below 3 percent of GDP and of inflation lower than 2 percent.

Euroland's counterproductive interaction between fiscal and monetary policies has also caused fragility due to austerity measures imposed on countries with crippled economies and competitive wage underbidding among members. The true causes of the ongoing EMU crisis are purely internal ones, and the heart of the problem is monetary policy. Euroland's key structural problem is ill-designed macroeconomic policies, concludes Bibow.

Federal Budget Policy

FDIC-Sponsored Self-Insured Depositors: Using Insurance to Gain Market Discipline and Lower the Cost of Bank Funding

PANOS KONSTAS

Working Paper No. 419, March 2005

www.levy.org/pubs/wp419.pdf

Deposit insurance protects depositors against loss, but it also creates moral-hazard problems (unjustified risk taking) for insurers. Panos Konstas, senior economist at the Federal Deposit Insurance Corporation (FDIC), outlines a plan that would make it advantageous for banks to replace some of their insured deposits with uninsured deposits. In his plan, the recipient of the guaranteed credit would still be the bank, but there would be no loan guarantee to depositors. Instead, the guarantee would apply to investors who bought the securities of a self-insured depositor's financing office (SIDFO), which made equity-secured loans to financial intermediaries (self-insured [SI] depositors) that invested in uninsured bank deposits. Under these terms, the government would be doubly protected against loss (the capital of banks and SI depositors), while SI depositors would monitor banks and demand premiums based on risk to avoid loss and earn a competitive return.

Konstas notes that there are two types of federal credit assistance: direct loans and loan guarantees, which differ in terms of budgetary treatment by government. The cost of funds to institutions making guaranteed loans is significantly higher than the cost of funds to government making direct loans. He further notes that federal deposit insurance is a loan guarantee program and that deposit insurance has not devised a central financing mechanism that enables banks to raise funds more economically. In the present system of federal deposit insurance, the government assumes all the default risk, so banks borrow money at the risk-free interest rate. The banks compensate for the assumed risk by paying flat-rate assessment premiums that are sufficient to cover insurance losses and FDIC operating costs and to maintain the reserve fund at a mandated ratio. Therefore, some banks are overpaying for deposit insurance, whereas others are underpaying.

The difference between the Konstas plan and the current system is the placement of an intermediary in the credit-flow chain between the initial lender (saver) and borrower (bank). The FDIC would guarantee the saver's loan to the intermediary, which is able to borrow at risk-free interest rates, but the guarantee would also dictate that the intermediary's deposit at the bank is statutorily defined outside the realm of FDIC insurance. This requirement means that the deposited funds would remain in the bank at the depositor's (i.e., the SI depositor's) own risk. In order for the SI depositors to remain viable, they would need to capture a return at least equal to their cost of borrowing plus a risk premium based on the risk profile of the bank.

The limitations of smaller depositors could be overcome if they borrowed funds through a central financing facility (i.e., SIDFO), rather than alone, says the author. The FDIC would guarantee the lenders (the buyers of securities) to SIDFO against default, which would enable SIDFO to raise its funds (i.e., loans to SI depositors) at risk-free rates. The SI depositors would use the proceeds (together with their capital) to buy certificates of deposit (CDs). The SI depositors' lending rate to banks would include their cost of funds plus a perceived risk premium.

The advantages of the proposed system compared to the Federal Home Loan Bank system (i.e., the financial model for the FDIC-sponsored SI-depositor system) include better system implementation, maximum funding efficiency on borrowing and lending, and virtually no risk of loss for government. Konstas notes that SI CDs would not be suitable for small savers because of their leveraged position. Instead, institutions handling large funds would most likely invest in SI CDs (e.g., banks, thrifts, insurance companies, credit unions, and money market mutual funds). The benefit that is not already available to these intermediaries (i.e., the institutions or SI depositors) would be the option of raising funds at rates equal to SIDFO's cost of borrowing. And funds raised through SIDFO would likely be raised in larger blocks than funds borrowed under an intermediary's own name.

The parameters and criteria for conversion to self-insurance include the capital ratios on SI accounts, the lending rate of SIDFO (and the spread between that rate and the rates on existing accounts), and the bank-failure risk to SI depositors. Konstas estimates that banks with an interest-expense ratio above 5.50 percent would convert profitably to SI CDs and that all SI funds would come from time deposits. He also estimates that $533.4 billion would be converted to SI status and that funds earning high interest (e.g., large-size CDs and brokered deposits) would most likely be converted (which would almost double the current amount of uninsured deposits). Moreover, banks switching to SI CDs would be smaller on average than banks not switching. The author concludes that the direct-loan method under the SI system is more cost efficient than the loan-guarantee method under the present system.

Explorations in Theory and Empirical Analysis

A Simplified Stock-Flow Consistent Post-Keynesian Growth Model

CLAUDIO H. DOS SANTOS and GENNARO ZEZZA
Working Paper No. 421, April 2005
www.levy.org/pubs/wp/421.pdf

The "stock-flow consistent" (SFC) approach to macroeconomic modeling provides a rigorous foundation for post-Keynesian macroeconomics, but the approach is relatively unexplored because the analysis of SFC models requires the assistance of computer simulations. Research Scholar Claudio H. Dos Santos and Research Scholar Gennaro Zezza of the University of Cassino, Italy, present a simplified SFC post-Keynesian model that sheds light on classic post-Keynesian macroeconomic issues, and they relate their model to the structuralist and post-Keynesian literature.

The authors present the "structural" hypotheses of their model and the logical (accounting) constraints imposed by their hypotheses. They "close" the constraints with a specific set of post-Keynesian behavioral hypotheses. This step is followed by a discussion of the short- and long-period properties of the "closure" and an outline of possible extensions and simplifications of the model.

The structure of the authors' simplified artificial economy includes the following institutional sectors: households, firms, banks, and government. These sectors are presented as a closed system where the flow of funds (money flows) "come from somewhere and go somewhere," so that all row totals are zero. The banking sector plays a crucial role by ensuring that the interrelated balance-sheet changes are mutually consistent. For simplicity, banks are assumed to provide loans demanded by firms, to accept deposits from households and T-bills from government, and to distribute profits. The interest rate on loans is a fixed mark-up on the interest rate on T-bills. The banks' behavior, therefore, is essentially passive. The behavior of the government sector is also simplified (e.g., taxes are a fixed proportion of wages and gross profits).

The authors note one of the methodological advantages of the SFC approach: it allows a natural integration of short (or temporary) and long periods. Both the capacity utilization and the (normalized) balance sheets of the economy are completely determined by policy distribution and behavioral parameters (which are hypothesized to be constant) and by the (normalized) beginning of period stocks of household wealth and public debt. Expectations are assumed to affect both the investment function and the portfolio choice of households (and, therefore, the financial conditions of firms and households).

The authors extend their model to include more complex investment and consumption functions, and financial structures. A more complex economy implies a more complex portfolio choice for households (e.g., an increased choice of assets) and a more complex determination of capitalist households' income, as well as a more complex role for banks (which can now hold money and T-bills). It also changes the budget constraint of government (i.e., a part of the public debt is free of charge). Since capacity utilization does not reach its technical maximum, the model can incorporate a wide range of hypotheses about nominal wage, mark-up, and technical-progress dynamics.

An important result from the authors' perspective is that a serious treatment of inflation requires the model to be solved in "real" (i.e., deflated) terms. Thus, all financial stock equations have to include "real capital gains" formulas. The authors note that inflation will hurt creditors (i.e., households and banks) and benefit debtors (i.e., firms and government), and that, if inflation is high enough, it would likely change the behavior of these sectors.

The authors are aware that the specific derivations depend crucially on their simplifying assumptions. They note, however, that the model's general structure appears to be robust to wide changes in assumed flow specifications and financial architecture. This point has not received enough attention in the literature, they say.

The Disutility of International Debt: Analytical Results and Methodological Implications

GREG HANNSGEN

Working Paper No. 422, April 2005

www.levy.org/pubs/wp/422.pdf

In dealing with the problematic relationship of morality to rational-choice theory, neoclassical economists since Lionel Robbins have often argued that they can incorporate moral values into consumer theory by putting those values into the utility function. Resident Research Associate Greg Hannsgen tests the viability of such an approach in the context of international finance. He finds that when values such as national autonomy are inserted into the utility function of a small economy, the growth rate of consumption and the level of investment change. To answer questions that mix morality and economics, economists must seek tools other than conventional rational-choice theory, he says.

Developing nations face nonpecuniary costs when they borrow, observes Hannsgen. Demands by international financial institutions, such as the International Monetary Fund, can impose economic policies that are contrary to the interests of borrowing nations and can inflict nonmonetary costs (e.g., a loss of national autonomy). Accounts of the benefits of credit market openness tend to overlook the effects of the exertion of power by lenders over borrowers, he says, particularly in small developing economies. Furthermore, potential borrowers may lose their ability to credibly commit to paying back loans, resulting in a complete absence of borrowing where it might otherwise take place.

Hannsgen incorporates nonpecuniary costs of borrowing into standard rational-choice models (based on Obstfeld and Rogoff [1996]) for a small nation that has access to international financial markets but suffers a loss of utility when it borrows or repays a relatively small amount of debt. A key feature of the models is that countries transfer current wealth into future wealth in two ways: investing in capital equipment, and lending or borrowing on international debt securities markets.

One model shows that a country suffering from a loss of sovereignty in borrowing allocates insufficient resources to investment in capital equipment. With investment, a disutility exists that applies differentially to investment and to lending or borrowing. Another model shows that a nation with a similar utility function will not take advantage of international borrowing to reduce economic risk. The author argues that while his models illustrate the possibility of analyzing a noneconomic value (sovereignty) through rational-choice theory, they also show that standard methods of empirical inference, policy evaluation, and welfare analysis may fail.

The author outlines a number of methodological implications associated with international borrowing disutility. Economists can misunderstand observed credit market behavior that is induced by failure to consider the appropriate measure of utility, so they support inappropriate policies. The ultimate source of behavior may even be irrational, he says. The disutility to borrowing under current international arrangements results in several failures of efficiency: underinsurance, underborrowing, and underinvestment. Therefore, disenchantment with the conditions attached to borrowing may be growing, and Argentina's substitution of domestic for foreign capital may reflect the kind of disutility of international capital modeled here.

Although conventional models agree that credit markets can benefit both borrowers and lenders, credit markets must be adapted to eliminate the disutilities of borrowing or paying a small return if the full benefit is to apply to both parties, says Hannsgen. The international financial institutions are responsible for an imbalance of power that enables lenders to dominate borrowers. In dealing with such a fundamental issue as a nation's autonomy, economics cannot pretend to be neutral about the values at stake. A modeler who simply observes that foreign governments have an increasing distaste for borrowing has only gone part way toward understanding the moral, political, and economic issues at stake.

New Program Codirector and Senior Scholar

The Levy Institute welcomes CAREN A. GROWN as senior scholar and codirector of its Gender Equality and the Economy program. Grown was director of the Poverty Reduction and Economic Governance team at the International Center for Research on Women, where she led research on the impact of multilateral and national economic policies on gender equality as well as asset accumulation and women's property rights. From 1992 to 2001, Grown was a senior program officer at the John D. and Catherine T. MacArthur Foundation in Chicago. Her responsibilities included managing a collaborative research competition on governance challenges in the global economy; conceiving and implementing a five-year foundationwide initiative to award grants for research, graduate training, and communication/application of new ideas in economics; and establishing the Fund for Leadership Development, which supports individuals working on new approaches to population problems in Mexico, Brazil, Nigeria, and India.

Before joining the MacArthur Foundation, Grown was an economist with the Center for Economic Studies at the U.S. Census Bureau. In the 1980s, she consulted with the Ford Foundation's Developing Countries and Rural Poverty programs. She is the lead author of *Taking Action: Achieving Gender Equality and Empowering Women*, published by Earthscan and the UN Millennium Project. She has guest-coedited three special issues of *World Development*, on macroeconomics, international trade, and gender inequality, and coauthored, with Gita Sen, *Development, Crises, and Alternative Visions: Third World Women's Perspectives* (Monthly Review Press, 1987). Grown holds M.A. and Ph.D. degrees in economics from the New School University and a bachelor's degree in political science from UCLA.

New Research Scholar

ED CHILCOTE has joined the Levy Institute as a research scholar for the macroeconomic modeling team. Chilcote brings with him seven years of banking experience. His research interests include macroeconomics, banking, input/output analysis, and the history of economic thought. Chilcote received a B.A. in economics from U.C. Berkeley and a Ph.D. in economics from the New School University.

New Research Associate

INDIRA HIRWAY has joined the Levy Institute as a research associate with the Gender Equality and the Economy program. She is director and professor of economics at the Centre for Development Alternatives, an academic research center in Ahmedabad, India. Her areas of specialization include issues in women's employment, time-use surveys, and integrating unpaid work into macropolicies; poverty and human development, social protection, and safety nets; labor-market structures and issues in employment generation; sustainable and regional development; and entrepreneurship development programs for economic diversification. Hirway has published extensively in these areas of specialization and has been a member of multiple committees and working groups for the Government of India. She is the editor of *Applications of Time Use Statistics* (2003) for UNIFEM and the Government of India and author of research papers such as "Employment Programmes for Protecting the Vulnerable Poor: Lessons from the Past Experiences in India" in *Protecting the Vulnerable Poor in India: The Role of Safety Nets* (2005), published by the World Food Programme, New Delhi. Hirway holds a B.A. in economics and statistics from Gujarat University, Ahmedabad; an M.A. in economics and statistics from the Delhi School of Economics, University of Delhi; and a Ph.D. in economics from the University of Bombay.

United Nations Development Programme and Levy Institute Partnership

Conference

Unpaid Work and the Economy: Gender, Poverty, and the Millennium Development Goals

October 1–3, 2005
Blithewood
Annandale-on-Hudson, New York

Updated program information is posted on the Levy Institute website.

The conference is organized by the Bureau for Development Policy, United Nations Development Programme, in partnership with the Levy Institute. Its purpose is to share views, experiences, and methodologies from around the world on women's unpaid work and its relationship to the economy within the context of pro-poor policies and in achieving the Millennium Development Goals (MDGs). During the last decade, time allocated to unpaid work, including unpaid care work, has received increasing attention. As a result, several countries have collected time-use data and developed Satellite Accounts. These efforts notwithstanding, nonmarket activities have not been sufficiently integrated into the formulation of public policies and pro-poor alternative macroeconomic strategies.

In most developing countries, efforts to reduce poverty and reach the MDGs provide a timely opportunity to draw attention to the contribution of unpaid work to economic and social development. The search for new methodologies to cost the MDGs and for policy alternatives that are pro-poor opens spaces for serious dialogue on the significance of unpaid work. During this conference, there will be discussion of the growing body of research on unpaid work and its application to pro-poor economics, and of tested tools, such as time-use surveys and economic modeling that includes unpaid work, and their use in policy analysis.

In light of the nature and organization of the conference, participation is by invitation only.

Upcoming Event

Conference

Time Use and Economic Well-Being

October 28–29, 2005
Blithewood, Annandale-on-Hudson, New York
Conference organizers: EDWARD N. WOLFF and AJIT ZACHARIAS

Updated program information is posted on the Levy Institute website.

Preliminary Program

Friday, October 28

8:30–9:00 a.m.
Breakfast and Registration

9:00–9:15 a.m.
Welcome and Introduction
DIMITRI B. PAPADIMITRIOU, President, Levy Institute

9:15–11:00 a.m.
Session 1
Determinants of Household Production I
"'What Gives' When Mothers Are Employed?"
SUZANNE M. BIANCHI, University of Maryland.

"Time to Eat: Household Production under Increasing Income Inequality." DANIEL S. HAMERMESH, University of Texas at Austin, National Bureau of Economic Research (NBER), and Institute for the Study of Labor (IZA).

Discussant: SUSAN HIMMELWEIT, Open University, UK

11:00–11:30 a.m.
Break

11:30 a.m. – 1:00 p.m.
Session 2
Determinants of Household Production II
"Where Do They Find the Time? A Time Diary Analysis of How Working Parents Preserve Their Time with Children." LYN CRAIG, Social Policy Research Centre, University of New South Wales.

"Parental Child Care in Single Parent, Cohabiting, and Married Couple Families: Time Diary Evidence from the United States and the United Kingdom." CHARLENE KALENKOSKI, Ohio University; DAVID RIBAR, George Washington University; and LESLIE STRATTON, Virginia Commonwealth University.

Discussant: JEAN KIMMEL, Western Michigan University

1:00–2:30 p.m.
Lunch

2:30–4:00 p.m.
Session 3
Labor Market Developments and Workers' Time Allocation Patterns
"Working Hour Arrangements and Income Inequality? An Earnings Treatment Effects Approach by Fragmentation and Timing of Work." JOACHIM MERZ, University of Lüneburg; Research Institute on Professions (Forschungsinstitut Freie Berufe); Center for Research in Entrepreneurship, Professions and Small Business Economics; and IZA.

"Time Allocation of Employed Population in Russia." IRINA SOBOLEVA, Center for Labor Market Studies, Institute of Economics, Russian Academy of Sciences.

Discussant: IRINA PALEY, Brown University

4:00–4:30 p.m.
Break

4:30–6:00 p.m.
Session 4
Time Use, Macroeconomic Modeling, and Social Policy
"From National Satellite Accounts of Household Production to Macroeconomic Modeling in African Countries." ALFRED LATIGO and OMAR ABDOURAHAMAN, United Nations Economic Commission for Africa; ISMAËL FOFANA, BERNARD DECALUWE, and JOHN COCKBURN, University of Laval.

"The Temporal Welfare State: A Cross-National Comparison." ROBERT E. GOODIN and JAMES M. RICE, Australian National University.

Discussant: MARZIA FONTANA, University of Sussex

6:00–9:00 p.m.
Reception and Dinner
Keynote Address: NANCY FOLBRE, University of Massachusetts, Amherst
"Valuing Time"

Saturday, October 29

8:30–9:15 a.m.
Breakfast

9:15–11:00 a.m.
Session 5
Measurement Issues in Time-Use Research
"Using Auxiliary Data to Compensate for Noisy Time-Use Data." N. ANDERS KLEVMARKEN, Uppsala University

"Examining the Dynamics of Child Care Using the American Time-Use Survey and USA Heritage Time-Use Data Sets." KIMBERLY FISHER, Institute for Social and Economic Research, University of Essex.

Discussant: DIANE HERZ, U.S. Bureau of Labor Statistics

11:00–11:30 a.m.
Break

11:30 a.m. – 1:00 p.m.
Session 6
Household Production and Economic Inequality
"Household Production and the Distribution of Economic Well-Being in the United States." AJIT ZACHARIAS, Levy Institute.

"How Does Nonmarket Production Affect Earnings Inequality? Evidence from the American Time-Use Survey." HARLEY FRAZIS and JAY STEWART, U.S. Bureau of Labor Statistics.

Discussant: FRANK STAFFORD, University of Michigan

1:00–2:30 p.m.
Lunch

2:30–4:00 p.m.
Session 7
Well-Being and Deprivation: Subjective and Objective Measures Utilizing Time-Use Data
"Time, Money, and Satisfaction." JENS BONKE, METTE DEDING, and METTE LAUSTEN, Danish National Institute of Social Research, Copenhagen.

"Developing Poverty Indicators Using Time-Use Statistics: A Study in India." INDIRA HIRWAY, Center for Development Alternatives.

Discussant: LARS OSBERG, Dalhousie University.

4:00–4:30 p.m.
Break

4:30–6:00 p.m.
Session 8
International Comparisons of Time Allocation
"International Differences in Market Work and Household Production." RICHARD B. FREEMAN, Harvard University and NBER; and RONALD SCHETTKAT, Bergische Universität Wuppertal.

"Elderly Time Allocation and Well-Being: What Changes after Retirement? An International Comparison." ELSA FONTAINHA, ISEG (Technical University of Lisbon).

Discussant: YOUNGHWAN SONG, Union College

6:00–6:05 p.m.
Closing Remarks

6:05–9:00 p.m.
Reception and Dinner

Levy Institute Awarded Grant from Smith Richardson Foundation, Inc.

The trustees of the Smith Richardson Foundation have recently approved a grant of $50,000 to The Levy Economics Institute of Bard College supporting the project "Government Spending on the Elderly." The goal of the project is to explore the implications of an aging society for the economy and for public policies. The Levy Institute will commission a series of papers that examine various aspects of the economics of aging, including such topics as prospects for aging and government spending, retirement security, progressivity of Social Security and Medicare, retirement behavior, the interaction between private and public provisioning of retiree benefits, government expenditures and the well-being of the elderly, and women and retirement security. The papers will be presented at a conference and issued as Working Papers by the Levy Institute.

A summary of the conference proceedings will be disseminated to members and staff of Congressional committees, appropriate federal and state officials, the academic community, and the Institute's press list, including all major newspapers. The dissemination of final papers to policymakers, professional associations, and advocacy organizations will provide them with new and crucial information as they explore options for the future financing of health and economic support programs for the aging.

PUBLICATIONS AND PRESENTATIONS

Publications and Presentations by Levy Institute Scholars

CLAUDIO H. DOS SANTOS *Research Scholar*
Publication: "A Stock-Flow Consistent General Framework for Formal Minskyan Analyses of Closed Economies," *Journal of Post Keynesian Economics*, Vol. 27, No. 4, Summer 2005.

GREG HANNSGEN *Resident Research Associate*
Publication: "Minsky's Acceleration Channel and the Role of Money," *Journal of Post Keynesian Economics*, Vol. 27, No. 3, Spring 2005.
Presentation: "The Disutility of International Debt: Analytical Results and Methodological Implications," Western Economic Association International annual meetings, San Francisco, July 4–8.

DIMITRI B. PAPADIMITRIOU *President*
Presentations: Interview regarding the Levy Institute's Strategic Analysis, along with indicators and the economy, with Ed Zwirn, CFO.com, April 8; interview regarding the effects of gas prices on businesses, employees, and payouts with John Eckberg, *Cincinnati Enquirer*, May 12; interview regarding the structure of the Federal Reserve with Cheryl Glaser, Marketplace, June 28; lecture on "Inflation Targeting" and "Full-Employment Schemes and Gender" and roundtable discussant on "Finance and Monetary Policy in Historical Perspective" and "Inflation Targeting and Its Alternatives," University of Utah, June 8.

JOEL PERLMANN *Senior Scholar*
Presentation: "'Race of People': American Social Science, Bureaucracy, and Ethnic Politics, 1898–1913," Society for the Advancement of SocioEconomics, Budapest, July 1.

EDWARD N. WOLFF *Senior Scholar*

Publication: *Retirement Income: The Crucial Role of Social Security* (with Christian Weller), Economic Policy Institute, 2005.

Presentations: Taping for BBC World (hosted by Tanya Beckett), March 3; NBC (New York) Nightly News, March 4; "Social Security, Pensions, and the Inequality of Household Wealth in the United States, 1983–2001," Center for the Study of Wealth and Inequality, ISERP, Columbia University, April 21; "Measures of Technical Change and Structural Change in Services in the United States: Was There a Resurgence of Productivity Growth in Services?" for a workshop on "The Economics of Services and Intangible Goods Revisited: Models and Empirical Evidence," University of Rome "La Sapienza," Rome, Italy, June 3–4; "The Vintage Effect in TFP Growth: An Analysis of the Age Structure of Capital," Fifteenth International Conference on Input-Output Techniques, Beijing, China, June 27 – July 1.

Recent Levy Institute Publications

LEVY INSTITUTE MEASURE OF ECONOMIC WELL-BEING

Interim Report 2005: The Effects of Government Deficits and the 2001–02 Recession on Well-Being
EDWARD N. WOLFF, AJIT ZACHARIAS, and HYUNSUB KUM
May 2005

Economic Well-Being in U.S. Regions and the Red and Blue States
EDWARD N. WOLFF and AJIT ZACHARIAS
March 2005

POLICY NOTES

Some Unpleasant American Arithmetic
WYNNE GODLEY
2005/5

Imbalances Looking for a Policy
WYNNE GODLEY
2005/4

PUBLIC POLICY BRIEFS

Breaking Out of the Deficit Trap
The Case Against the Fiscal Hawks
JAMES K. GALBRAITH
No. 81, 2005 (Highlights, No. 81A)

The Fed and the New Monetary Consensus
The Case for Rate Hikes, Part Two
L. RANDALL WRAY
No. 80, 2004 (Highlights, No. 80A)

STRATEGIC ANALYSES

How Fragile Is the U.S. Economy?
DIMITRI B. PAPADIMITRIOU, ANWAR M. SHAIKH, CLAUDIO H. DOS SANTOS, and GENNARO ZEZZA
March 2005

WORKING PAPERS

Europe's Quest for Monetary Stability: Central Banking Gone Astray
JÖRG BIBOW
No. 428, August 2005

Liquidity Preference Theory Revisited: To Ditch or to Build On It?
JÖRG BIBOW
No. 427, August 2005

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