



Conference Proceedings

15th
ANNUAL
HYMAN P. MINSKY CONFERENCE
ON THE STATE OF THE U.S. AND
WORLD ECONOMIES

*Economic Imbalance: Fiscal and Monetary
Policy for Sustainable Growth*

*April 21–22, 2005, Blithewood, Annandale-on-Hudson, New York
A conference of The Levy Economics Institute of Bard College*

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*The proceedings consist of submitted papers by the speakers
and summaries of session participants' presentations.*

Foreword



Most analysts agree that the U.S. economy has recovered following a short-lived recession. However, the strength of 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 at this year's conference discuss their viewpoints, policy guidelines to be considered within the context of current economic trends, and the implications for both the national and international economies. What are the monetary and fiscal policy prescriptions for growth, employment, and price stability?

The presenters come from business, government, and the academy. They are uniquely qualified to offer their insights on these issues.

Your comments and suggestions are welcome.

Dimitri B. Papadimitriou

President, Levy Economics Institute, and Jerome Levy Professor of Economics, Bard College

Program

Thursday, April 21

8:30–9:15 a.m.

BREAKFAST AND REGISTRATION

9:15–10:00 a.m.

WELCOME AND INTRODUCTION

Dimitri B. Papadimitriou, *The Levy Economics Institute*

“How Fragile Is the U.S. Economy?”

10:00–10:45 a.m.

SPEAKER

Sandra Pianalto, *Federal Reserve Bank of Cleveland*

“The Power of Price Stability”

11:00 a.m.–12:45 p.m.

SESSION 1

The State of the U.S. and World Economies

Moderator: Dimitri B. Papadimitriou, *The Levy Economics Institute*

Steven B. Kamin, *Federal Reserve Board*

“Financial Market Developments and Economic Activity during

Current Account Adjustments in Industrial Economies”

James W. Paulsen, *Wells Capital Management*

“Economic and Financial Market Outlook”

Frank A. J. Veneroso, *Dresdner RCM*

“China’s Inevitable Investment Bust: Ignore It at Your Peril”

12:45–2:30 p.m.

LUNCH

SPEAKER

David D. Hale, *Hale Advisors LLC*

“Do the Republicans Need a Trillion-Dollar Current Account Deficit to Keep the White House in 2008?”

2:45–4:15 p.m.

SESSION 2

Monetary Policy in the U.S. Economy

Moderator: Greg Hannsgen, *The Levy Economics Institute*

Bruce C. Kasman, *JPMorgan Chase*

“The End of Easy Money”

Albert Wojnilower, *Craig Drill Capital Corporation*

“Why Monetary Policy?”

L. Randall Wray, *The Levy Economics Institute and University of Missouri–Kansas City*

“The New Monetary Consensus and Neutral Rate Targets:

What Would Minsky Think?”

4:15–4:45 p.m.

COFFEE BREAK

4:45–6:15 p.m.

SESSION 3

Financial Instability in a Global Economy

Moderator: W. Ray Towle, *The Levy Economics Institute*

Robert Z. Lawrence, *Harvard University* and *Institute for International Economics*

“What Happened to the Great American Job Machine:

The Role of Trade and Outsourcing”

Edwin (Ted) Truman, *Institute for International Economics*

“The United States and the World Economy”

6:30–7:15 p.m.

RECEPTION

7:15 p.m.

DINNER

Friday, April 22

9:00 a.m.

BREAKFAST

9:30–11:15 a.m.

SESSION 4

**The Macroeconomic Prospects for
the U.S. Economy**

Moderator: Ajit Zacharias, *The Levy Economics Institute*

Lakshman Achuthan, *Economic Cycle Research Institute*

“The Importance of Being a ‘Monitorist’”

James K. Galbraith, *The Levy Economics Institute* and *University of Texas at Austin*

“Breaking Out of the Deficit Trap”

Richard W. Peach, *Federal Reserve Bank of New York*

“Is There a Housing Bubble?”

11:00 a.m.–12:15 p.m.

SPEAKER

Paul Davidson, *New School University*

“Is a Declining Dollar Good for the U.S. Economy or the Global Economy?”

12:15–2:00 p.m.

LUNCH

Donald L. Kohn, *Federal Reserve Board*

“Imbalances in the U.S. Economy”

Welcome and Introduction

DIMITRI B. PAPADIMITRIOU

President, The Levy Economics Institute

How Fragile Is the U.S. Economy?

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.

Speakers

SANDRA PIANALTO

Federal Reserve Bank of Cleveland

The Power of Price Stability



(Please note that the views I express today are mine alone. I do not presume to speak for any of my colleagues in the Federal Reserve System.)

Introduction

I am beginning my third year as president and CEO of the Federal Reserve Bank of Cleveland and as a participant of the Federal Open Market Committee (FOMC), the Federal Reserve's policymaking arm. I will tell you that I have seen more than a few twists and turns in the path of the economy during that time.

The economy has been expanding for the past few years, but many people seem to think that, in spite of its fundamental underlying strength, the economy could face some challenges from fiscal and trade deficits. Today, I would like to explain how I think central banks can best meet those challenges and promote economic prosperity—by maintaining price stability, or low and stable rates of inflation. I will talk about three aspects of this message.

First, we have achieved a global consensus that central banks should pursue price stability.

Second, while large budget deficits are clearly undesirable and may add some complexity to monetary policy decision making, they do not need to undermine our success in maintaining price stability.

Finally, a firm commitment to price stability is the best contribution monetary policy can make toward resolving the challenges posed by external account imbalances.

Thankfully, we are not so severe with those who create inflation today. But we do understand that sooner or later, inflation introduces all sorts of costly economic distortions and uncertainty. When consumers and businesses come to realize that the purchasing power of their money is declining, they look for ways to avoid holding that money. Those of us who remember the 1970s can attest to the deep troubles brought on by spiraling inflation.

Over the past couple of decades, we have seen growing public support for a return to low inflation, not just in the United States, but around the world. Inflation in the industrialized countries fell from 9 percent in the first half of the 1980s to 2 percent early in this decade. But even more impressive was the huge decline in inflation among the developing nations—from roughly 30 percent to 6 percent— during those same two decades.

Dramatic reductions in inflation have also been accompanied by improved economic performance in many countries. In the United States, real output growth has been higher, the frequency of business cycles has declined, and the swings in the business cycle seem to have become milder. Federal

Reserve Board Governor Ben Bernanke, whom President Bush recently nominated to chair his Council of Economic Advisers, is one observer who calls the post-inflation era “the Great Moderation.”

The Price Stability Consensus

Let me begin by explaining why I believe we have achieved a global consensus in support of price stability. We know that central banks have a rather checkered past when it comes to the pursuit of price stability. Throughout human history, when governments became involved with money, inflation typically followed. That is because when economic times got tough, or budgets were pinched, governments often yielded to the temptation to cheapen the value of money by printing too much of it, or sometimes by minting lighter coins. Perhaps they were trying to stimulate faster economic growth, or perhaps they were simply trying to finance their own spending without raising taxes. But whatever the reason, the result was the same—economies eventually suffered under an inflationary policy.

Even as early as the 14th century, the dangers of inflation were discussed. In *The Inferno*, Dante writes about the fate of counterfeiters and other “falsifiers of money”—the people who were responsible for devaluing the currency. He places them in one of the deepest parts of hell. Again in the third book of his *Divine Comedy*, Dante predicts a terrible fate for two officials who debased their currencies. According to a translator, Dante envisioned this severe punishment not because he loved money, but because he believed that a sound coinage—or sound money—was an essential principle of social order.

People may disagree about how much of the improvement in economic growth and financial stability is the result of noninflationary monetary policies, how much is due to structural changes in national economies, and how much we can chalk up to just plain good luck. But I am convinced that this improved performance would not have been possible and could not have been sustained if central banks had not suppressed the urge to solve problems through inflation.

The consensus support for price stability among central banks has clearly made an important difference to the public and to their governments, and it remains strong around the world. In fact, some nations have chosen to set explicit numerical inflation-rate objectives for their central banks. Others, like the United States, have been successful without them. I believe that overall, central banks are aiming in a similar direction: to promote sustained economic growth by maintaining low and stable inflation rates.

Monetary Policy in an Era of Fiscal Deficits: More Difficult, Not Impossible

Let me turn now to the issue of whether large budget deficits may undermine central banks’ success in maintaining low and stable inflation rates.

In the United States, current budget deficits, as well as prospective deficits over the immediate horizon, seem to be well within the boundaries of historical experience. Relative to the size of gross domestic product, recent government budget shortfalls are still substantially below the peak levels of the 1980s. Nevertheless, the public is expressing growing concerns about fiscal discipline. In the United States, these concerns have been provoked by the rapid increase in the federal budget deficit, to about 3-1/2 percent of GDP in 2004, from a budget surplus in 2001. And the concerns are not unique to our own country. In Europe, we have seen a revision of the Growth and Stability Pact, which originally required euro countries to maintain fiscal deficits below 3 percent of GDP.

The current level of budget deficits certainly understates the magnitude of fiscal pressures. Both the United States and Europe face demographic changes where we see entitlement liabilities growing

faster than the tax base available to support them. While these issues are not new, they are serious and should be addressed sooner rather than later.

Of course, resolving fiscal imbalances is not the job of monetary policymakers, but that does not mean that we can ignore their consequences. The stance of monetary policy—that is, whether a specific setting of the federal funds rate target is determined to be “tight,” “easy,” or “neutral”—depends on the level of what economists usually refer to as the “equilibrium real interest rate.” This is the interest rate that would match the demand for funds with their supply, assuming that the markets are working efficiently.

It is not unreasonable to expect that persistent government deficits will eventually yield upward pressure on the equilibrium real interest rate. If central banks want to maintain their intended policy stance, they will need to respond to this pressure with corresponding movements in their policy rates. This process would be easier if the equilibrium real interest rate could be readily estimated—but it cannot. In the United States, with the shift from fiscal surplus to deficit, we now have the added complication of trying to incorporate the effects of fiscal imbalances on changes in the equilibrium real interest rate.

Of course, any change in the economic environment that puts pressure on interest-rate fundamentals could introduce the same complication. But, unlike many other complicating factors, large and persistent fiscal deficits introduce another risk—namely, that they could be the source of inflationary pressures.

However, there is no need for deficits to be inflationary. The prospect of inflation arises only if the central bank ignores or, even worse, tries to resist any rise in real interest rates. By doing so, the central bank would keep its policy rates too low and inadvertently ease monetary policy. Of course, the real risk of an excessively stimulative monetary policy is that inflation expectations may eventually become unanchored. History shows that once inflation expectations become unstable, more stringent policy actions might be required.

A central-bank commitment to price stability can avoid that outcome. A central bank cannot always offset the effects of government deficits on economic growth and stability. But the more credible the central bank’s commitment to stability, the less likely it is that an inflation premium will be built into market interest rates, and the less likely it is that rising inflation expectations will distort economic decisions.

I believe that the FOMC is trying very hard to preserve its credibility by being clear and unwavering in its commitment to low and stable inflation. However, it goes without saying that our job is made easier if the public expects that the fiscal authorities will address budgetary imbalances in timely and effective fashion.

Monetary Policy in an Era of Current Account Deficits

Now I would like to discuss how monetary policy can best contribute to resolving the challenges brought by external account imbalances. Substantial current account deficits developed in the 1980s, and these deficits now stand at record postwar levels as a share of GDP. I think everyone agrees that these levels are unsustainable, and that a reversal is inevitable, even if the timing and pace of the adjustment are uncertain.

Some people envision a soft landing. As we all know, a return to current account balance will ultimately require that U.S. households consume less and save more of their incomes. Households could become concerned about having enough money for future consumption and step up their saving, even at today’s interest rates. The more commonly expected scenario, though, is that foreign savings coming

into the United States could become less plentiful over time, driving up interest rates. Then, households might be induced to save more and spend less.

If a substantial turnaround in U.S. current account deficits results in higher equilibrium real interest rates, the FOMC would most likely need to adjust its federal funds rate target accordingly to prevent a change in its policy stance. It is also possible that a decline in the exchange value of the dollar could result in temporary upward pressure on the price level, due to rising import prices and the prices of import-competing goods. The first responsibility of the central bank is to ensure that these price pressures do not feed into higher inflation expectations in the long run. Once again, a clear commitment to price stability—in words and deeds—is the best contribution the central bank can make to the adjustment process toward more sustainable external account positions.

The soft-landing point of view is really just the expectation that the process of adjustment will be a smooth one. I believe that a gradual and orderly transition toward smaller current account deficits is the probable outcome. But of course there are those who believe that the landing might not be so soft—and that the reversal of our large current account deficits will be sudden and disruptive.

Those who imagine this worst-case scenario seem to have in mind a magnified version of the stress on global financial markets that emerged in the last half of 1998. Of course, they believe that the impact on the U.S. economy would be more severe this time because our own imbalances would be at issue. In these circumstances, it is difficult to predict what the specific course of monetary policy ought to be, but the usual answer to financial market crises is for the central bank to provide enough liquidity to short-circuit systemic market failure.

How, then, should monetary policy deal with current account imbalances today? I do not think that the FOMC should take preemptive measures to address these imbalances. However, I do think that the Committee should continue to bring the federal funds rate target to a level that is consistent with maintaining price stability in the long run. If we achieve that, then we will be in a position of strength to address whatever challenges arise.

Conclusion

Over the past 20 years, price stability has achieved some remarkable things. It has contributed to better real economic performance through less volatile interest rates, it has allowed resources to be allocated more efficiently, and it has contributed to healthier financial systems. But nations must inevitably contend with economic issues that monetary policy cannot solve.

In the long run, a central bank cannot balance the government's budget, boost national saving, create more energy resources, or solve the many economic problems that we must confront. But a credible monetary policy will help smooth the adjustment to economic circumstances that come our way.

I hope that my comments have helped to clarify why I believe that price stability is the most important contribution that central banks can make to economic prosperity. The best way for an economy to adjust to challenges like government deficits and current account deficits is in an environment of low inflation and stable inflation expectations.

That is the contribution that the Federal Reserve can reasonably deliver, and it is the contribution that I intend to pursue as a policymaker.

DAVID D. HALE

Hale Advisors LLC

Do the Republicans Need a Trillion-Dollar Current Account Deficit to Keep the White House in 2008?



It is a great pleasure to be here today and to see a lot of old friends in this very lovely setting. My assignment was to talk about the outlook for the American dollar and a lot of the global economic imbalances that we have been talking about today. I gave Dimitri a very provocative title because I think at the end of the day the questions that center on the dollar and the global payments imbalances will become very political, at least for America. The question is, Will Republicans need a trillion dollar current account deficit to retain the White House in 2008? And my conclusion is “yes.” I want to spend the next few minutes exploring the issue and give you the reasons for my conclusion.

The first point is that the issue of exchange rates and the dollar is a bit like the weather. Everybody has an opinion because there are so many different factors and issues that come into play. Indeed, if we just look at the economic backdrop that could be made about the dollar, there are many very interesting statistics that help to define the issue. The first big fact, of course, is the size of the deficit. America will have a current account deficit that will probably exceed \$700 billion this year (approaching 7 percent of GDP). By any historical standard, that is a truly awesome number. The second (less well-known) fact is that emerging-market (developing) countries had a current account surplus of \$330 billion last year. Five years ago, this surplus was less than \$100 billion, and eight or nine years ago, these countries had a \$100 billion current account deficit. The change in their financial position is as profound in the opposite direction as the financial change in this country. We have two polar opposites and, if Frank Veneroso is right about a Chinese hard landing in the next 12 to 18 months, the emerging-market current account surplus will be \$400 billion and still expanding by the end of this year. This number could get larger before it gets smaller. In addition a few industrial countries had large current account surpluses last year, such as Japan (\$170 billion) and Germany (\$105 billion). The deficits in the industrial world are very much the English-speaking countries, except for Canada. Britain has a big current account deficit, as does Australia and New Zealand. Because of the very overvalued rand, South Africa is moving from a surplus to a deficit of 3 or 4 percent of GDP this year.

Another interesting background fact has been the performance of bond markets in recent times. U.S. bond yields three years ago were down to 3 percent. They rebounded back to levels close to 5 percent a year ago when the Fed began to tighten monetary policy in June 2004, but then fell back to 4 percent by the beginning of this year. Indeed, in congressional testimony six weeks ago, Alan Greenspan described the U.S. bond market as an anomaly. He was surprised that with Fed tightening, rising inflation, and a very weak currency American bond yields could still be as low as 4 percent. On the whole, this is also a global phenomenon. Bond yields in Britain are at the lowest levels since the

founding of the Bank of England in 1694. German bond yields are back to where they were in the 1870s after the establishment of the German Empire.

These are very low interest rates on a global basis. The fact that America would have these (low) yields along with a very weak currency and a huge current account deficit is also a bit of an anomaly. Very low bond yields and low interest rates in the last 3 or 4 years have resulted in a great asset inflation: not in the stock market, as in 1999 and 2000, but in the U.S. real estate market. George Bush presided over more housing inflation in his first term than any American president in the 20th century. During his four years as president, we had a real house price gain of 35 percent. The previous record for any presidential administration was Ronald Reagan's second term (a gain of 25 percent).

I think that a very important factor explaining how Bush got reelected last year is house prices. George Bush had the worst employment record of any American president since Herbert Hoover. He lost 3 million manufacturing jobs. By the time of the election, we had an employment recovery, but he was still down on election day by half a million jobs. Every American president since Herbert Hoover has had an employment gain of at least 2 million jobs. And many presidents have had employment gains over 10 million. Bush was the first president in 60 or 70 years to lose employment. But, because of a \$5 trillion capital gain in the housing market, the American people still felt pretty good about their financial position and their economic status and therefore the president was reelected.

Now if we look at the current account deficit and these background factors, we'll see that there are three major points of view about the outlook. The conventional view of the Institute of International Economics, Fred Bergsten, and many mainstream economists is that the American current account deficit is unsustainable—no country could keep borrowing on this scale indefinitely, as there will have to be a correction and an adjustment. People like Fred are both predicting and advocating big dollar depreciation. Wall Street firms like Goldman Sachs believe the dollar has to go to \$1.40 or \$1.45 against the euro by the end of the year and most Wall Street people are biased in the same direction. They think that the current account deficit requires a big currency adjustment to bring the deficit down.

The second contrary view has been articulated by David Folkerts-Landau and Michael Dooley at Deutsche Bank over the last 12 or 18 months. They believe that we have a new emerging exchange rate system that they compare with Bretton Woods 30 or 40 years ago. It's not a global Bretton Woods, but a regional Bretton Woods in the Pacific. The basic argument is that the countries of East Asia (i.e., China, Japan, Singapore, Korea, Taiwan, etc.) don't want to have any meaningful exchange rate appreciation against the American dollar and therefore they are prepared to intervene indefinitely to maintain stable exchange rates. We have had a lot of intervention over the last few years. Japan spent \$300 billion in 2003 and \$140 billion in the first quarter of last year on maintaining a stable currency. China expanded its foreign exchange reserves by over \$200 billion last year. In aggregate, the east Asian countries now have \$2.5 trillion of foreign exchange reserves (66 percent of the world total). As recently as 15 years ago, they had 25 or 30 percent of the world's currency reserves. In the 1960s, European countries had 45 percent of the world's currency reserves, while the Asians had less than 20 percent. This is a very profound change over the last 10 to 15 years.

I think the initial cause is the east Asian financial crisis seven or eight years ago, which was a very profound shock to the region and made all of these countries very conservative. They were under one current account surplus for a while just to rebuild their reserves and be more financially sound and independent of the IMF and multilateral institutions. There is not doubt about the primary cause of

this reserve accumulation over the last two or three years—an attempt to maintain exchange rate stability against the American dollar.

Ben Bernanke articulated the third point of view last week. He is now arguing that the American current account deficit is not caused by domestic factors, like budget deficits and low household savings rates, but is the counterpart to a big surplus of savings and therefore, also foreign exchange reserves in the developing countries. And he is the one who will tell you that because we have a current account surplus of \$340 billion in the developing market countries, we shouldn't be surprised that America has a big current account deficit. It is the only way that the system can balance. Indeed, perhaps the only real solution to the American current account problem is not to lobby Germany and Japan for higher growth (and get out of stagnation), but to produce a big capital-spending boom in the developing countries. The loose solution is not going to be in the G7 countries, Europe, or Japan. It is going to be in east Asia, Latin America, and South Africa—countries that are running current account surpluses, have foreign exchange reserves, and lots of pent-up spending potential. These are the three different points of view.

Now, how will the issues evolve? A critical issue, obviously, is going to be the exchange rate policies of emerging market countries that have been spending very heavily to maintain currency stability, and the two key players are, of course, Japan and China. Based on my conversations with people in the Japanese government, if the yen starts to dramatically appreciate back to 100, 99, or 98 yen to the dollar, I have no doubt that they will intervene again. They decided to intervene massively two years ago because they were concerned that an exchange rate appreciation would magnify Japan's problems with deflation.

I had dinner last week with the international director of the Bank of Japan and he told me that their forecasting model showed that a 10-percent appreciation of the yen would depress Japan's domestic price level by 0.3 percent. They don't mind some yen volatility or appreciation, but a big appreciation (10 to 15 percent) would simply magnify their deflation problem. Therefore, I think they would resist it and, if necessary, expand their foreign exchange reserves from \$840 billion to, perhaps, \$1.5 trillion. There is no way to know what the final number would be. Japan has not intervened for a year, but if the dollar once again has a major depreciation against the Japanese yen, intervention will resume.

China is the other important player because it has had a pegged exchange rate against the American dollar since 1994, which was the last time there was major dollar depreciation. The Chinese views are extremely complex because, as Frank (Veneroso) indicated, they have a number of very important economic challenges. The first challenge is the banking system, which is both huge and full of bad debt. The Chinese banking system is the biggest in the world: 150 percent of GDP versus 75 percent here and 20 to 30 percent in most developing countries. It has been estimated that 15 to 30 percent of these loans are nonperforming. Since there has been dramatic loan growth over the last two or three years to finance this great capital spending boom, the risk is very high. The stock of nonperforming loans could increase further in the future.

As a consequence of all this bad debt, China has been trying to keep interest rates quite low with the result that their monetary policy has really not been that effective at reining in the boom. It tried to compensate for its low interest rate policy by bringing in credit controls last April and May, which produced a decline in bank lending (for a few months) for the first time in five years. However, as a result of complaints and criticism, they began to relent and finally eased up and now bank lending is growing once again by 14 to 15 percent per annum. But the fact is, an imbalance persists.

China has nominal GDP growth of 15 percent, a core lending rate for banks of 5.5 percent, and deposit yields of only 2 percent. These low interest rates are producing a dramatic growth in China's underground financial system, which developed because the big state-owned banks that dominate the system do not have a tradition of lending money to the private sector. Historically, they have looked after the big state-owned bureaucratic companies, so there has always been a bit of a void in the credit market. Because of very low deposit yields in the last two years, a lot of wealthy people in China have taken their money out of the banking system and put it to work in an underground lending market (a so-called curb market where interest rates are 15 to 20 percent). And the growth rate of this underground money market has been accelerating over the last 12 to 18 months because of attempts at credit controls, the huge imbalance between nominal GDP growth and the very low level of deposit yields, and an inflation rate that was 5 percent for much of last year. This means that depositors had negative interest rates on their savings accounts. I estimate that this underground lending market is now probably 30 to 35 percent of GDP.

The precedent for this is what happened in Korea 30 to 40 years ago. In the late 1960s Korea was a lot like China today, with a big state-owned banking system that only made loans to companies like Samsung and Hyundai. There were no loans for small companies or individuals, so a big underground lending market developed that was 35 percent of GDP by 1972. At that time, President Park clamped down and tried to get the situation under control, and money moved to other forms of financial intermediation. I think that China's money and credit growth now is actually understated. There is more lending growth and it is not occurring within the financial system.

China is aware of all of these contradictions and they finally raised interest rates (by 25 basis points) in October for the first time in nine years. How they reached this decision is a very important commentary on how difficult it is for them to make important policy changes. I heard the true story of how they changed monetary policy back in October from a friend in the Chinese government three weeks ago. The story puts in perspective how cumbersome and difficult is the policy process in China, not only applied to interest rates but also to the exchange rate.

In the third week of October last year the former premier Zhu Rongji (from two years ago) had dinner with a high-level official of the economic reform ministry. At the dinner, former premier Zhu was very critical of the Chinese government for having an ineffective and weak monetary policy. He criticized the government for not being more effective or disciplined at reining in the big capital-spending boom. There was also rising inflation at the time. Zhu had been central bank governor 10 years ago when inflation was 30 percent. His very tough and ruthless policies brought the inflation rate down from 30 percent to 3 or 4 percent in just a few years. The next day, the official of the foreign ministry wrote a private letter to President Hu Jintao about the criticism from Zhu Rongji. The following day, President Hu Jintao called Zhu Rongji personally to get his views on this question, whereupon Zhu held forth his criticism of the government's conduct of monetary policy. The next day, Hu Jintao instructed the central bank to raise interest rates 25 basis points: there was no meeting of the monetary policy committee and no central bank decision. This response was driven entirely by a private dinner party conversation.

We ask the question, Why can't China change its exchange rate policy? The answer is very simple: they find it very hard to arrive at a consensus. The new leaders, in contrast to Zhu Rongji, are not decisive, high-powered men. Wen Jiabao, the new premier, is famous for always seeking consensus. Jokes

are made about him in government circles because he is indecisive and not a strong leader. So, at a critical moment in Chinese history, we have a government that is very much consensus-driven and therefore finds it very hard to make decisions.

The fact is that the exchange rate question is a big decision. The Chinese government is concerned that any volatility in their currency could create a problem of confidence in the banking system. They've also got the problem of a large number of very inefficient state enterprises, which are taking part in the big Chinese global export boom and doing so with very low profit margins. A 15 to 20 percent exchange rate appreciation could wipe out these profit margins and jeopardize the survival of employment in these companies and sectors. Over the last four years, China has created 8 million new jobs in its manufacturing industry, in part because of the big global export boom. Because of concerns about employment security and social stability that follow for employment security, the government is reluctant to do anything that might jeopardize these employment gains.

So my conclusion is that China will change its exchange rate policy very reluctantly. I do, however, see a mechanism in the next year that could finally set the stage for change—further dramatic growth in China's foreign exchange reserves, which are now \$640 billion (up \$200 billion from a year ago). These reserves could easily increase by \$300 billion this year and total a trillion dollars in 12 or 18 months. China will once again have \$50 or \$60 billion of foreign direct investment (FDI) this year and the trade surplus could be \$100 billion, compared to just \$30 billion last year. And last year, the trade surplus and foreign direct investment helped to attract a further \$100 billion of speculative money, "hot money," into the foreign-exchange reserves. If investors see a big trade surplus developing this year in combination with FDI, I think speculation about the exchange rate will intensify and the growth rate of reserves could accelerate.

Needless to say, China will have to sterilize this development and the cost of sterilization will increase because the consequence of the great boom is that they have no choice but to raise interest rates further. The rise will happen slowly and gradually, but I think that China's interest rates could be 100 basis points higher at the end of the year. Raising interest rates increases the cost of sterilization. So, perhaps by the middle of next year, the financial pressure from growth, reserves, and sterilization costs will be great enough so that China will finally decide to allow an adjustment in its exchange rate.

The question then is, By how much? The common view in brokerage houses in Hong Kong is very modest; maybe 3 or 5 percent. Others think it might be 10 or 15 percent. We don't know. A lot will depend on the economic environment in 12 to 18 months. If Frank Veneroso is right about a collapse in capital spending, the current account surplus could skyrocket to \$200 billion. The investment share of GDP would come down from 45 to 35 percent, and if you have that kind of a change in your investment ratio vis-a-vis GDP, the current account surplus could only expand. That is why countries like Thailand, Korea, and Malaysia have big surpluses today. Their investment share of GDP has fallen by 10 to 15 percent compared to the early and mid 1990s.

A big hard landing could make China more reluctant to revalue because they fear it would jeopardize export-led growth, which has been a strong growth sector in recent years. Because China will be reluctant to change, we could easily have another \$250 billion of intervention by China in the next 12 to 15 months to maintain a stable exchange rate. The current equilibrium that we've had for the last two to three years could persist easily for at least 12 to 18 months.

A consequence of the China boom has been a big increase in commodity prices, which has also created a new demand for dollars in developing countries that produce commodities. OPEC's current account surplus is up \$50 or \$60 billion from a year ago. The OPEC countries typically keep two-thirds of their reserves in U.S. dollars. Russia's reserves are up \$50 billion and they keep 75 percent of reserves in U.S. dollars. South Africa has gone from foreign exchange reserves of minus \$25 billion two years ago to \$15 billion in real reserves of which 70 percent is in U.S. dollars. So, one of the secondary effects of the China boom has been a transfer of income to commodity-producing countries, which has also created a new demand for the dollar. And that's not going to change quickly because it appears that these commodity prices will persist for at least another 12 or 18 months.

This equilibrium, or new Bretton Woods system as outlined by Deutsche Bank, looks like a viable scenario for at least 12 or 18 more months. The question then is, What does it mean for our economy here at home? We would have some very interesting adjustment questions if we were to have big dollar devaluation. The fact is, we don't have adequate manufacturing capacity to really eliminate or even fundamentally reduce by more than 50 percent our large current account deficit. The current account deficit is equal to 45 percent of the value of U.S. manufacturing output. We have had a long parade of declining spending on American-manufactured capital goods. In 1998 manufacturing investment in this country was \$150 billion. In 2003 it had fallen to \$115 billion. In 2002 and 2003 American firms spent more on foreign-manufactured capital stock than domestic-manufactured capital stock. Foreign investment in 2003 was \$130 billion compared to \$115 billion here at home. So we don't have a huge amount of excess capacity and, if we were to cut the current account deficit by only 25 percent, our capacity utilization rate would increase from 79 to 86 percent. If we cut the deficit in half, the utilization rate would go to 93 percent.

Historically, the Federal Reserve Board has regarded a capacity utilization rate of 86 percent to be dangerously inflationary. With that scenario, the Fed wouldn't just raise the federal funds rate to 4 percent (the common forecast for December of this year)—they might well go to perhaps 6 percent or 6.5 percent, which was the rate 5 or 6 years ago. That would then set up a big rise in mortgage rates that would cripple this big U.S. housing boom. That result would be followed in short order by an increase in our domestic private savings rate, which would slow domestic consumption. And that would set the stage for a current account adjustment, not just through more export growth, but through much slower growth and slower domestic consumption—not in 2005, but in 12 or 18 months, if we have a big enough dollar devaluation to improve the current account and drive up the utilization rate.

What happens on this front will depend very heavily on some key decisions in Washington in the next 9 or 12 months. One decision, of course, will be the policy in the Bush administration, which is to talk the dollar down and to encourage time to revalue. Another important decision is who will take the place of Alan Greenspan as the Federal Reserve chairman. The White House has told me that they are focusing on a short list of three candidates to replace Mr. Greenspan in January of next year. The first is Marty Feldstein, a professor at Harvard University, who was chairman of the Council of Economic Advisors in the first Reagan administration twenty years ago. The second candidate is Glenn Hubbard, who was the chairman of the council 18 months ago and is now the Dean of the Columbia Business School. This is someone who knows President Bush well because he worked very closely with him in the first three years designing the tax policies of this administration. The third candidate is Ben

Bernanke, the Fed governor who is about to leave the Fed to become the chairman of the Council of Economic Advisors in the White House this summer. Bernanke came to the Fed three years ago and he is the candidate promoted by Glenn Hubbard. Alan Greenspan was totally opposed to his appointment because he came from Princeton. Greenspan had a very bad relationship with Alan Blinder and was terrified that a new Princeton professor would also be a source of controversy and tension. As it turns out, Ben Bernanke is quite charming and very pleasant, and there is no conflict at all with Greenspan. However, in the very beginning, Greenspan was quite frightened that there would be a conflict.

How would these men affect the dollar exchange rate? In profoundly different ways. Whenever I see Marty Feldstein at private gatherings with the Federal Reserve (like Jackson Hole last year), he always talks the dollar down. He's like Fred (Bergsten) and thinks a big current account deficit is wrong and that we have to reduce it, which means the dollar has to fall. Indeed, Marty goes out and buys options to short the dollar. He's actually putting his money where his mouth is. Glenn Hubbard has no view on the dollar. He just thinks the market will drive it somewhere, but he feels no preexisting need to have devaluation or any kind of currency adjustment. Ben Bernanke told us two weeks ago that the current account deficit doesn't matter; in fact, the current account deficit is caused by somebody else's surplus liquidity. So I doubt he would advocate big dollar devaluation the way Marty might or others in this debate have been advocating in the past.

So what does this mean? If Marty Feldstein gets the job, I think the dollar will fall quickly because most people in the markets are aware of his point of view. If people thought that we had a central bank chairman committed to dollar depreciation and favored it, they would, I think, be very cautious and concerned. Alan Greenspan has from time to time raised questions about the dollar, but basically his message for many years has been about big, flexible, global capital markets. America can fund the current account deficit. It's not going to be a big problem. He briefly alluded to risk in a speech in Frankfurt last November, but realized after a few weeks that that was a big mistake. In speeches this year, he has gone back to being optimistic and constructive because his Frankfurt speech caused a big dollar decline for a few weeks.

Glenn Hubbard or Ben Bernanke: I don't think the market would quite know how to react. The market doesn't have any well-defined views and indeed, if you believe what Ben said two weeks ago, the current account is not a problem, so why should we have dollar depreciation at all.

Now here's the point for the Bush administration: if they go for a Fed chairman who actively devalues the dollar and causes the dollar to go to \$1.50 against the euro, 80 against the yen, or maybe 7 against the Chinese currency, they might get the current account adjustment over two or three years. If they get the current account adjustment, they're going to get a federal funds rate of 7 percent, which is going to wreck the housing market. If they wreck the housing market, they are going to weaken domestic consumption. I would not want to be the Republican presidential candidate in 2008 campaigning against a backdrop of weak house prices and falling domestic consumption. The American people don't like falling house prices or falling domestic consumption. So, ironically, the low-risk strategy for the Bush administration is a trillion-dollar current account deficit. Let it just keep growing. Let Japan expand its foreign exchange reserves to \$2 trillion. Let China go to \$1.5 trillion. With that kind of policy, the federal funds rate can stay below 5 percent, the housing boom can continue, and they will be no need to have a recession in domestic consumption in the next three years.

So my conclusion for you today is that we may well be heading for a trillion-dollar current account deficit, but we'll enjoy it. We'll continue to have a housing boom, a high level of domestic consumption, and in 2009 we can come back to the Levy Institute and have a conference about what to do with a trillion-dollar current account deficit.

Thank you very much.

PAUL DAVIDSON

New School University

Is a Declining Dollar Good for the U.S. Economy or the Global Economy?

(The Exchange Rate and the Twin Deficits)



A headline on the front page of the *New York Times* (January 13, 2005) stated “U.S. Trade Deficit Rises to A New High: More Risk to the Dollar.” The *Times* reported that in November 2004, the monthly U.S. trade deficit reached nearly \$60 billion. In other words, Americans spent \$60 billion more on imports than they earned by selling exports to foreigners. The *New York Times* article noted that this record trade deficit figure confounded predic-

tions that the deficit would diminish with the weakening of the dollar.

Why are these economic predictions so confounded? The conventional wisdom propagated by economic pundits is that the U.S. trade deficit will disappear if there is a deliberate policy for permitting (and promoting) a market decline in the value of the dollar in terms of foreign currencies. This dollar devaluation, it is claimed, is a necessary and sufficient condition for (1) eliminating the persistent and enormous American annual trade deficit, and (2) regaining balance and stability for the global community. For example, a 1999 *Institution for International Economics* publication suggested that the U.S. trade deficit was not sustainable and indicated that “25 percent is a good ballpark figure for how much the dollar would have to depreciate to reach its fundamental equilibrium exchange rate” (Mann 1999, p. 168–9).

This assertion is based on the argument that, with a decline in the value of the dollar, U.S. exports will become cheaper to foreigners and hence they will buy more U.S. goods. Simultaneously, a decline in the dollar means imports will become more expensive to Americans and they will buy less from foreigners. Now it is true that as the value of the dollar declines, there will be an increase in exports and a decline in imports in terms of the physical volumes of exports and imports bought and sold, but this does *not* mean that the trade deficit will be reduced.

A decline in the dollar means that, except for commodities such as oil, which are priced in dollars, all imports are more expensive in terms of dollars. Consequently, Americans will buy a smaller physical volume of imports. This does not guarantee that Americans will spend a smaller total of their hard-earned dollars on imported goods and services. For example, suppose that at a price of \$450, Americans are importing 1,100 television sets per week, thereby spending \$495,000. When the dollar depreciates, suppose the price of imported televisions rises to \$550? At this higher dollar prices the number of imported television sets bought by Americans is reduced, say, to 1,000. In this hypothetical example, American dollar spending on imported television sets increases from \$495,000 to \$550,000 despite the fewer number of TV sets being imported.

Similarly, a decline in the dollar will mean that the price of U.S. exports to foreigners will decline in terms of their domestic currency, so that foreigners should buy a larger physical volume of imports from the United States. This does not guarantee that American exporters will earn more foreign currency for this greater volume of exports. A declining dollar may be a sufficient condition to eliminate, or even significantly reduce, the huge annual U.S. trade deficit. (In technical terms, the Marshall-Lerner condition necessary for a dollar depreciation to improve the trade balance may not be applicable to the U.S. trade pattern.¹)

The *New York Times* headline is suggestive that the Marshall-Lerner condition is not applicable to the U.S. trade deficit. The dollar has been declining for three years. Nevertheless, the U.S. trade deficit has almost doubled—from \$30 billion a month in January 2002 to \$59 billion a month in January 2005. Faced with these unpleasant facts, proponents of conventional wisdom reply that it takes time for adjustments in exports and imports to occur, but *in the long run*, a decline in the dollar will ultimately eliminate the U.S. trade deficit. But, as the famous English economist John Maynard Keynes once noted, “in the long run we will all be dead.”

Calls for a continuing dollar decline assure that the dollar and foreign currencies are on a collision course that will encourage speculators to look for significant profits by selling dollars and, thereby, driving down the market value of the dollar. The question then is not whether there will be an abrupt further dollar decline leading to a financial market crisis, but when will such a crisis occur. If Treasury Secretary John Snow continues to speak out for a weaker dollar against Asian currencies and, at the same time, Fed Chairman Greenspan continues to suggest that the dollar needs to fall further, then U.S. policymakers are only encouraging speculators to bet against the dollar. Future historians will refer to the resulting decline of the dollar as the bursting of the dollar bubble.

Since World War II the world has been on a dollar standard. Until 1973, the dollar was fixed in terms of an ounce of gold. Under this Bretton Woods dollar-based payments system, the noncommunist world experienced the highest global rate of real economic growth ever recorded. The average annual per capita rate of real economic growth for the OECD nations from 1950 to 1973 was almost precisely double the previous *peak* growth rate of the industrial revolution period. Productivity growth for the OECD nations was more than triple that of the industrial revolution era. The average per capita growth rate for less developed countries (LDCs) was 3.3 percent, almost triple the growth rate by the industrializing nations during the industrial revolution (*see Davidson 2002, pp. 1–3*). Moreover, as McKinnon (1990, p. 10) has noted, during this period there was a “much better overall record of price stability.” As I indicate in my book *Financial Markets, Money and the Real World* (Davidson 2002, pp. 226–27), it was not the fixity of exchange rates alone that contributed to this “golden age.” An additional essential condition (which we discuss further *infra*) was that the creditor nation accepted responsibility for curing current account imbalances.

After 1973 there was an exchange rate mix, with some countries pursuing a managed float against the dollar and others pursuing some form of fixity. Nevertheless, the U.S. dollar remained as the anchor (and standard) for the international payments system. Today, however, a continual and significant falling dollar threatens the very existence of this dollar standard. Can something take the place of this dollar standard?

Short of convening another Bretton Woods conference to hammer out a new international payment system, today's global economy has two choices: either to defend the existing dollar standard, or abandon any international standard for the global payments system and accept that all currencies are free to float against one other. The latter may be desirable by classical economic-theory ideologues, but if history is any guide, the adoption of “beggar-thy-neighbor” exchange rate polices in the 1930s does not auger well for such a system.

To protect the existing dollar standard, however, foreign central banks would have to intervene in markets by buying dollars even more than they currently do in order to maintain some stability in international financial relations. Today's conventional wisdom among central bankers, however, is that the monetary authorities should not intervene in any significant manner in foreign exchange markets. When some central bankers do intervene—as the Bank of China and the Bank of Japan have done—they are told by other nations' central bankers and government officials that it is wrong for them to interfere with the efficient financial markets of the international community.

I believe that the global economic community faces a dilemma in the currency markets that may have even more serious repercussions than the terrorist strike on 9/11. A decline in the value of the dollar sufficient to significantly reduce (even if it does not eliminate) the U.S. trade deficit can be a weapon of mass destruction. Can we muddle through on the hope that speculators in our liberalized international financial markets “know” what is good for the global economy, as the Bush/Snow/Greenspan pronouncements suggest? Or should we wake up our policymakers and insist that they develop contingency plans to avoid this potentially devastating bursting of the dollar standard?

Paths to Economic Growth

Orthodox economists are almost unanimous in preaching the virtues of floating—and its logical inevitability. Yet many, perhaps most, countries remain attached to some form of fixing. Is this a case of economists being out of touch with reality? Or is it that reality is out of touch with economists?

The post-Bretton Woods world has never been one of pure, generalized floating. There is a kaleidoscope of currency arrangements ranging from “hard” fixers to “pure” floaters, and almost anything in between. Conventional wisdom claims floaters are gaining over currency fixers and currency-rate managers, and that soft pegs are unsustainable. Are we moving toward a bipolar world where most currencies float freely and a minority of nations adopt hard pegs, such as euroland?²

Conventional wisdom assumes that the motives of “fixers” have always been predominantly economic. For decades after World War II, however, fixers were motivated in large part by geopolitical, rather than purely economic reasons. The western European countries accepted the dollar standard in return for military protection against communism. Today, willingness of the euro countries to float against the dollar can be viewed as an assertion of political independence.³

Nevertheless the growing financial maturity and the reduction of trade barriers in euroland did *not* lead the European countries to float against one another. Rather, it led them toward the most extreme version of hard fixing. The euro nations have recognized that fixed, but not necessarily undervalued rates, should be preferred both for macroeconomic stability and to facilitate interregional trade expansion. If this is true for euroland, is it not true for the global economy of the 21st century?

It should be clear that the most vocal advocates of floating are predominantly Americans operating under the ideological spell originally cast by Milton Friedman's classical theory–monetarist approach and ultimately based on the Walras/Arrow/Debreu classical theory that is founded on the axiom⁴ that money is neutral (i.e., money relations have no effects on real output). Only relative prices are important in determining the composition of output of a fully employed economy. But as Frank Hahn (1973, p. 14) noted “practical men and ill-trained theorists everywhere in the world do not understand what they are claiming . . . when they claim a beneficent and coherent role for the invisible hand” of a market with freely flexible prices.

The desire of nations such as China, India, Japan, and other Asian countries to maintain a competitive fixity of exchange rates against the dollar reflects the desire of these nations to pursue export-led growth. The U.S. economy is the ultimate, primary marketing target for the export industries of these Asian nations. Of course, the Asian decision to pursue export-led growth permits the consumers in the United States to live well beyond their means. At the same time, it means that these export-oriented nations are pursuing policies that encourage significant savings on their rapidly growing international accounts.

Taking advantage of the world's appetite for dollars, the United States has accepted the view that other nations should bear the onus for Americans' exuberant consumption-spending patterns. These other nations have a choice of how they accept this responsibility. They can either (1) revalue their currencies, but to do so would mean that they would have to accept lower rates of real growth, or (2) accept dollars almost without limit to maintain their real economic growth and to move toward prosperity. Given these options, it is not difficult to understand why the imbalance between the Asian creditors and the world's largest international debtor tends to persist despite a declining dollar. Asiatic nations recognize that their rapid export-led economic growth policies' success relies on encouraging the United States to overspend. The euro nations, on the other hand, perhaps in their desire to demonstrate their geopolitical independence from the United States, apparently prefer to impose overall lower real economic growth on their residents.

What generalization regarding economic growth policies can we draw from this current world situation? To slightly oversimplify, I believe that there exist today two roads to real economic growth. Most of the world relies on export-led growth for achieving significant rates of real economic growth.⁵ On the other hand, the road that the United States travels (and euroland apparently desires to trod on) requires significant labor productivity growth to generate real output growth. Under the Bush administration, despite a slight recession, there has been a respectable rate of economic growth, while total employment is still less than the employment levels in January 2001, when President Bush took office. Higher real GDP with fewer workers signifies a strong rate of productivity growth associated with the real economic growth experienced by the United States in the 21st century.

At the beginning of the 21st century, when the U.S. fiscal budget turned to a deficit, many economic pundits predicted that within two to three years the United States' current account deficit would be unsustainable. But even earlier, on February 17, 1999, Treasury Secretary Robert Rubin warned that “the international system cannot sustain indefinitely the large current account imbalance” (Mann 1999, p. 166). More than five years have passed and the evidence is that foreigners continue to finance an ever-increasing U.S. trade deficit despite pressure from Washington to end these U.S. capital inflows.

Nevertheless, the conventional wisdom remains that foreigners will not accept dollars without limit in the long run; hence, the U.S. current account deficit is not sustainable. Foreigners, especially foreign central banks, will not continue to finance the “extravagant” consumption patterns of Americans. Ultimately, the United States will have to reduce its exuberant consumption spending on foreign-produced goods. Is this likely, as long as the Asiatic nations pursue the export-led growth route for economic growth and prosperity?

Is the U.S. Problem Its Twin Deficits?

Many of the talking heads in the media complain that the U.S. problem is one of twin deficits: the U.S. government spends more than it raises in taxes, while the dollar value of U.S. imports significantly exceeds the value of exports. In 1981 U.S. exports minus imports was \$8 billion. Every year since then there has been a trade deficit, but in 1991 the current account showed a small surplus when the first President Bush launched the Desert Storm war against Iraq and insisted that nations such as Japan and Germany pay for that war, which protected them from Saddam Hussein. In 1991 foreign government unilateral transfer payments to the United States were sufficient to turn the U.S. trade deficit into a small current account surplus.

In the latter half of the Clinton administration the federal government ran significant fiscal surpluses. Nevertheless, the U.S. trade deficit continued to grow from \$52 billion in 1993 to \$379 billion in 2000. This fact alone suggests that it is not the fiscal budget deficit per se that is the cause of the persistent U.S. current account deficits.

In the years since 1981 the United States has acted as the primary engine of economic growth for the rest of the world. Given the current international payments system, if either the United States voluntarily ended its trade deficits or if the rest of the world refused to continue to finance U.S. international overspending, then the major growth industries of the rest of the world would stagnate as their export market in the United States dried up.

Those who advocate that China, Japan, India, etc., should stop sterilizing their export-earning, surplus-dollar inflows and let their currencies float (upward) against the dollar are using the old classical argument: When there is an international payments imbalance, it is the duty and obligation of the debtor to curtail spending and creditors should accept (encourage) their debtor-trading partners to tighten their belts and accept a lower real income for their residents. But a rapid and significant belt-tightening exercise by large customers of nations that rely on export-led growth has deflationary repercussions for the creditor nations such as rising unemployment, falling aggregate incomes, and potential bankruptcies of previously expanding industries. This could result in outstanding bank loan defaults in creditor nations that already have shaky banking systems.

Given the history of the global economy in the last quarter of the (20th) century, creditor nations would be foolish to suddenly stop sterilizing their large and growing surplus dollar export earnings and adopt a free-floating exchange rate.

In his Bretton Woods papers, Keynes argued that when large international debtors have persistent current account deficit problems, it is enlightened creditors who expand their spending on the products of the debtors, so that the latter can earn sufficient foreign exchange. Can we design an international payments system where the creditor nations take on the responsibility to help debtor nations work their

way out of debt? The answer is “yes,” but before we get to such a proposal, let us look at a proposal by a Nobel Prize winner to deal with these international financial problems that have been put on the table.

Currency Crises and Global Greenbacks

In the Spring 2003 issue of *Harvard Relations Council International Review*, Nobel Prize winner Joseph Stiglitz indicated that the international financial system is suffering from a virulent malady that, at one time or another, has left developing nations such as Korea, Indonesia, Thailand, Mexico, Argentina, and Brazil economically devastated.

Stiglitz notes that international capital flows are a primary cause of this disease, as every prudent nation (except the United States) strives to maintain a surplus of exports over imports in order to add to the nation’s foreign reserves. Since the global economy is, in essence, on a “dollar standard,” foreign reserves are held primarily in the form of U.S. Treasuries.

Stiglitz correctly notes that one country’s surplus must be some other nation’s deficit, as the saved foreign reserves are not used to buy the products of the nation’s trading partners. In essence, when any nation pursues policies that successfully run persistent trade surpluses, it is like a nation playing a game of Old Maid and passing the Black Queen of unemployment and indebtedness to other nations. In a dollar-standard world, nations (other than the United States) stuck with the Old Maid must use a combination of previously saved foreign reserves plus new international loans to pay for their excess imports and to service their existing international debts. Ultimately, as foreign reserves dwindle and international indebtedness increases, the deficit nation is unable to service its outstanding international debt obligations.

To prevent default, the International Monetary Fund (IMF) can make new loans to the indebted nation. The IMF loans require deficit nations to adopt Washington Consensus reforms where (1) all domestic financial, labor, and product markets must be “liberalized” (i.e., freed of government control); and (2) the nation must “tighten its belt” (i.e., run fiscal surpluses and tight monetary [high interest] policies). These belt-tightening policies depress the nation’s economy in the hope that the resulting impoverished population will drastically reduce their purchases of all goods and services, including imports.

Even as the deficit nation tightens its belt, however, its increased international indebtedness (as the IMF loans are added to the existing loans) enlarges the annual international debt-service payments. Adding to this burden is any decline in the nation’s exchange rate as domestic residents and foreign investors that take advantage of the liberalized international financial market attempt to move their funds to a safe haven in another country. Almost inevitably, the indebted nation cannot free itself from the increasing weight of its hard currency international debts—except by default. The result is a moribund economy (e.g., Argentina in 2002).

Stiglitz suggests creating “global greenbacks” (known as special drawing rights [SDR]) to be issued as grants (handouts) to developing countries and other countries in times of international financial difficulties. Under Stiglitz’s plan, these global greenbacks can be converted into hard currencies to service debts, buy imports, or supplement foreign reserves. Unfortunately, such handouts are merely palliatives and are not the solution to the problem. Moreover, some countries will become SDR addicts, and when the handouts end, the economic withdrawal symptoms can be even more deadly.

The cure lies in creating a new international financial architecture, as called for by President Clinton after the 1998 Russian debt default. Unfortunately, Clinton’s clarion call went against the

Washington Consensus and therefore was never seriously studied by major political decision makers. Stiglitz fails to provide a new architecture because he ignores some guidelines that Keynes indicated were essential to avoid international financial problems and recessionary forces in the post–World War II era. Keynes’s suggestions included: “We need a quantum of international currency . . . [which] is governed by the actual current [liquidity] requirements of world commerce, and is capable of deliberate expansion . . . We need a method by which the surplus credit balances arising from international trade, which the recipient does not wish to employ can be set to work . . . without detriment to the liquidity of these balances” (Keynes 1980, p. 168).

In my book *Financial Markets, Money and the Real World* (Davidson 2002, chapter 14), I have embedded Keynes’s suggestions in a proposal for a new international financial architecture that is designed to (1) prevent a lack of global effective demand due to any nation either holding excessive idle reserves or draining reserves from the system; (2) provide an automatic mechanism for placing a major burden of payments adjustments on the surplus nations; (3) prevent financial crises, while providing each nation with the ability to monitor and, if desired, to control movements of flight capital⁶; (4) expand the liquidity of the international financial system as global capacity warrants; and (5) encourage the debtor nations to work their way out of debt rather than either await handouts or default on international obligations to encourage short “haircuts” for their international creditors.

The health of the global economic system will not permit us to muddle through with the present international financial arrangements much longer. Before an international financial calamity occurs, it is time to look at blue prints for a New Financial Architecture that will prevent recurrent financial crises and the possibility of another international Great Depression.

Noting that there have been almost 100 currency crises in the previous 30 years, Stiglitz states “the question is not whether there will be another crisis, but where it will be.” According to Stiglitz, “This much is clear: the IMF, whose responsibility it is to ensure the stability of the global financial system, has failed miserably in its mission to stabilize international financial flows, and has arguably made matters worse.”

Thirty years before 2003, however, marked the breakdown of the most successful international financial system⁷ in the history of mankind—the Bretton Woods system. Unfortunately, this fact did not stimulate Stiglitz to raise the following questions: (1) Despite the existence of the same IMF during the quarter century after WWII, why did the Bretton Woods financial system tend, in general, to avoid international financial crises? (2) What was it about the international financial system during the Bretton Woods period that encouraged (or, at least, did not hinder) year after year of unparalleled rates of increase in real GDP per capita for every nation this side of the Iron Curtain?⁸ and (3) Why were there such unparalleled growth rates even though every major nation, including the United States, instituted some form of international capital flow restrictions during the Bretton Woods period?

Where Do We Go from Here?

In my books (1992, 2002) I developed in great detail a proposal for a new financial architecture for the international payments system. Building on Keynes’s proposal for an international clearing union, I developed an 8-point system that produces the necessary and sufficient conditions to permit the establishment of a global golden age of economic growth in the 21st century. The main provisos of my proposal are:

The unit of account and ultimate reserve asset for international liquidity is the International Money Clearing Unit (IMCU). All IMCUs are held *only* by central banks and not by the public.

Each nation's central bank is committed to guarantee one-way convertibility from IMCU deposits at the clearing union to its domestic money. Each central bank will set its own rules regarding the availability of foreign monies (through IMCU clearing transactions) to its own bankers and private sector residents.⁹ Ultimately, all major private international transactions clear between the central banks' accounts in the books of the international clearing institution.

The exchange rate between the domestic currency and the IMCU is set *initially* by each nation—just as it would be (set) if one instituted an international gold standard.

Contracts between private individuals will continue to be denominated into whatever domestic currency is permitted by local laws and agreed upon by the contracting parties.

An overdraft system to make available short-term unused creditor balances at the clearinghouse to finance the productive international transactions of others who need short-term credit. The terms will be determined by the pro bono clearing managers.

A trigger mechanism to encourage a creditor nation to spend what is deemed (in advance) by agreement of the international community to be “*excessive*” *credit balances accumulated by running current account surpluses*. These excessive credits can be spent in three ways: (1) on the products of any other member of the clearing union, (2) on new direct foreign investment projects, and/or (3) to provide unilateral transfers (foreign aid) to deficit members.

The development of a system to stabilize the long-term purchasing power of the IMCU (in terms of each member nation's domestically produced market basket of goods). This requires a system of fixed exchange rates between the local currency and the IMCU that changes only to reflect permanent increases in efficiency wages.¹⁰ This assures each central bank that its holdings of IMCUs, as the nation's foreign reserves, will never lose purchasing power in terms of foreign produced goods, even if a foreign government permits wage-price inflation to occur within its borders.

If a country is at *full employment* and still has a tendency toward persistent international deficits on its current account, then this is *prima facie* evidence that it does not possess the productive capacity to maintain its current standard of living. If the deficit nation is poor, then surely there is a case for the richer nations who are in surplus to transfer some of their excess credit balances to support the poor nation.¹¹ If it is relatively rich, then the deficit nation must alter its standard of living by reducing the relative terms of trade with major trading partners. If the payment deficit persists despite a continuous positive balance of trade in goods and services, then there is evidence that the deficit nation might be carrying excessive international debt-service obligations. The pro bono official of the clearing union should bring the debtor and creditors into negotiations to reduce annual debt-service payments by (1) lengthening the payments period, (2) reducing the interest charges, and/or (3) debt forgiveness.¹²

It should be noted that proviso no. 2 permits capital controls.¹³ Proviso no. 6 embodies Keynes's innovative idea that whenever there is a persistent (and/or large) imbalance in current account flows—whether due to capital flight or to a persistent trade imbalance—there must be a built-in mechanism that induces the surplus nations to bear a major responsibility for eliminating the imbalance. The surplus nation must accept this burden, for it has the wherewithal to resolve the problem.

In the absence of no. 6, under any conventional system, whether it has fixed or flexible exchange rates and/or capital controls, there will ultimately be an international liquidity crisis (as any persistent current account deficit can deplete a nation's foreign reserves) that unleashes global depressionary forces. Thus, proviso no. 6 is necessary to assure that the international payments system will not have a built-in depressionary bias. Ultimately, it is in the self-interest of the surplus nation to accept this responsibility, for its actions will create conditions for global economic expansion, some of which must rebound to its own residents. Failure to act, on the other hand, will promote global depressionary forces that will have some negative impact on its own residents.

Some think that my specific clearing union plan, like Keynes's bancor plan a half century earlier, is utopian. But if we start with the defeatist attitude that it is too difficult to change the awkward system in which we are trapped, then no progress will be made. Global depression does not have to happen again if our policymakers have sufficient vision to develop this post-Keynesian approach. The health of the world's economic system will simply not permit us to muddle through.

Notes

1. Even if the Marshall-Lerner condition is met if the sum of the price elasticity of demand for imports plus the price elasticity for exports only slightly exceeds unity, it may take a tremendous plunge in the dollar to even significantly reduce the balance of trade deficit.
2. Stanley Fischer. 2001. "Exchange Rate Regimes: Is the Bipolar View Correct?" *Journal of Economic Perspectives*. 15, 3–24.
3. If the euro was pegged to the dollar, would European support for President Bush's intervention in Iraq be different?
4. An axiom is a doctrine that is accepted as a universal truth for which no proof is required.
5. I have explained why export-led growth is such an attractive option in P. Davidson, "The General Theory in an Open Economy Context" in *A Second Edition of the General Theory*, Vol. 2, edited by G. C. Harcourt and P. Riach, London: Routledge, 1996, and reprinted in *Uncertainty, International Money, Employment and Theory*, Vol. 3 of the *Collected Writings of Paul Davidson*, edited by Louise Davidson, London and New York: Macmillan and St. Martins Press, 1999.
6. It would make visible, the international movement of funds earned in illegal activities, tax dodges, and funds to finance international terrorist activities.
7. Successful in the sense that during this period, the average annual real growth per capita was almost double the peak growth rate of developed nations during the period of the industrial revolution, while the average real growth rate of developing nations equaled or exceeded the industrial revolution growth rate (see Davidson 2002, p. 2).
8. For the figures, see Davidson 2002, p. 1–2. For an explanation, see pp. 225–8.
9. Correspondent banking will have to operate through the International Clearing Agency with each central bank regulating the international relations and operations of its domestic banking firms. Small-scale smuggling of currency across borders, etc., can never be completely eliminated. But such movements are merely a flea on a dog's back—a minor but not debilitating irritation. If, however, most of the residents of a nation hold and use (in violation of legal tender laws) a foreign currency for domestic transactions and as a store of value (e.g., it is estimated that Argentina holds more than

- 5 billion U.S. dollars), this is evidence of a lack of confidence in the government and its monetary authority. Unless confidence is restored, all attempts to restore economic prosperity will fail.
10. The efficiency wage is related to the money wage divided by the average product of labor. It is the unit-labor cost modified by the profit markup in domestic money terms of domestically produced GNP. At the preliminary stage of this proposal, it would serve no useful purpose to decide whether the domestic-market basket should include both tradable and nontradable goods and services. (With the growth of tourism, more and more nontradable goods become potentially tradable). I personally prefer the wider concept of the domestic market basket, but it is not obvious that any essential principle is lost if a tradable-only concept is used or if some nations use the wider concept, while others the narrower one.
 11. This is equivalent to a negative income tax for poor fully employed families within a nation.
 12. The actual program adopted for debt-service reduction will depend on many parameters, including the relative income and wealth of the debtor vis-à-vis the creditor, the ability of the debtor to increase its per capita real income, etc.
 13. The function of capital controls is to prevent sharp changes in the bull/bear sentiment from overwhelming market makers and inducing rapid changes in price trends, for such volatility can have devastating real consequences.

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DONALD L. KOHN

Federal Reserve Board

Imbalances in the U.S. Economy



I am pleased to be here today at this conference considering U.S. financial and macroeconomic conditions and the economy's prospects, puzzles, and imbalances. You have considered a broad range of issues of interest to us at the Federal Reserve. I thought it might be useful for me to close the conference by giving you my perspective on some of the imbalances currently evident in the U.S. and global economies, how they might be resolved, and their implications for policy—including monetary policy. I must emphasize that these views are my own and not necessarily those of my colleagues on the Federal Open Market Committee.¹

The Current State of the Economy

The United States has been doing well over the past few years by most measures of overall economic performance. Real gross domestic product growth has rebounded smartly from the 2001 recession, and slack both in labor and product markets has eroded appreciably. After a substantial period of little or no increase in employment, payroll gains have picked up to an average of 160,000 per month over the past half year, and the unemployment rate has fallen to 5.25 percent, almost 1 percentage point below where it was two years ago. Household spending on goods and services and housing has been strong throughout the expansion, and, more recently, business investment in capital equipment has surged. The increase in output has been accompanied by large increases in labor productivity that, since 2002, have been in excess of even the elevated pace of the second half of the 1990s. To be sure, the rise in energy prices seems to have taken a toll on consumer confidence and spending most recently. But with financial conditions still accommodative, profits and cash flow still healthy, and incomes continuing to increase, most forecasters expect growth to remain solid.

Excluding food and energy, the rate of inflation has fluctuated around 1.5 percent over the past few years, measured by the chain-weighted price index for personal consumption expenditures. Core inflation has been running somewhat faster more recently, in part because of the increases in the prices of energy, commodities, and imports that began last year. Nevertheless, barring further sizable increases in the prices of oil and natural gas, both core and headline inflation rates should moderate later this year. Buttressing this view, long-run inflation expectations have been, on balance, fairly stable in the face of these price gyrations.

Imbalances in the Economy

Although the overall state of the economy is favorable, some aspects of the current situation might be viewed as worrisome. In particular, beneath this placid surface are what appear to be a number of

spending imbalances and unusual asset-price configurations. At the most aggregated level, the important imbalance is the large and growing discrepancy between what the United States spends and what it produces. This imbalance, measured by the current account deficit, has risen to a record level, both in absolute terms and as a ratio to GDP. Moreover, the cumulative value of past current account deficits—the net foreign indebtedness of the United States—is also at a record high, again both in absolute terms and as a ratio to GDP.

The growing current account deficit has been associated with a pronounced decline in the saving proclivities of both the private and public sectors. Over the past year, households have saved only about 1 percent of their after-tax income, compared with about 8 percent on average from 1950 to 2000. In the public sector, the federal budget deficit has been larger in the past, at least relative to the size of GDP, but the deterioration in the balance over recent years has been sizable, moving from a surplus of \$236 billion in fiscal year 2000 to a deficit of more than \$400 billion last year. The resultant overall decline in national saving contrasts with the pace of capital spending: Residential investment as a share of GDP now stands at its highest level since the 1950s, while the share of GDP devoted to investment in plant and equipment has recovered sufficiently from its recent slump to return to the neighborhood of its long-run average.

One might have thought that, with probably limited economic slack remaining, such a pronounced imbalance between national saving and domestic investment would have placed substantial upward pressure on interest rates. One also might have expected real interest rates to be high at a time when we are experiencing rapid productivity growth. But, as you know, nominal and real yields on both short-term and long-term Treasury securities are low by historical standards. Moreover, although premiums on private bonds relative to Treasury yields have risen somewhat of late, they are still at the low end of their historical range, suggesting that investors are sanguine about default risk and other types of uncertainty.

Low interest rates have, in turn, been a major force driving the phenomenal run-up in residential real estate prices over the past few years, and the resultant boost to net worth must be one of the reasons households have felt comfortable directing so little of their current income to saving. However, whether low interest rates and other fundamental factors can fully explain the current lofty level of housing prices is the subject of substantial debate.

This situation raises some difficult questions. Can the aforementioned spending imbalances and possible asset-price anomalies continue without threatening macroeconomic stability? And if they cannot be sustained, how will they unwind? Will the transition be relatively benign, or will it be a rocky adjustment with deleterious effects on economic growth, inflation, and other factors? And finally, what role will government policies play in influencing the path of adjustment?

Sustainability of Current Imbalances

On the question of sustainability, it is worth noting these sorts of imbalances are not new. The trade account has been persistently in deficit since the late 1970s, and the current account has been in a similar state almost continuously since the early 1980s. The personal saving rate has been declining since the mid 1980s. And the federal government has spent more than it has taken in every year since 1970 except for a brief respite between 1998 and 2001. So these imbalances have been around for a long

time, and our economy is still churning out high rates of productivity and income growth. But, the magnitude of these imbalances is increasingly moving into unfamiliar territory. I have already noted the unprecedented level of the current account deficit and the depressed household saving rate. As for the federal budget, the projected funding shortfall in Social Security and exploding Medicare and Medicaid costs mean that without a reassertion of fiscal discipline, the long-run outlook for the federal budget balance is for worse to come.

The sustainability of these large and growing imbalances has become especially suspect because it would require behavior that appears to be inconsistent with reasonable assumptions about how people spend and invest. For example, it seems unlikely that foreigners would be willing to continue to indefinitely increase the proportion of their wealth held in dollars without upward movements in the expected return on these assets. And if the government tried to honor its current long-run commitments to future retirees without raising tax rates, it seems unlikely that it could borrow the massive amounts needed without paying creditors higher returns—returns potentially so high over coming decades as to be economically debilitating.

Similar considerations apply to the current low rate of household saving. Most theories of consumer behavior emphasize the desire of households to save for retirement. However, given average life expectancies and the typical number of working years, a sustained saving rate of less than 2 percent is too low for households to accumulate enough wealth to maintain their standard of living after retirement—unless, of course, those households are lucky enough to receive outsized capital gains on their homes and other assets. Although many households have received such windfalls over the past few years, such gains are not likely to be continually repeated in the future.

The current imbalances will ultimately give way to more sustainable configurations of income and spending. But that leaves open the question of the nature of that adjustment. Ideally, the transition would be made without disturbing the relatively tranquil macroeconomic environment that we now enjoy. But the size and persistence of the current imbalances pose a risk that the transition may prove more disruptive.

The Underlying Causes of the Imbalances

Speculating on the adjustment path would be more fruitful if we understood how we got to where we are today. Unfortunately, the situation is complicated and, even after the fact, not fully understood, which is why we hold conferences like this one. Nevertheless, I think we can identify several factors that have played an important role in the emergence of these imbalances, and in so doing gain some insight into their likely resolution.²

A rise in the net supply of saving in other countries, the perception that dollar assets are a relatively favorable vehicle in which to place that saving, and an increase in global financial integration that has facilitated the transfer of savings have been important factors in our growing trade and current-account imbalances. The increased desire to hold dollar assets resulted in part from the jump in the rate of increase in productivity that materialized in the United States in the mid- to late-1990s and that, in turn, raised the perceived rate of return on U.S. assets. At the same time, sluggish growth and recessions in other developed countries and the Asian financial crisis of 1997 damped returns elsewhere. Moreover, foreign governments—especially in Asia—took the lesson from the financial crisis that a

large war chest of reserves was needed to protect against the volatility of capital flows. Such a buildup of dollar reserves was also consistent with an emphasis on stable exchange rates that fostered exports as means to sustaining high growth rates in their countries. The resultant shift toward dollar-denominated assets was associated with capital inflows into the United States and a deterioration of the current-account balance. In addition, the increased willingness of the rest of the world to hold U.S. assets, along with the jump in our productivity growth, contributed to a sharp increase in U.S. equity valuations. And the associated capital gains, in turn, caused the net worth of U.S. households to soar relative to their income and induced a reduction in personal savings rates.

Then, in 2000 and 2001, global stock markets slumped and business investment was slashed. In the United States and elsewhere, monetary and fiscal policies turned stimulative to bolster demand and to stave off unwelcome disinflation. The size of the stimulus required to accomplish our macroeconomic objectives in the United States was further increased by the sluggish economic growth of our trading partners and by continued demand for dollar assets, which further exacerbated our trade imbalance.

In the aftermath of the recession in the United States, private aggregate demand, both here as well as in Europe and Japan, has strengthened only gradually. This slow rebound has meant that many central banks around the world have held real interest rates low to support real activity and keep inflation stable. The climate of low interest rates has in turn bolstered asset markets in some countries, especially residential real estate markets. The associated capital gains, coupled with financial market innovations that make extracting housing equity easier in the United States, help to explain the depressed level of the personal saving rate here; low interest rates themselves also have probably boosted consumption relative to income by reducing the return to saving.

At the same time, demands for dollar-denominated assets have been sustained at a high level. Returns on these assets have apparently continued to look reasonably attractive to private investors. And some foreign governments have continued to accumulate dollar assets, adding to already high levels of reserves. Their actions likely reflect in part a concern about the adequacy of their domestic demand to support the advances in economic activity required for job creation.

This explanation has emphasized a favorable relative return on U.S. investment, coupled with increased foreign willingness to hold dollar assets, as causal factors driving the United States' growing current account deficit and low national saving rate. But causation may in part also have run from structural influences that contributed to reduced U.S. saving. That is, 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 resultant upward pressure on rates of return here relative to those abroad have helped to draw in capital and increase the current account deficit.

Unwinding the Imbalances

What can we say about the likely path by which these spending imbalances will resolve themselves and about the effects those resolutions will have on the broader economy? Almost a year ago, the Federal Reserve started a process of removing the unusual degree of policy accommodation, which was outliving its usefulness as the economic expansion gathered strength and the possibility of declines in infla-

tion receded. We have not yet finished this task: The federal funds rate appears to be below the level that we would expect to be consistent with the maintenance of stable inflation and full employment over the medium run, and, if growth is sustained and inflation remains contained, we are likely to raise rates further at a measured pace. By increasing the return to saving and by damping the upward momentum in housing prices, rising interest rates should induce an increase in the personal savings rate, and thereby lessen on of the significant spending imbalances we have noted.

Forecasting the path of the overall spending-production imbalance is more difficult. To a great extent, continuation of the current account deficit depends on the willingness of investors to provide financing. One factor that will influence their willingness is the rate at which U.S. dollar assets are increasing in global portfolios relative to other assets. We can speculate that unless a persistently large current account deficit in the United States is accompanied by further and continuous shifts in the world's willingness to increase holdings of dollar-denominated assets in their total portfolios, investors will ultimately require higher *ex ante* rates of return on their U.S. assets relative to those available on foreign assets. This presumably applies to foreign governments as well as private investors. Governments will eventually see that returns from encouraging domestic investment will outstrip those expected on their growing holdings of dollar reserves, or that more flexible exchange rates are required to exercise a stabilizing monetary policy. Over the past few years, we have seen a moderate decline in the dollar, indicating that the demand for dollar-denominated assets is not infinitely elastic. And, at some point, the current account deficit should start to narrow.

In addition, the process of narrowing deficits may be helped by an autonomous rise in domestic saving. We do not understand all the reasons for recent low personal savings rates, and the rise in the savings rate could exceed the increase that results from likely movements in interest rates and house prices—especially as households contemplate the adequacy of their retirement income. And fiscal policymakers do seem to be more aware of the need to change the medium-term trajectory of the federal budget.

To the extent that current spending behavior is built on realistic expectations—in particular, for future short-term interest rates, the exchange rate, rates of return on capital investments in the United States relative to those abroad, and housing price appreciation—the transition should be relatively orderly: Asset prices should adjust gradually to changing developments, as should the spending patterns of households and firms. But if current expectations are badly distorted, then the way forward may not be so smooth. Eventually, reality always asserts itself over wishful thinking, and such realignments are sometimes abrupt, as illustrated by the collapse of the high-tech bubble a few years ago. In such circumstances, asset prices can adjust sharply, and private spending may also respond quickly, making it difficult for monetary and fiscal policy actions to provide a timely enough counterweight to keep the economy continuously on track.

Are expectations substantially distorted? Because we seldom have direct and reliable readings, it is hard to say. Still, some observations can be made. First, even after their recent increases, both Treasury yields and risk premiums on private securities are low by historical standards. To a considerable extent, Treasury yields reflect two factors: low actual and expected inflation; and the market's belief that, with growth moderate and inflation contained, the federal funds rate will move up only gradually as the expansion proceeds. In addition, with the macroeconomic climate expected to remain calm, investors seem to require less compensation for the risks inherent in lending over a longer term

or of supply credit to borrowers who usually have a greater chance of defaulting. In this environment, the likelihood that major credit problems will develop would seem limited, and that limited risk makes it not unreasonable for private bond premiums to be at the low end of their historical range. Still, investors seem to expect short-term interest rates to remain on the low side of historical averages for some time. These subdued expectations may reflect a belief that underlying global demand will remain damped and that the world will continue to be willing to invest heavily in the United States.

A second observation concerns the housing market, which you have already discussed. A couple of years ago I was fairly confident that the rise in real estate prices primarily reflected low interest rates, good growth in disposable income, and favorable demographics. Prices have gone up far enough since then relative to interest rates, rents, and incomes to raise questions; recent reports from professionals in the housing market suggest an increasing volume of transactions by investors, who (along with homeowners more generally) may be expecting the recent trend of price increases to continue. Even so, such a distortion would most likely unwind through a slow erosion of real house prices, rather than a sudden crash. Moreover, experience suggests that consumer spending would respond only gradually to any loss in wealth—an important consideration because a gradual adjustment in spending would give offsetting policy actions time to work. In any event, I take some comfort from the continuing disagreement among close students of the market about whether houses are overvalued, and, given the widespread press coverage of this issue, from my expectation that people should now be aware of the risks in the real estate market.

Finally, there is the exchange rate. The inability of anyone to predict movement in the dollar accurately and consistently has been evident. Presumably, the dollar's value is based partly on market expectations about future interest rates, trade flows, and portfolio preferences, among other things. There is no particular reason to think that these expectations are substantially distorted. Certainly no investor out there buying dollar assets could be surprised to learn that the United States has a growing current account deficit. And I do not anticipate a marked and persistent downshift in U.S. productivity growth that would greatly reduce the expected returns from holding dollar denominated assets. Governments who have been accumulating dollar assets also would seem to have no reason for shifting their preferences suddenly and disruptively, even in the context of allowing greater exchange rate flexibility.

Financial markets are flexible and increasingly integrated around the world, facilitating continuous and gradual adaptation of capital flows to changing circumstances. Markets for goods and services are also becoming more integrated and flexible, though this trend has been, perhaps, more subject to government actions to slow the process. In fact, the dollar has risen in 2005, reflecting the interplay of portfolio preferences and shifting patterns of saving and investment in markets. In all likelihood, adjustments toward reduced imbalances in the United States and globally will be handled well by markets without, by themselves, disrupting the good, overall performance of the U.S. economy—provided, of course, that the Federal Reserve reacts appropriately to foster price and economic stability.

Still, complacency would be ill-advised. Although the odds seem favorable for an orderly adjustment, the current imbalances are large and—importantly for gauging risks—unusual from a historical perspective. Thus, we have little experience to call on in judging when and how they will be corrected. In such circumstances, we cannot rule out sudden shifts in expectations, whether or not they are unreasonable to begin with, and asset prices may change suddenly. Investors may recognize the unsustainabil-

ity of some flows and prices, but believe they can adjust in advance of the market—as apparently many thought they could in the tech-stock bubble—and their reactions when prices move could add to volatility. Moreover, we cannot rule out governments engaging in unwise policies—policies that might undermine confidence or might hinder market adjustments and associated changes in asset prices.

The Role of Policy

Sound public policies are essential to enhance the chances that any transition will be smooth. A permanent correction to the spending imbalances must involve the restoration of fiscal discipline and long-run solutions to the financing problems of Social Security, Medicare, and Medicaid. Achieving these objectives is important in any event, but they take on added weight to the extent that we cannot count on an ever-increasing flow of global savings coming to the United States. Without a resolution of these fiscal problems, the balance of aggregate production and spending would be much more difficult and would result in intensified pressures on interest rates. Those pressures would tend to hold down the growth of investment and productivity and they would exacerbate asset-price movements and adjustment difficulties in other markets.

Adjustment of global current-account imbalances could also be aided by changes over time in the policies of our trading partners. To some extent, it would seem appropriate for them to use their macroeconomic policies to stimulate domestic spending. In many cases, however, the root cause of deficient demand seems to be more structural than cyclical in nature, and would thus call for more micro-oriented measures. Combined, these policy initiatives on the part of our trading partners should yield higher productivity growth, generate more vigorous spending abroad, raise rates of return on their capital investment, and ease their adjustment to smaller U.S. deficits. These changes, in turn, would boost the demand for U.S. exports and could shift portfolio preferences away from dollar-denominated assets.

Other public policies here and abroad can have an important influence on the transition process by working with markets and facilitating adjustment. For example, governments should strive to maintain and enhance the flexibility of markets. In particular, the United States and its trading partners should vigorously protect the current degree of market openness and should aim to reduce trade barriers further. Over time, increased exchange rate flexibility abroad would also be beneficial. These and other types of market flexibility help facilitate needed shifts in spending and prices; without them, rigidities might impede such stabilizing changes, causing adjustments to break out forcefully in other, more disruptive ways.

Strong financial institutions are especially important at this time when asset prices could move by large amounts unexpectedly. By ensuring that financial institutions are adequately capitalized and well prepared in general to deal with major changes in asset prices, prudential regulation decreases the risk that the actions of impaired financial institutions could disrupt the flow of credit and thereby intensify what might already be difficult adjustments. In addition, strong institutions should be positioned to weather any necessary changes in short-term interest rates as policy is adjusted.

Finally, there is the role that monetary policy plays in reacting to these imbalances and their inevitable unwinding. The Federal Reserve's mandate is to keep inflation low and stable and to promote full resource utilization, with the economy expanding at its maximum sustainable rate. Thus,

anything that has the potential to threaten the stability of output and prices is of concern to us. These imbalances certainly affect the forces of supply and demand and have consequences for price stability. Nevertheless, their direct influence on monetary policy is limited: They are important to us in so far as they affect the macro economy, and in this regard they are just a few of the factors that the Federal Open Market Committee considers in assessing the prospects for the stability of prices and output. Hence, we should take into account the claim on resources implied by the federal budget, as we should the effect that housing wealth has on consumer spending and the economy more broadly. We should note the implications of changes in the exchange rate or borrowing rates by U.S. corporations that result from shifts in global investor sentiment. But, in the same vein, we should not hesitate to raise interest rates to contain inflation pressures just because it might set off a retrenchment in housing prices, just as we were willing to keep rates unusually low as house prices rose rapidly. Nor should we hesitate to raise rates because higher rates mean higher debt-servicing burdens for the current account, the fiscal authority, or households. In my view, our role is to anticipate as best we can the macroeconomic effects of imbalances and their correction and to respond to unexpected changes in asset prices and spending propensities as they occur. It is through such actions that we aim to achieve our objective of economic stability.

Notes

1. Eileen Mauskopf and David Reifschneider, of the Board's staff, contributed greatly to the preparation of these remarks.
2. For a model-based examination of this question, see "U.S. Current Account Deficit: Causes and Consequences," remarks by Vice Chairman Roger W. Ferguson, Jr., to the Economics Club of the University of North Carolina at Chapel Hill (April 20, 2005).

Sessions

SESSION 1

The State of the U.S. and World Economies



Frank A. J. Veneroso, James W. Paulsen; Steven B. Kamin

MODERATOR:

DIMITRI B. PAPADIMITRIOU

President, The Levy Economics Institute

STEVEN B. KAMIN

Federal Reserve Board

JAMES W. PAULSEN

Wells Capital Management

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.

SESSION 2

Monetary Policy in the U.S. Economy



Left to right: L. Randall Wray; Albert Wojnilower; Bruce C. Kasman; Greg Hannsgen

MODERATOR:

GREG HANNSGEN

Resident Research Associate, The Levy Economics Institute

BRUCE C. KASMAN

JPMorgan Chase

ALBERT WOJNIIOWER

Craig Drill Capital Corporation

L. RANDALL WRAY

Senior Scholar, The Levy Economics Institute, and Professor and Research Director of the Center for Full Employment and Price Stability, 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, cur-

rency 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 WOJNIIOWER 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.

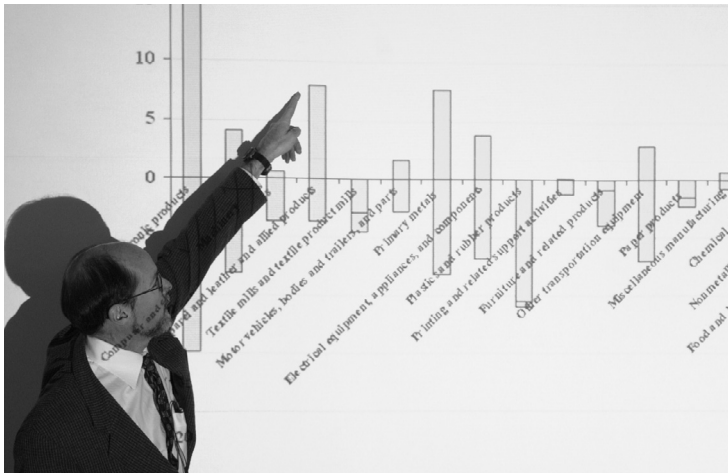
Monetary policy is only effective if credit is widely unavailable at any price. Rather than raise general interest rates and potentially trigger a crisis, it is better to employ selective measures and reasonable safeguards early on in order to rein in the economy. The main question about the next Fed 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



Robert Z. Lawrence

MODERATOR:

W. RAY TOWLE

Resident Research Associate,
The Levy Economics Institute

ROBERT Z. LAWRENCE

Harvard University and Institute for
International Economics

EDWIN (TED) TRUMAN

Institute for International Economics

ROBERT Z. 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 export. 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 force 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



Richard W. Peach; Lakshman Achuthan; James K. Galbraith

MODERATOR:

AJIT ZACHARIAS

Research Scholar, The Levy Economics Institute

LAKSHMAN ACHUTHAN

Economic Cycle Research Institute

JAMES K. GALBRAITH

Senior Scholar, The Levy Economics Institute,
and University of Texas at Austin

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 either 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 *whatsoever* 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), Galbraith 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 to 13 percent of all occupied single-family homes in 2003, a result of an ongoing shift from rental to owner occupancy.

Participants

LAKSHMAN ACHUTHAN is managing director of the Economic Cycle Research Institute (ECRI), an independent organization focused on business cycle research and forecasting in the tradition established by Geoffrey H. Moore. Achuthan plays a key role in helping asset managers, corporate strategists, and policymakers regularly use cyclical forecasts in their decision-making process. He is also the managing editor of ECRI's forecasting publications and regularly participates in a wide range of public economic discussions in the press. He is a member of *Time* magazine's board of economists and the New York City Economic Advisory Panel. He coauthored *Beating the Business Cycle: How to Predict and Profit from Turning Points in the Economy*, published by Doubleday.

PAUL DAVIDSON, of the Bernard Schwartz Center for Economic Policy Analysis at New School University, is Holly Chair of Excellence in Political Economy Emeritus, University of Tennessee. He is the editor of the *Journal of Post Keynesian Economics* and member of the editorial board of *Ekonomia*. He is the author, coauthor, or editor of 19 books and the author of more than 150 articles. His research interests include international monetary payments and global employment policies, monetary theory, income distribution, energy economics, demand and supply for outdoor recreation, and post-Keynesian economics. Davidson earned a Ph.D. from the University of Pennsylvania. He is listed in *Who's Who in Economics*, *Who's Who in the East*, *Who's Who in the South and Southwest*, *American Economists of the Late Twentieth Century*, *Dictionary of International Biography*, *Men of Achievement*, and *Contemporary Authors*.

JAMES K. GALBRAITH holds the Lloyd M. Bentsen Jr. Chair in Government/Business Relations at the Lyndon B. Johnson School of Public Affairs and is a professor in the Department of Government at the University of Texas at Austin and a senior scholar at The Levy Economics Institute. He is also director of the University of Texas Inequality Project and national chairman of Economists for Peace and Security. He is the author of *Created Unequal: The Crisis in American Pay* and *Balancing Acts: Technology, Finance and the American Future*, and the coauthor of two textbooks, *The Economic Problem* (with R. L. Heilbroner) and *Macroeconomics* (with W. Darity Jr.). Galbraith writes a column on economic and political issues for the *Texas Observer*. He received a B.A. from Harvard University and a Ph.D. from Yale University and was a Marshall Scholar at King's College, Cambridge University.

DAVID D. HALE, the renowned global economist, has launched his own firm, Hale Advisors LLC. The company is headquartered in Chicago, where Hale has spent the last 25 years, first as an economist for Kemper Services, and finally as global chief economist for Zurich Financial Services. Hale Advisors offers a variety of consulting services, primarily to financial and professional service firms, including an electronic newsletter focused on global economic trends. Hale is a prolific author, and his in-depth economic analyses and thought-provoking insights have appeared regularly in leading financial and business publications around the world for more than two decades, including the *Financial Times* (UK), *Wall Street Journal*, *Barron's* (USA), *Nihon Keizai Shimbun* (Japan), and *Australian Financial Review*. He is also a frequent television commentator on breaking news events that affect the global economy. Hale, a graduate of Georgetown University and the London School of Economics, is

widely known as an economic historian. He is founding chairman of China Online, Inc. (www.chinaonline.com), and serves as global economic adviser to both private clients and international institutions. He serves on numerous boards and advisory boards internationally, including the Academic Advisory Board of the Federal Reserve Bank of Chicago and the Hong Kong Monetary Authority, as well as a variety of government and private sector economic policy research groups in Washington, Tokyo, and Berlin.

GREG HANNSGEN, resident research associate at The Levy Economics Institute, is editor of the *Report* and many other Levy Institute publications. His research interests are money, macroeconomics, and social economics. His publications include “Minsky’s Acceleration Channel and the Role of Money,” *Journal of Post Keynesian Economics*, Spring 2005. He received his Ph.D. in economics from the University of Notre Dame in 2002.

STEVEN B. KAMIN is an associate director of the International Finance Division of the Federal Reserve Board, where he is responsible for forecasting the U.S. trade and international payments balances. He has also served as a visiting economist at the Bank for International Settlements, a senior economist for international financial affairs at the Council of Economic Advisors, and as a consultant for the World Bank. Kamin received a Ph.D. in economics from MIT in 1987, and has published research on various topics in international and development economics.

BRUCE C. KASMAN is managing director and head of economic research at JPMorgan Chase. He is the editor of *Global Data Watch*. From 1996 to 1999, he was head of economic research, Europe. Prior to his arrival at J. P. Morgan in 1994, he was senior international economist at Morgan Stanley & Co. He started his career at the Federal Reserve Bank of New York, where he was a research officer in the International Research Department. He received a Ph.D. in economics from Columbia University in 1985.

DONALD L. KOHN is a veteran of the Federal Reserve System. Before becoming a member of the Federal Reserve Board, he served on its staff as adviser to the Board for monetary policy (2001–02), secretary of the Federal Open Market Committee (1987–2002), director of the Division of Monetary Affairs (1987–2001), and deputy staff director for monetary and financial policy (1983–87). He also held several positions in the Board’s Division of Research and Statistics: associate director (1981–83), chief of capital markets (1978–81), and economist (1975–78). Kohn began his career as a financial economist at the Federal Reserve Bank of Kansas City (1970–75). He has written extensively on issues related to monetary policy and its implementation by the Federal Reserve. These works were published in volumes issued by various organizations, including the Federal Reserve System, Bank of England, Reserve Bank of Australia, Bank of Japan, Bank of Korea, National Bureau of Economic Research, and Brookings Institution. He received a B.A. in economics in 1964 from the College of Wooster and a Ph.D. in economics in 1971 from the University of Michigan. He was awarded the Distinguished Achievement Award from The Money Marketeters of New York University (2002) and the Distinguished Alumni Award from the College of Wooster (1998).

ROBERT Z. LAWRENCE is Albert L. Williams Professor of International Trade and Investment at Harvard University, a senior fellow at the Institute for International Economics, and a research associate at the National Bureau of Economic Research. He served as a member of the President's Council of Economic Advisers from 1998 to 2000. Lawrence has also been a senior fellow at the Brookings Institution. He has taught at Yale University, where he received his Ph.D. in economics. His research focuses on trade policy. He is the author of *Can America Compete?; Crimes and Punishments? An Analysis of Retaliation under the WTO; Regionalism, Multilateralism and Deeper Integration;* and *Single World, Divided Nations?* He is coauthor of *Has Globalization Gone Far Enough? A Prism on Globalization; Globaphobia: Confronting Fears about Open Trade; A Vision for the World Economy;* and *Saving Free Trade: A Pragmatic Approach.* Lawrence has served on the advisory boards of the Congressional Budget Office, Overseas Development Council, and Presidential Commission on United States–Pacific Trade and Investment Policy.

DIMITRI B. PAPADIMITRIOU's areas of special interest are community development banking; banking and financial structure; the Federal Reserve; monetary, fiscal, and international trade policy; and the distribution of wealth and income in the United States. He heads the Levy Institute's macro-modeling team and is one of the authors of the Institute's regular *Strategic Analysis* report. His interests also include measures of well-being and the effects of macroeconomic policy on the distribution of income. In addition to his duties as president of The Levy Economics Institute, Papadimitriou is executive vice president and Jerome Levy Professor of Economics at Bard College. He served as vice chairman of the congressional U.S. Trade Deficit Review Commission. He is general editor of The Levy Economics Institute book series and a member of the editorial board of *Challenge*. He holds a Ph.D. from the New School University.

JAMES W. PAULSEN, a 20-year veteran of the investment management industry, is the chief investment strategist at Wells Capital Management. In that post, he is responsible for developing strategies that assist in the management of separate institutional accounts and mutual and collective investment funds. He joined Norwest Investment Management, Inc., which later combined with Wells Capital Management, as the chief investment officer in 1997. He had previously served as senior managing director and chief investment strategist at Investors Management Group in Des Moines, and prior to that was president of SCI Capital Management, Inc., in Cedar Rapids. Paulsen is nationally recognized for his views and is frequently quoted in the national media. Since 1983 he has published his assessment of national and global economic trends in his monthly newsletter, *Economic and Market Perspective*. He earned a bachelor's degree and Ph.D. in economics at Iowa State University.

RICHARD W. PEACH is a vice president in the Business Conditions Function Department of the Federal Reserve Bank of New York. He participates in the development of the Bank's forecast for the U.S. economy and oversees the Bank's projections of federal receipts and outlays. His long-term research interests have been primarily in the topics of housing and real estate finance. Prior to joining the Federal Reserve Bank of New York in June 1992, he was staff vice president and deputy chief economist of the Mortgage Bankers Association of America (MBA). He played a key role in the develop-

ment of MBA's Weekly Survey of Mortgage Loan Applications, a closely watched indicator of conditions in housing and mortgage markets. Prior to joining the MBA in 1986, he was staff vice president for forecasting and policy analysis of the National Association of Realtors (NAR).

SANDRA PIANALTO is the president and chief executive officer of the Federal Reserve Bank of Cleveland. Her tenure with the Bank spans more than 20 years. She joined the Bank in 1983 as an economist in the Research Department. She was appointed assistant vice president of public affairs in 1984, vice president and secretary to the board of directors in 1988, and first vice president and chief operating officer in 1993. She assumed her position as president in 2003. Before joining the Bank, Pianalto was an economist at the Federal Reserve Board of Governors and served on the staff of the Budget Committee of the U.S. House of Representatives. She is active in the Fourth District's civic community, serving on the boards of directors of many community organizations, including The Cleveland Foundation, Greater Cleveland Partnership, University Hospitals Health System, United Way Services of Cleveland, Rock and Roll Hall of Fame and Museum, Northeast Ohio Council on Higher Education, and Catholic Diocese of Cleveland Foundation. She earned a bachelor's degree in economics from the University of Akron and a master's degree in economics from The George Washington University. She is a graduate of the Advanced Management Program at Duke University's Fuqua School of Business and holds honorary doctor of humane letters degrees from the University of Akron, Baldwin-Wallace College, and Ursuline College.

Resident Research Associate **W. RAY TOWLE** is the editor of the *Summary* and other Levy Institute publications. He is interested in research on macroeconomic forecasting, international financial systems, regional economic development, balanced budgets, and deregulation. Towle was a consultant, writer, and editor in Canada and New York, and has an extensive background as an energy economist. He completed B.S. and M.A. degrees at the University of Alberta, an executive master of science in finance degree from the Zicklin School of Business at Baruch College, City University of New York, and a Ph.D. from the University of London, England.

EDWIN (TED) TRUMAN is a senior fellow at the Institute for International Economics in Washington, D.C. He served as assistant secretary for international affairs at the U.S. Treasury from December 1998 to January 2001. Before joining the U.S. Treasury, he was director and later staff director of the Division of International Finance of the Board of Governors of the Federal Reserve System, beginning in June 1977. He was on the staff of the Federal Open Market Committee from March 1977 until he resigned from the Federal Reserve. He joined the staff of the Federal Reserve in July 1972. Truman has been a member of numerous international groups working on economic and financial issues, including the Financial Stability Forum's Working Group on Highly Leveraged Institutions (1999–2000), G-22 Working Party on Transparency and Accountability (1998), G-10-sponsored Working Party on Financial Stability in Emerging Market Economies (1996–1997), G-10 Working Group on the Resolution of Sovereign Liquidity Crises (1995–1996), and G-7 Working Group on Exchange Market Intervention (1982–1983). He has published on international monetary economics, international debt problems, economic development, and European economic integration.

Truman is a former associate professor of economics at Yale University, where he received his M.A. in 1964 and his Ph.D. in 1967. He received his B.A. from Amherst College in 1963 and an honorary L.L.D. from Amherst in 1988.

FRANK A. J. VENEROSO is market strategist for the Global Policy Committee of Allianz Dresdner Asset Management and is responsible for alternative asset product development at Dresdner RCM. Formerly, he was a partner of Omega Advisors, a hedge fund, where he was responsible for investment policy formulation. Prior to this, acting through his own firm, he was an investment strategy adviser and economic policy consultant in the areas of money and banking, financial instability and crisis, privatization, and the development and globalization of emerging security markets. His clients have included the World Bank, the International Finance Corporation, and the Organization of American States, and he has been an adviser to the governments of Bahrain, Brazil, Chile, Ecuador, Korea, Mexico, Portugal, Thailand, Venezuela, and the United Arab Emirates. Veneroso is the author of many papers on subjects in international finance such as the Asian financial crisis, an Asian monetary fund, and the theory of financial instability and its policy implications for Asia. He graduated from Harvard University.

ALBERT WOJNIOWER is currently an economic consultant to a variety of domestic and foreign money management firms, including senior economic adviser to Craig Drill Capital Corp. For over 25 years, he was chief economist of Credit Suisse First Boston, a leading New York investment bank. Previously, he was chief of the Financial Statistics and then the Domestic Research Divisions of the Federal Reserve Bank of New York. He is recognized in the financial community for many interest rate forecasts that departed widely from the consensus but turned out to be correct. Holding a Ph.D. from Columbia University, he is also well known in the academic and government communities for his analyses of the macroeconomic consequences of financial regulation and deregulation. His essays and articles have been published by, among others, the Brookings Institution, National Bureau of Economic Research, *American Economic Review*, International Economic Association, several Federal Reserve Banks, and Encyclopedia Britannica. He has been adjunct professor of finance at New York University and a director of the American Finance Association.

Levy Institute Senior Scholar **L. RANDALL WRAY** is working on projects in the areas of monetary policy, employment, and social security. His most recent publications focus on application of the “new monetary consensus” by the Fed in its formulation of monetary policy. He has also written on the current debate surrounding President Bush’s plan to “reform” Social Security. He continues to examine the population that did not benefit from the economic expansion of the 1990s, especially low-skilled, prime-age males who are not officially counted as employed because they are not part of the labor force. He has also focused on the failings of the War on Poverty, updating the analysis of H. P. Minsky made during the 1960s. Wray is developing policies to promote true full employment, focusing on Minsky’s “employer of last resort” proposal as a way to bring low-skilled, prime-age males into the labor force. With Dimitri B. Papadimitriou, Wray has also written on deflation and on growing U.S. indebtedness at all levels: household, government, and foreign sectors. Wray has published widely in journals and is the author of *Understanding Modern Money: The Key to Full Employment and*

Price Stability and is the editor of *Credit and State Theories of Money*. He is a professor of economics and research director of the Center for Full Employment and Price Stability at the University of Missouri–Kansas City. He received a B.A. degree from the University of the Pacific and M.A. and Ph.D. degrees from Washington University in St. Louis.

Research Scholar **AJIT ZACHARIAS** is primarily working on the Levy Institute Measure of Economic Well-Being (LIMEW) within the distribution of income and wealth program. The LIMEW is an alternative measure that can provide the foundation for a comprehensive view of the level and distribution of economic well-being. His research interests include concepts and measurement of economic well-being, effects of taxes and government spending on well-being, valuation of noncash transfers, and time use. Zacharias received an M.A. from the University of Bombay and a Ph.D. from New School University.

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THE LEVY ECONOMICS INSTITUTE OF BARD COLLEGE

Blithewood

Annandale-on-Hudson, NY 12504-5000

Telephone: 845-758-7700 or 202-887-8464 (in Washington, D.C.)

Fax: 845-758-1149

E-mail: info@levy.org

Website: www.levy.org