



Conference Proceedings

13th
ANNUAL
HYMAN P. MINSKY CONFERENCE
ON THE STATE OF THE U.S.
AND WORLD ECONOMIES

Economic Policy for Sustainable Growth

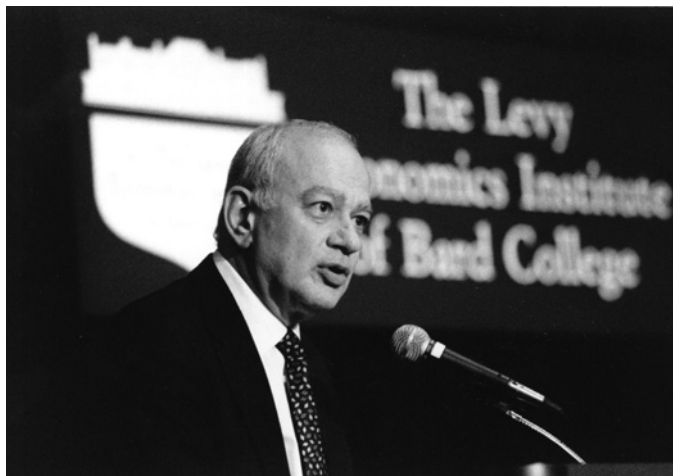
*April 15, 2003 Hilton New York, New York City
A conference of The Levy Economics Institute of Bard College*

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*The proceedings consist of edited transcripts of the speakers' remarks
and summaries of session participants' presentations.*

Foreword



Dimitri B. Papadimitriou speaks at the 13th Annual Minsky Conference

The objective of the 13th Annual Hyman P. Minsky Conference is to exchange views on the current state of the U.S. and world economies and their future direction. Uncertainty about the resilience of the U.S. economy and the strength of its recovery carries implications for the global economy. What are the monetary and fiscal policy prescriptions for renewed growth, employment, and price stability, and what implications do the answers to this question have for public policy?

Participants at this year's conference discuss their viewpoints, policy guidelines to be considered within the context of current economic trends, and implications for the national and global economies. The U.S. economy appears to be recovering, following a short-lived recession. The "resilience" of our economy and the strength of the recovery, primarily due to higher-than-expected federal outlays and low interest rates, is still uncertain, however. Other data—the U.S. trade balance and private expenditure, for example—indicate that the recovery could be less than robust, with growth rates that, while positive, remain anemic for some time.

The presenters note that the recent U.S. and world economic recession and recovery are atypical, that economic imbalances and deflationary pressures persist, and that a high degree of economic uncertainty exists in light of geopolitical events, the financial markets, and consumer confidence levels. They express differing opinions about the underlying strength of the U.S. economy, particularly in the short term; the role of the U.S. economy in stimulating world economic growth; and the threat of a double-dip recession.

This conference is dedicated to the memory of our founder, benefactor, and chairman, Leon Levy. His keen insights, guidance, and wise counsel have contributed immeasurably to the Institute and its work. He was a longtime friend and a valued colleague.

I hope you find these proceedings enlightening, and I welcome your comments.

Dimitri B. Papadimitriou

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

Program

8:30–9:15 a.m.

REGISTRATION

9:15–10:00 a.m.

INTRODUCTION

Dimitri B. Papadimitriou, *President, Levy Institute*

10:00–11:45 a.m.

SESSION 1

The State of the U.S. and World Economies: A Wall Street Perspective

Moderator: Constance Mitchell-Ford, *Economics Editor, Wall Street Journal*

Lakshman Achuthan, *Managing Director, Economic Cycle Research Institute*

William C. Dudley, *Managing Director and Director of U.S. Economic Research, Goldman Sachs & Co.*

John Lipsky, *Chief Economist and Global Head of Economic Policy Research, JP Morgan Investment Bank*

James W. Paulsen, *Chief Investment Strategist, Wells Capital Management*

11:45 a.m. – 12:30 p.m.

SPEAKER

Marc Faber, *Marc Faber Limited*

“A World Out of Balance”

12:30–2:30 P.M.

LUNCHEON

KEYNOTE SPEAKER

Ernst Welteke, *President, Deutsche Bundesbank*

“A European Perspective on the World Economy”

2:30–4:15 p.m.

SESSION 2

The Macroeconomic Prospects for the U.S. Economy

Moderator: Michael Mandel, *Chief Economist, Business Week*

J. Alfred Broadus Jr., *President, Federal Reserve Bank of Richmond*

Randall S. Kroszner, *Member, President’s Council of Economic Advisers*

Martin Mayer, *Guest Scholar, Brookings Institution*

William Poole, *President and CEO, Federal Reserve Bank of St. Louis*

4:15 p.m.

CLOSING REMARKS

Dimitri B. Papadimitriou, *President, Levy Institute*

Speakers

MARC FABER

Marc Faber Limited

A World Out of Balance



I would like to take a broad-brush approach and look at some of the imbalances in the world economy that have developed and that may cause problems in the future.

At a seminar recently someone asked me, "What was your greatest investment mistake in life?" I answered that my biggest mistake was that I worked too much. When I started to work on Wall Street in 1970, I could have identified oil

(selling at \$1.30 a barrel) and gold (selling at \$35 per ounce), bought these two commodities, and gone on holiday for 10 years. In January 1980, realizing that there was a mania in the commodities market, I could have sold those commodities with more than a 20-fold gain. With the proceeds, I could have looked at financial assets, commodities, and real estate, bought Japanese stocks, and then taken another 10-year holiday before coming back in December 1989 and selling them for a seven-fold gain. Realizing at the time that all the money in the world had flowed into Asia and that U.S. equities may have been undervalued, I could have shifted all my proceeds into the S&P 500 or, ideally, into NASDAQ and then taken another 10-year holiday, before coming back in March 2000 and selling those holdings. Now, holding cash, today's question is, "Where will we invest for the next 10 years, rather than the next 6 months?"

I'd like to make a few observations about the major investment scene. First, if you have an asset class, such as real estate, stocks, or bonds that substantially increases in value over an extended period of time, then, obviously, more money will flow into that asset class and more borrowing will take place to acquire that asset class. An asset's long-term uptrend will lead to an investment mania, and every investment mania and bubble eventually bursts. Once the bursting has occurred, [asset] leadership usually changes. The gold and commodities mania of the 1970s was not followed by a renewed mania in hard assets or commodities, but by a shift to financial assets (the bubble in Japan was not followed by a renewal of the Japanese bubble in the 1990s—it shifted somewhere else).

This progression is important to understand when we look at technology stocks today. The bubble sector of the last few years (1997 to 2000) is unlikely to be the leading sector again in the years to come. The leading sector will shift to somewhere else. Also important to remember is that if you have a bubble in one sector of the economy, such as real estate, money will flow into that sector but, by definition, something else will be undervalued. The mania is interesting not for the object of the mania (e.g., the technology sector, gold, or Japanese stocks) but for the undervaluation it creates in other sectors of the economy, which are not usually the focus of investors.

A second important point relates to commodity price cycles versus business cycles. It is very clear that the world has, from time to time, periods of rising and falling commodity prices. This is important to understand because during periods of rising commodity prices, interest rates tend to rise, and during periods of falling commodity prices, interest rates tend to fall. To summarize the period between 1950 and today in western industrialized countries, we had accelerating inflation between 1950 and 1980, along with rising interest rates, mild recessions, and very strong real-wage growth. This period was called the golden age of capitalism. After 1980, we had declining inflation rates (in some cases, deflation), commodity prices, and interest rates. In other words, the trend of declining commodity prices and interest rates lasted from September 30, 1981, until now—close to 22 years. The question is, “How much longer will this trend last?”

There have always been periods of commodity-price cycles. What’s interesting is that all the major waves of innovation have occurred during the periods of weak price structures and falling interest rates that led to an investment mania—the canal boom of 1835–36, the railroad boom of 1868–73, the application of new technologies in the boom of the 1920s, and the innovation and invention-driven boom of the 1990s. Obviously, it’s important now to distinguish whether we are close to the end of a deflationary cycle (with a pick-up in the rate of inflation) or whether tremendous deflationary pressures still exist.

The period 1873 to 1900 saw dramatically declining commodity prices because America’s railroads and canals allowed the western territories to produce agricultural products that could reach world markets and in that way put tremendous pressure on commodity prices throughout the world. American agriculture was much more cost-effective and essentially put European agriculture out of business. Since then, European agriculture has always had subsidies. In the period from 1870 to 1900, we had very strong deflation in the world, yet real wages in the United States rose vigorously. In other words, the United States had a deflationary boom. I mention this period because today, the opening of China, with its ability to produce just about anything at a much lower cost than that of the United States, and the entry of India into the global economy (in terms of providing tradable services) put tremendous pricing pressure on the western industrialized nations. And we still have a very strong deflationary bias in some sectors of the economy.

The whole 19th century was deflationary. For example, copper prices fell by more than 50 percent despite industrialization and the growth of the United States from 4 million people in 1800 to 80 million in 1900. So if someone comes to me and says that deflation is bad, I say that deflation is wonderful, for real wage growth. That’s why China is doing so well—they’re having a deflationary boom. A deflation problem is related only to the preceding inflation and debt accumulation. If deflation occurred today on a massive scale in the United States, and the deflationary period started with a debt level as high as it is now (as a percentage of the economy), then we would have a problem. The problem is not the deflation but the preceding inflation, especially if the inflation relates to asset prices (not consumer prices), which lead to over-borrowings (as observed by a number of economists). In the 1950s, the debt-to-GDP level was very low, so corporations should have gone out and borrowed money in the corporate bond market at 2 to 3 percent. In the last couple of years, when the rates were still relatively high by historical standards, this was not an option.

The inflation/deflation debate is important, and not just for buyers of bonds. Bond yields are still relatively high, and if interest rates start to rise, rather than continue to decline, then the refinancing

boom will come to an end. There is a very close correlation between the movement of interest rates and the level of refinancing in this economy. The economy is caught between two trends: either you have further deflationary pressures and a weak economy, which will hold up the refinancing boom that has led to more consumption in the United States (when does consumption and retail sales growth mean economic growth?), or you have a strengthening economy, which likely will bring rising interest rates and the end of the refinancing boom that allowed people to consume despite relatively poor employment and nominal income gains.

Credit growth is lopsided in the United States. The so-called qualitative distribution of the money stream is at the consumer level, with very little at the corporate level. Eighty percent of credit growth in the last two quarters was mortgage debt and consumer credit, not borrowing by the corporate sector. From an economic point of view, I think the monetary policies in this country are suicidal. They stimulate borrowing and spending, but not industrial production. Normally, a boom in the housing industry leads to a boom in appliance sales and [industrial] production, but today we have a boom in appliance sales but not in industrial production, which is taking place in other countries, particularly China. So policies are [designed] to print money and expand credit at an alarming rate, which leads to additional spending here and to capital spending and growth in industrial production in China, Vietnam, India, and any country other than the United States. I think this [response] is creating further imbalances in the global economy.

Whereas Britain and the United States took 40 to 50 years to double real per capita incomes in the 19th century, China has doubled its real per capita income every 10 years for approximately the past 25 years. I think this [pattern] will continue, along with an acceleration in the speed of change. Shipping goods and factories between London and China took a long time 150 years ago, but today we can send an entire factory overnight to China by Boeing 747. We have instant communication and information flows. People can become educated and specialized in a field much faster than before.

As a result of outsourcing, an enormous amount of high technology and knowledge was transferred, almost overnight, to emerging economies. China has become a major competitor on world markets in just the last 10 years, squeezing out other countries. The U.S. and euroland share of imports from China is growing very rapidly, at the expense of imports from Japan, South Korea, and Taiwan. Squeezing out other Asian countries is not particularly favorable for the macroeconomic situation in Japan, Taiwan, and South Korea. Is it negative for the stock market? Not necessarily. If a company in Taiwan closes down its production in Taiwan, the macroeconomic effect is negative, but if the company reduces costs by producing in China, it may be favorable for profit margins and profits. Therefore, a number of companies in Asia will do quite well by shifting [production] into China. You could essentially argue that, at some point, it will be beneficial for the Japanese stock market, as Japanese companies shift more of their production outside Japan into China and other emerging economies. The problem is that the rise of competitiveness of the Chinese economy occurs, obviously, at the expense of western industrialized countries. I'm sorry to say that I have a very negative outlook on future economic growth in this country and Europe, compared to emerging economies.

The overall U.S. market share in the export markets has declined, so the statistics do not support the contention of great productivity improvements in this country over the last 10 years. It appears to me that U.S. competitiveness has diminished very dramatically. The trade imbalance with China has continued to expand in the last few years; first in terms of the production of footwear, textiles, garments,

and toys, and now in the production of electronic and high-tech products, which will drive out foreign manufacturers the same way textiles and garments did. I think the monetary policies in this country actually accelerate the process of increased production flows to the lowest-cost producer [in a global environment]. This is a logical conclusion, particularly in reference to my earlier statements about price pressures, and it means a huge transfer of wealth, as a result of trade and current account deficits, into the Asian economies.

Foreign exchange reserves of Asian central banks, such as the Bank of Japan, Bank of China, Central Bank of Taiwan, and the Hong Kong monetary funds, have risen to approximately a trillion U.S. dollars, which is mostly invested in U.S. dollars, but [investment] may shift at some point. The issue is that the central banks are not the only ones to increase holdings of U.S. assets; foreigners own 30 or 40 percent of the Treasury bond market (depending on which measure you use), 12 percent of the equities market, and roughly 23 percent of the corporate bond market. What has happened? The United States had a positive net investment position until 1987: Americans owned more assets overseas than foreigners owned assets in the United States. After 1987, this position deteriorated very badly, and the result is that today foreigners own \$2 trillion more assets in the United States than Americans own overseas. We call this a negative net investment position. If today's position is now 20 percent of GDP (with a current account deficit of \$546 billion), it will possibly grow to around 50 percent of GDP in five years and to 100 percent of GDP in 10 years. The problem is that more and more of the economic strengths of the United States are hostage to foreign capital flows, and not only via the dollar mechanism. As foreigners own more of the bond and share markets, the value of these assets, and real estate, will also be vulnerable to the whims of foreign investors. I think of this as the Achilles heel of the U.S. economy.

It's been suggested that the imbalance will be corrected through a currency realignment (the value of the dollar goes down against foreign currencies). The question is, "Against what?" The U.S. dollar is not a particularly desirable currency, nor is the euro or the yen. So we have three essentially undesirable major paper currencies, one hard currency (gold), commodities that may be desirable, and paper money, such as the Chinese renminbi, which is now probably the most desirable paper currency to own for the long run. It may move like the yen between 1950 and 1971 (pegged to the U.S. dollar) and then shoot up at some stage. If I had to make a bet which currency might appreciate significantly against the dollar in the very long run, I would probably bet on the Chinese renminbi. So, under these conditions (and I'd like to stress that I am optimistic about economic growth in China and emerging economies, and not very optimistic about our ability to make China modern), how should you invest in Asia?

It is important to understand the huge shift in the economic geography of the world. After America and the trading routes around the Cape of Good Hope were discovered in 1497, the center of economic activity in western societies changed from the Italian trading cities to Lisbon, Antwerp, and Amsterdam, and later to London. The Italian trading cities, which had been at the forefront of capitalist development, are today unimportant economically. Similarly, the first growth centers in the United States were on the East Coast, followed by the Great Lakes districts and the West Coast. Of the 10 largest U.S. cities in 1850, 7 are no longer on the list, while Los Angeles was not on the list until 1930 and is now the second-largest city. New Orleans, then the richest city, is now a dump. Economic geography changes from time to time for a variety of reasons.

Before the communist takeover in 1949, industrialization of China had occurred around Shanghai and Manchuria (under the Japanese). Although Shanghai was never a British colony, the British had more than 80 percent of their investments there and only 10 percent in Hong Kong. Outside of Osaka and Tokyo, Shanghai was the commercial, industrial, and financial center of Asia. Then the Chinese closed down Shanghai and all of China and as a result of their closed-door policy, growth shifted into Hong Kong and allowed the rise (with American help) of Taiwan, South Korea, and to some extent, Japan. Now, suddenly, we have the opening of China and Vietnam, and eventually of Myanmar, so the whole situation will change very dramatically, with implications in the way of an arbitrage effect for the property markets of high-cost countries, such as Japan, and low-cost countries, such as China and Vietnam.

Unless something like SARS becomes similar to the black death that wiped out 30 percent of the European population between 1346 and 1400, huge cities will develop in Asia and prices in the real estate markets of most Asian cities will rise dramatically. So, housing and commercial buildings would be sectors for investment, and I suggest that you consider acquiring properties in China (e.g., Shanghai, Beijing, and other cities). China will also eventually have an Aspen and a Palm Beach, and other resort areas as the leisure industry grows. Another sector that will benefit is tourism, which is under a lot of pressure today because of SARS (in the last two years, global tourism was essentially flat). In China outbound travelers increased by 25 percent to 12.5 million people, which is just less than 1 percent of the population. In England, understandably, more than 100 percent of the population leaves the country every year, while the proportion is 13 percent in Japan and between 13 and 15 percent in Taiwan and South Korea. I think China can go up to 5 or 10 percent over the next 10 years, which means that 50 to 100 million travelers will leave China every year. That would obviously be very good for tourist-related investments, especially in Southeast Asia.

Another sector in which China will become a huge customer of other Asian countries and the world relates to resources. China, which is relatively poor in resources, will sell products to the United States and buy products from resource-rich countries: iron ore from Australia; oil, plywood, and lumber from Indonesia; or oil from the Middle East and other Asian producers. China became dependent on oil imports in 1993. Asia has a population of more than 3 billion people and oil consumption is 19 million barrels per day. The United States has a population of 285 million people and oil consumption of 22 million barrels per day, a per capita consumption of more than 10 times that of Asia. Asia's consumption will not rise to the American level, but per capita consumption of oil in Japan rose from a barrel to around 17 barrels between 1950 and 1970 and the same rate of increase occurred during the industrialization of South Korea between 1965 and 1992. I don't think this will happen in China, but daily oil consumption could increase from 19 million barrels to 35 or 45 million barrels in the next 10 years, which would put pressure on oil prices. For those who are negative about oil prices, I have bad news: if oil prices declined for an extended period to around \$10 or \$15 a barrel, then the per capita income of Saudi Arabia would fall significantly, which would guarantee a revolution in that country. The revolution is going to happen anyway: Saudi Arabia is a country like France under Louis XVI, a week before the revolution. A meaningful oil price is over \$25 U.S. a barrel; otherwise, disaster will strike, regardless of American involvement in the Middle East.

I have talked about the decline in commodity prices since 1980 and the bull market in financial assets. In the last couple of years we had the weakest global economic growth rate over the previous 30

years, but we had the beginning of a significant rise in commodity prices last year, and not just in oil. This is interesting because, given the (economic) weakness, commodity prices should not have risen as much as they did. Even the price of industrial commodities rose significantly. Demand must have come from somewhere. I think it kicked in from China, a market for such things as televisions, motorcycles, refrigerators, and cellular phones that is significantly larger than the United States. The Chinese and Indian markets, and the whole Asian market (in physical terms), are much larger than the Western world. In money terms, however, these markets are still smaller because the price level is much lower. With the rise in physical markets of countries like China, the demand for raw materials will increase dramatically. With rising standards of living, the demand for food products will also go up dramatically. In Hong Kong and Taiwan, the per capita consumption in many sectors of the food industry is more than 10 times higher than in China. As the Chinese become richer, however, they will eat more fish, fruits, and vegetables, and drink more milk, whisky, and beer, and the demand for food products will rise very dramatically. Grain prices have started to go up. The per capita consumption of coffee in Switzerland is 50 times greater than that of China, but the Chinese population is 200 times larger than that of Switzerland. Therefore, the overall coffee market in China is much larger than that of Switzerland. The Chinese will not reach Switzerland's per capita consumption of coffee, but they can reach South Korea's or Taiwan's, which are significantly higher than that of China. The impact on the commodities markets in the long run will be very substantial.

The reason I'm hammering the commodity markets so much is that during periods of rising commodity prices, financial assets do not do particularly well. Bonds and stocks tend to under perform, and bonds go down significantly. Rising commodity prices will greatly benefit emerging economies because the stock market cycle of these economies is closely correlated with OECD growth (and more so through commodity-price cycles). Rising commodity prices will benefit countries like Argentina, Brazil, Russia, Malaysia, and Indonesia; to some extent, the entire continent of Africa; Vietnam; and countries such as New Zealand, Australia, and Canada, which supply China with food. Currencies in these economies will strengthen, while commodity prices that rise as much as I think they will, should be negative for bond prices.

I think I can make a very strong case that the economists previously heard were far too optimistic and that the real recession hasn't even begun yet and will arrive with virulence in the years to come. A [counter] argument is that, in a weak economic environment, commodity prices will do badly. In theory that is correct, but given the monetary policies pursued in the United States under [Alan] Greenspan and, most likely, under [Ben S.] Bernanke in the future, we can be sure that we will have a weak economy and high inflation rates, as in Latin America in the 1980s. Don't think that strong economies have high inflation rates and weak economies have low inflation rates—the opposite is true. If commodity prices rise, you should be out of bonds, particularly in Japan. The big trade (and many people have tried this trade for the last five years) has been to short bonds, and to go long on stocks. It's been wrong in Japan, but I think the time is approaching when the trade should work out (probably some time this year). Japanese stocks as a percentage of market capitalization and of the economy are at an extremely low level (about 40 percent) right now. In the environment that I have just described, I would also be very careful about financial stocks, especially in the United States. They have already been hammered in Asia during the last couple of years, but their situation is slightly different. If I look at the world, 1990–2000 was the great bull market for U.S. and western European

financial assets, and a tremendous bear market for emerging economies. Financial assets of emerging economies tumbled after 1997, having peaked between 1990 and 1994. This [scenario] may also happen in this country. After a decline, there is a trading range for several years and then a major collapse brought about either by the currency or deteriorating economic conditions, which leads to deflation in financial assets.

In Asia the financial condition of the corporate sector has improved. You can buy large numbers of shares. In Japan the stock market has a higher dividend yield than the bond market. Most markets in Asia will have a higher dividend yield than bonds or deposit rates. So there is actually a compelling case for [overweighting] Asia, vis-à-vis the United States. To answer the question of where to invest for the next 10 years, as suggested earlier, I would bet that commodity prices and commodity-related countries will do relatively well, and that the Asian economies will outperform the economies of the Western world by a very wide margin.

The exposure of foreigners in Asia is relatively low, as John Lipsky mentioned in his presentation. I also think that we'll see a huge change in the economic geography of Europe. In my opinion the inclusion of so many new countries into the European Union will be very favorable, resulting in bull markets and the arbitrage effect. Last year the eastern European stock markets went up by 50 to 100 percent. The real estate market will rise in eastern Europe and stagnate in western Europe.

In conclusion I would say that if the economists that spoke before me were right—especially the optimists—then commodity prices would go up in the world anyway, and the Asian economies will do rather well. I lean more toward renewed or severe weakness in the United States this year or next, and I believe that this country is ill equipped to finance imperial ambitions overseas, starting with the negative net investment position, and that may significantly cost this country in the long run. To what extent foreigners will continue to finance the American current account deficit is difficult to tell. At some stage the money flows will probably reverse, but eventually money will again flow out of this country, leading to weaker economic conditions and, obviously, a weaker dollar. I think that Asia, including Japan, is probably going to be more attractive to investors in the future and that a basket of commodities will appreciate against the dollar. The dollar is unlikely to tumble against the euro and the yen, but it may tumble against hard assets and the basket of commodities.

ERNST WELTEKE

President, Deutsche Bundesbank

A European Perspective on the World Economy



At times like these, when transatlantic ties are under strain, I regard it as both an exceptional honor and a welcome opportunity to be able to present my European view of the world economy here at the 13th Annual Hyman P. Minsky Conference on the State of the U.S. and World Economies. Our transatlantic dialogue must not be interrupted, even when our views differ in important respects.

I am a member of the German-American friendship organization

“Atlantik-Brücke.” In February, our organization ran an ad in the *New York Times* entitled “A Message from Germany.” Its essence reads: “For the overwhelming majority of Germans, the relationship with the United States remains of vital importance. Current differences of opinion between governments over the question of Iraq must not be allowed to sever that bond.” I would like to confirm that view today here in midtown Manhattan.

In the following, I will first comment on the present state of the world economy, which is characterized by unusually high uncertainty. Afterwards, I would like to give you some facts about the German economy. Finally, I will try to spell out the European view of how the fundamentals must be set for sustainable growth to take place.

I.

The world economy has not exactly been in very good shape these past few months. The ongoing war in Iraq is weighing on it. Financial markets are fickle; confidence among businesses and consumers remains subdued.

We must, however, not be fooled into regarding the war in Iraq as the sole source of uncertainty or the predominant issue for the world economy. Uncertainty was around before that war was on the horizon, and uncertainty will stay on for a while even after a—hopefully, fast—end to the war.

What is more, uncertainty stemming from geopolitical strife seems to be deflecting our focus from some fundamental imbalances. Redressing these imbalances is a precondition for a return to sustainable growth. Overinvestment incurred during the millennium boom is being unwound only slowly. Vast spare capacity forms the backdrop for weak capital spending. The economy is bound to recover, but recovery is not necessarily just around the corner.

The IMF expects the U.S. economy to grow at a rate of 2.2 percent in 2003. According to this estimate, the euro area can expect GDP growth of 1.1 percent, while Germany should brace for a third year in a row with significantly subpar growth of 0.5 percent.

In 2002, North America and non-Japan Asia were the main contributors to world output growth, with the euro area and Japan lagging behind significantly. Two implications are worth consideration:

1. The world economy is depending far too heavily on the United States' taking the driver's seat. The euro area and Japan must work on improving their ability to produce self-sustained economic growth.
2. The world economy is even more fragile than this tilted growth performance suggests at first sight, for the growth path of the U.S. economy itself is somewhat unbalanced. Its macroeconomic imbalances deserve careful addressing.

The expectation that the world economy will return to a healthy and stable growth path once the dust of war in the Middle East has settled is unrealistic to begin with. Obviously, the workload to return the world economy to healthy growth will be high on both sides of the Atlantic.

In the euro area, structural weaknesses have been building up for more than a decade. They are well known, as is the adequate therapy. Labor-market inflexibility is the core European weakness. In a currency union, market flexibility is all the more crucial, as exchange rates can no longer cushion asymmetric shocks. The euro-area countries now need to seize the opportunity to embark on serious reforms during times of crisis, when the reform zeal is more pronounced than at more quiet times.

The key message that the present situation of the world economy conveys for Europe is that Europe would be well advised to improve its ability to grow on its own. A tripolar economic and financial world cannot afford to rely on one pole only. Europe, especially now that European Union enlargement is just a year away, has a responsibility to assume in at least three areas: political, financial, and economic. We are prepared.

We have strengths we can build on. The framework for economic and monetary union is sound and strong. You probably know that a European Convention is working on drafting a European constitution. For more than four years we have had a single currency, the euro. First, outsiders said EMU would never happen. It happened. Next, they said it would not work. It works. Now, they say it will not last. Well, guess what? I think it will last.

The euro-area economy can rely on a strong industrial core. European products are highly competitive, even after accounting for the massive appreciation of the euro against the dollar, by as much as around one-third, since it hit its trough in the fall of 2000. The export performance of the euro-area economy speaks for itself.

Weaknesses of the U.S. economy are of a more recent origin. They stem mainly from the late '90s bubble economy. The balance sheets of businesses and consumers are debt laden, while the public sector also has returned to dissaving. In the environment of weak capital spending, the current account deficit of 5 percent of GDP is no longer investment driven. Therefore, it is more of a concern for me now than it was during the last couple of years. More recently, the equity markets' boom-bust scenario has left pension liabilities underfunded on a grand scale. To catch up on old-age provision is a key task for our aging societies; saving needs to be expanded.

II.

Let me now comment on the situation in Germany. Germany-bashing has become a bit of a fashion recently. Some even suspect that we will become another Japan. I take that sort of criticism seriously, and I do see the parallels that lead to such comparisons. However, I am not the least convinced it is accurate; there are some decisive differences.

My country is strong, and so is its economy. Let me explain. Our modern infrastructure excels. Our economy is highly productive. Our industry therefore is highly competitive, as can be seen from the rising volume of exports we ship—a fact worth mentioning since, first, world trade growth is down sharply, and, second, the euro is appreciating.

Yet I would be the last person to deny the structural weaknesses that the sluggish world economy is bringing to light. At the Bundesbank, we tend to regard the current confidence crisis not only as highly serious, but also as a window of opportunity for reform. In March, the Bundesbank's Executive Board took the unprecedented step of publishing a staff paper entitled "Ways out of the Crisis." The paper, which is posted on our website, contains analyses of the key areas of reform: public finances, social security systems, and labor-market issues. It spells out which reforms need to be enacted.

We stress the need for a consistent overall reform package. The key is to strengthen the willingness among individuals to take risks, to perform, and to develop initiative. Only then will the fundamentally strong German economy regain momentum.

We must not forget that German reunification in 1990 was a once-in-a-lifetime opportunity. Reunification is a boon for us. But Germany is still suffering from economic policy mistakes made during the unification process. For example, a considerable portion of the recent weak German growth performance is due to the boom-bust scenario that was triggered in the construction sector. Early in the reunification process, building activity was boosted by overly generous tax incentives; now this sector needs to shrink back to normalcy. For seven years in a row, this trend has shaved our growth rate.

Insolvencies have been on the rise, not only in the construction sector. The economy at large is also affected, as overall demand is weak in the low-confidence environment. As companies go bust and loans turn sour, is the German banking sector now in crisis?

German banks are well capitalized, and German banking supervision is highly efficient. There has been only one single bank collapse in the postwar era (Herstatt). Many other industrialized countries have since seen outright banking crises. In Japan, as you may recall, financial supervision in the early stages of the banking crisis tolerated the banks' procrastination, eroding capital bases, and misclassification of bad loans, therefore laying the foundation for deep trouble.

The second important difference between the German and the Japanese banking sector is the real estate bubble that still plagues Japanese banks but never existed in Germany. A major portion of Japanese collateral diminished to virtual nonexistence and thus accounts for the bulk of bad loans in Japan.

During the strong financial market stretch in the late 1990s, German banks were able to generate returns to match the high costs of maintaining their extensive branch networks. Now that financial market activity is less profitable and loan provisioning is on the rise, German banks have embarked on deep cost-cutting measures. The cost-income ratio has been falling for months.

The German banking sector is in dire straits, it is true, but there is no lurking systemic risk, by any means. The case for Germany turning into another Japan is utterly unconvincing. There is, however, one thing Germany—and not only Germany—can learn from the Japanese example: postponing structural reforms is downright unhelpful.

III.

What are the foundations for sustainable growth? From my European perspective, I would like to mention the following three foundations for sustainable growth:

1. a macroeconomic policy geared toward stability;
2. a structural policy geared toward growth;
3. a sound financial sector.

Let me start with my core business as a central banker: price stability. Price stability is the best way a central bank can contribute to steady growth. Any market economy relies on prices to signal relative scarcity or abundance to market participants. That way, resources are channeled to their most productive uses. A well-functioning price mechanism therefore is a precondition for efficiency and thus for a high standard of living.

Frequent and large movements in the price level tend to disguise movements in relative prices; they tend to block information. It becomes more difficult for market participants to tell the difference between overall price rises and changes in relative prices. Stability in the general price level is a necessity for a market economy to function properly and for investors to make the right decisions. To sum up, price level stability is invaluable for growth. A crisp and clear stability orientation of monetary policy therefore is the number-one foundation for sustainable growth.

Price stability is a good only central banks can deliver. The Maastricht Treaty, which established European monetary union, reflects this insight in setting up a framework for the European System of Central Banks (ESCB) that prioritizes price stability as the single most important goal of monetary policy. The euro system will support the overall economic policies of the European Union only to the extent that this does not threaten price stability. All EU central banks must be free of—and are free of—political interference.

The Governing Council of the ESCB has defined price stability as an annual increase in the general price level of 2 percent or less in the medium term. During the run up to EMU, countries notorious for their inflationary bias have experienced marked disinflation. No longer do people in those countries tolerate price rises. When some retailers tried to raise prices of some products after euro notes and coins came into circulation (in January 2002), people were in a rage. This is a good indication of how deeply the newly won stability consensus in Europe already runs. Never before has there been so much price stability in Europe as during the last decade.

However, price stability is not unique to Europe. Disinflation occurred on a global scale, as price stability has been recognized as the superior concept of monetary policy. No major economy or economic bloc is willing to go back to inflationary habits. In this respect, the prospects for the world economy are highly favorable.

The European stability consensus aims at underpinning price stability with an equally stability-oriented fiscal policy. EU governments therefore agreed on the Stability and Growth Pact. The idea of the pact is not only to promote stability by preventing the emergence of conflicts between monetary policy and fiscal policies. Sound public finances as envisioned by the pact contribute to sustainable growth, for they foster confidence.

The pact provides a credible framework designed to stabilize the economy automatically over the business cycle. The budget should be balanced over the course of the cycle, allowing for deficits if necessary, but also calling for surpluses if growth is high. The overall debt level of the public sector must be sustainable.

We regard the Stability and Growth Pact framework as a major improvement, compared to the discretionary stimulus packages that in the past have all too often proved to be ill timed and debt-propelling. The much chided euro-area social security systems are the main tools of automatic stabilization.

Calls to revise the pact to counter its alleged procyclicality lead astray. Counter to conventional wisdom, the pact is flexible. It even allows for large macroeconomic stimulus. The only problem with the pact is that some governments wish to apply it asymmetrically: they are willing to run deficits in a weak growth environment but wish to dodge consolidation in times of budgetary abundance. This deficit bias is the very reason for the 3 percent-of-GDP deficit limit. The ongoing debate is the best evidence of how important the 3 percent deficit ceiling is.

I am well aware that in the field of fiscal policy, the United States and the euro area have recently started to pursue diverging paths. One might even be tempted to speak of a “global experiment.” Policies on both sides of the Atlantic aim at rebuilding confidence, though the approaches vary. While you in the United States trust fiscal stimulus to actively rouse the economy from its current stupor, euro-area governments are basically trying to stick to the planned fiscal consolidation paths in order not to undermine hard-won confidence in their stability-oriented fiscal policies.

So, if macroeconomic policies need to be geared toward stability, who, then, is responsible for growth? It’s economic policymakers’ business to design a framework conducive to growth in which enterprises can thrive. Progrowth policies are multifaceted, but at the end of the day you must get the incentives right: incentives to invest and incentives to work.

The dissatisfying growth performance of Europe owes much to its inflexible labor markets. Labor-market policy in the EU is a responsibility of the national governments. Some countries, like the Netherlands, have successfully improved the framework for their labor markets and already brought down unemployment.

Other countries, like my own, are still in the middle of an extensive debate as to how best to address the labor-market issue. The chancellor has recently laid out his ideas, and they seem to be going in the right direction. However, the crucial details for most measures must still be worked out. So what I can tell you today is a bit tentative, but it is nevertheless encouraging.

In Germany, the combination of high labor costs and generous welfare benefits had, over time, crowded out an entire segment of the labor market: low-wage jobs for the low-skill group. As in other countries, this is the group with the highest unemployment rate. We are now pondering adjusting the incentive structure on the supply side by revamping the schemes of unemployment benefits and welfare assistance. A new type of “minijob,” with lower-than-usual payroll taxes, is intended to help revitalize that labor market segment. Like other countries in Europe, Germany will need to tolerate a higher degree of wage differentiation.

Wage negotiations, centralized up to now, will in the future become more open to company-specific deals. This increase in differentiation is a crucial feature of progrowth policies. Labor contracts in general will have to become more diverse. More extensive use of fixed-term contracts will be allowed for expanding small businesses, thus abolishing a major impediment to small-business growth.

Another core task in growth-spurring labor-market reform will be to bring down nonwage labor costs, which are a major barrier to employment growth. That is equivalent to further reforming the social security systems. We have already added a small but fully funded pillar to our pay-as-you-go pension system. However, pension reform is still unfinished business. Employees will need to resort to more private provisioning.

In terms of growth orientation, Europe has been a bit of a laggard, although we have sound economic fundamentals. The time for more structural adjustments has undoubtedly come. They should help to both exploit and raise the growth potential. In general, economic policymakers need to provide a viable framework for giving enterprises and households certainty of planning.

Progrowth policies are not restricted to domestic issues. A coherent approach to progrowth policies must encompass liberal trade policy. Lowering barriers to trade and granting market access must be part of any credible set of progrowth policies. There are really few things economists are willing to agree on, but the benefits of free trade are among them. Therefore, the Doha round of international trade negotiations is another great opportunity for the world economy to foster growth.

The third factor in policies for sustainable growth is a sound financial system. This is a necessary precondition for the exploitation of the growth potential. There can be no investment without financing, and there can be no proper financing without a sound financial sector. It is not a question of whether a financial system is a capital market system or relies more on banks for the allocation of funds. By tradition, continental Europe tends to be more bank centered than the English-speaking countries. This tradition is now under change. Not even the setback for financial markets that followed the bursting of the millennium bubble brought this process to a halt.

Under the new single currency, capital markets in the euro area have begun to play a larger role in financing. Financial integration is—aside from price stability—one of the hopes we had for the euro. It materialized quickly. More liquid and more thoroughly integrated euro-area capital markets are providing businesses with better and more diverse financing options. Ever more companies are going straight to the market, implying a changing role for banks. The euro-area financial system is becoming more balanced. Finance in Europe (which had not been bad before the euro arrived!) achieved a structural improvement. The foundations for economic growth in the euro area have improved in step.

To safeguard the soundness of a financial system is a rather complicated task. Effective financial regulation and financial supervision are key to financial stability. As financial products become ever more complex, financial regulators and supervisors need to keep pace with developments in the capital markets. They have to strike a fine balance. Their core task is to make sure that financial institutions are capitalized commensurate to their respective risk profiles, not least in order to contain systemic risk. On the other hand, they do not want to hinder the development and the use of new instruments and will therefore try to permit as much room as possible, so as not to hinder growth.

In the aftermath of the late 1990's financial market boom, new questions arose. The role of market integrity has been highlighted by a series of financial scandals. Cases of insider trading, of investment banks recommending clients' stocks against their better judgment, and even some spectacular cases of outright accounting fraud have shaken financial markets to the core. Trust has been lost on a grand scale. It needs to be rebuilt by improving the framework of the markets. Financial markets must be trustworthy; only then will investors be willing to provide finance.

Let me cite one last aspect of sound financial systems. It is also a matter of trust. The infrastructure of the markets needs to be stable and able to withstand shocks. 9/11 was a shock, not least to the world financial system. It put payment systems to the test. With a little help from the central banks—we stood ready to provide liquidity—the international financial system proved resilient. Disruptions in the world financial net might easily have a severe negative impact on the world economy. Hence, the robustness of the market infrastructure is a major factor in steady and sustainable growth.

IV.

Ladies and gentlemen, uncertainty currently weighs on all debates on economic issues. We cannot abolish uncertainty. It is a feature we will have to live with for some more time, as its causes are many. We can and we should, however, work to improve the resilience of the world economy. World economic growth needs to become better balanced. For this to happen, each of the world's major economic zones has some homework to do.

Let me again point out how happy I am to be able to be here with you this afternoon to discuss some important issues of the world economy. Transatlantic debate has traditionally been intense, and it is a tradition I hold in high esteem. Our countries do have differences on vital political questions. We must not let these differences spoil our long-term relationship. The world urgently needs a strong United States of America and a strong Europe to work together with confidence for the benefit of mankind.

Sessions

SESSION 1

The State of the U.S. and World Economies: A Wall Street Perspective



John Lipsky; Constance Mitchell-Ford; Lakshman Achuthan; James W. Paulsen; William C. Dudley

MODERATOR:

CONSTANCE MITCHELL-FORD

Economics Editor, *Wall Street Journal*

LAKSHMAN ACHUTHAN

Managing Director, Economic Cycle
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WILLIAM C. DUDLEY

Managing Director and Director of
U.S. Economic Research
Goldman Sachs & Co.

JOHN LIPSKY

Chief Economist and Global Head of
Economic Policy Research
JP Morgan Investment Bank

JAMES W. PAULSEN

Chief Investment Strategist
Wells Capital Management

LAKSHMAN ACHUTHAN noted one of the main points made at the previous year's Minsky conference: If we did not believe that there was a recession in 2001, we are likely to underestimate the probability of future recessions. Denials about recession had been voiced by individuals who considered the economy recession proof, but Achuthan deemed the 2001 recession a foreseeable downturn that stemmed from cyclical economic fundamentals.

Asynchronous growth of the world economies and excess capacity abroad in the 1990s had produced low inflation growth in the United States. A popular explanation for low inflation growth was the new paradox created by the information technology (IT)-enhanced economies: strong productivity growth enables inflation-free growth, which lowers the risk of recession. This explanation helped support higher "new economy" valuations and investment. However, when the world's central banks hiked interest rates in sync

in 1999, as the Japanese economy expanded, inflation pressures began to rise. This event upset the global demand relationships at the margin, so the United States had less imported disinflation. The lagged effect of the interest rate hikes, combined with an oil price spike, triggered a sharp deceleration in global growth. This event was accompanied by an IT sector bust; IT investment represented almost half of all capital investment in the United States, and IT had become a notably cyclical industry. Therefore, a cyclical triple whammy (interest rate hikes, oil price spike, IT investment) rather than a combination of freak events caused a global recession.

Achuthan observed that the volatility of the business cycle decreased dramatically after World War II. A number of rationales were proposed to support the view that the business cycle was at an end (i.e., the decline in cyclical volatility was here to stay): the secular shift to a service-oriented economy reduces the impact of the inventory cycle; just-in-time supply-chain management systems eliminate inventory cycles; deregulation and derivatives increase market efficiency; better monetary policy mitigates the boom-bust cycle; a larger government sector and higher taxes stabilize the business cycle; the technology sector is immune to cyclical forces that buffet the old economy; the trend toward globalization may smooth out business cycles; and in the short run, a prevalent view becomes a self-fulfilling prophesy.

Achuthan countered the various rationales by observing that many discretionary services remain highly cyclical (e.g., advertising, consulting, some financial services); supply-chain management systems—the producers of the equipment that should have eliminated the inventory cycle—become the foremost victim, since a lack of information about upcoming cyclical turns raises volatility, which may be triggered by factors such as terrorism or supply disruptions; derivatives may increase volatility (consider, for example, the case of Long Term Capital Management, the Asian currency crisis, or the Russian bond default); just-in-time monetary policy allows a buildup of imbalances; smaller government and lower taxes reduce stabilizing effects and raise volatility; technology is more cyclical than are many “old economy” businesses; globalization often increases the synchronization of business cycles, leading to more pronounced upturns and downturns in the economy, with the 1990s the exception to the rule; and the self-fulfilling prophecy becomes a self-negating prophesy, i.e., behavior resulting from the lack of an economic downturn creates excesses that ensure an economic downturn.

U.S. and global cyclical volatility, which has been in a long-term decline since World War II, reached a record low in the late 1990s. It has risen noticeably since then, observed Achuthan, so more recessions, recoveries, and turning points may occur. This pattern would affect budget deficits and the stock market: the equity risk premium is linked to cyclical volatility. The coexistence of positive economic growth and a declining stock market in 2002 may be partly the result of a changing equity risk premium as volatility shifts in the business cycle. Although cyclical volatility has fallen during all of our adult lives, there are reasons to believe that the downward trend may have reached bottom.

WILLIAM C. DUDLEY predicted that the U.S. economy would continue to grow, but the rebound would be relatively slower over the next year. Stock market weakness has set in motion very large balance sheet adjustments by corporations, households, and state and local governments. While the corporate adjustment is advanced, the household adjustment is less than half complete and the state and local government adjustment is just beginning. Government policy has sought to offset these balance sheet adjustments and strengthen the economy, so most of the effects of monetary policy have already

occurred. Therefore, the 2002 fiscal impact on such interest-rate-sensitive sectors as housing and automobiles was much more powerful than what we can expect in 2003.

Dudley anticipated an acceleration in the U.S. economy between the second and third quarters of 2003 because the end of the Iraq war should prompt an above-trend rebound in economic activity, as a result of pent-up demand. However, he also expected the economy to return to its relatively weak underlying trend. The current business cycle (an investment boom/bust cycle or a stock market bubble/burst cycle) is not normal, he said, noting that this is the only recovery episode since World War II in which the stock market has continued to decline.

The corporate sector will probably not amount to a significant drag on future economic activity, but it is unlikely to contribute much to economic growth. Incentives currently facing corporate America, such as maximizing free cash flow, are different from those of a few years ago, when maximizing EBITDA was an objective. Such changes translate into a negative corporate financing gap, since capital spending will not exceed cash flow. Productivity growth generally fares well during the early stages of the business cycle but subsequently slows significantly, a pattern that is likely to occur in the next quarter (contrary to Alan Greenspan's argument that because productivity growth is very high, capital spending will recover quickly).

On the consumer side, the main effects of mortgage financing and mortgage equity withdrawals (which amount to more than 3 percent of disposable income) on economic growth have already occurred and are likely to subside. Consumers have not yet fully repaired their balance sheets, so the saving rate will likely return to approximately 8 percent of disposable income, from 4 percent today, and consumption will grow more slowly than income for a sustained period of time. The adjustment process will be complete and the economy will be poised for rapid growth when the private sector balance returns to normal.

Future contributions from government policy are likely to be less substantial than in the recent past. The Congressional Budget Office's standardized budget balance, which measures the fiscal impulse, was enormous in 2002 but will be much smaller in 2003. Considerations of monetary policy must include not only the federal funds rate, but also how this rate affects financial conditions. Monetary policy works through three channels: the interest rate, wealth, and dollar trade. The interest rate channel has functioned well, but the wealth channel has moved in the wrong direction and the dollar channel has been constrained by the strength of the U.S. dollar.

Goldman Sachs' financial conditions index, which captures the effects of these channels, suggests that financial conditions today are no different from their status in January 2001 when the Federal Reserve began aggressively to ease monetary policy. The Fed has failed to accomplish much because the stock market has been of little help. Since the positive effects of the interest rate channel have already occurred, the other two channels must begin to exert their effects before monetary policy can boost the U.S. economy, i.e., through a rise in the stock market and a drop in the strength of the dollar, so that wealth and trade move in a positive direction. This may happen later, but definitely not in 2003.

According to **JOHN LIPSKY**, the U.S. and global economies will improve only temporarily as a result of the aftermath of the Iraq war. GDP growth in the United States will accelerate at an annual rate of 3.5 to 4.0 percent in the second half of 2003, with some upside and downside risk—recent events have been disinflationary—and there will be an additional modest decline in the U.S. dollar.

The growth gap between the United States and the rest of the world during most of the 1990s disappeared briefly in 2001, but reappeared with a vengeance in 2002. Although Lipsky had more confidence in the prospect of continued economic expansion in the United States than abroad, he expected the gap to disappear over the next year. His data suggest that structural problems related to the U.S. current account deficit have disappeared, and there is no evidence that income elasticities of import demand differ between the United States and other countries. Therefore, no competitive or dollar valuation problems exist; rather, a period of below-potential growth has persisted in the rest of the world.

Lipsky expected consumer prices in the G7 nations to continue to be disinflationary. He noted that consumer price inflation in the industrial countries is at a 40-year low. On a broad, trade-weighted basis, the exchange rate of the dollar has remained stable since the mid 1990s because the United States trades less with the euro zone compared to areas that manage their currencies relative to the dollar.

A review of the components of GDP growth shows that the last recession was entirely a business phenomenon—household and government spending remained intact—and thus atypical. Three factors made it so. First, household spending grew at the same time as the saving rate rose during a period of contraction (no job growth) in the business sector. This occurred as a result of stronger-than-anticipated productivity gains (the “new economy” was not completely a pipe dream), which led to higher real wages during a time of increasing profit margins. Second, an unprecedented amount of fiscal and monetary support for household income resulted in higher spending and higher saving at the same time. Third, a substantial change has occurred in the financial underpinnings of the U.S. corporate sector, which has increasingly relied on the issuance of corporate bonds as the primary means of raising funds (i.e., selling marketable securities to investors who mark their balance sheets to market). Thus no net borrowing by U.S. corporations was seen in the 1990s, as corporations were net purchasers, rather than net sellers, of equities. Corporations today face greater pressure to show profits and thus convince investors to hold their debt at sensible interest rates. Only 12 percent of U.S. corporate borrowing relates to traditional bank lending, compared to 90 percent in the euro area, noted the speaker.

Lipsky was moderately optimistic about the future because of two basic assumptions. The first is that household spending growth will continue, but will lag slightly behind income gains, yielding a continued modest rise in the saving rate—meaning that households have acted, and will continue to act, normally. The second is that a gradual acceleration in the growth of business inventories will occur. He noted that spending on capital equipment and software grew last year at about the pace of the overall economy, and that the large decline in the inventory sales ratio in the 1980s and early 1990s did not continue in the remaining years of the 1990s. He presumed a return to a more normal relationship between inventory levels and real final sales.

The latest data show that corporate bonds represent 55 percent of all corporate debt. This phenomenon, which is not present in other economies, has produced a sharp rebound in manufacturing profits. According to Lipsky, pessimists about capital spending have been wrong. Business capital spending on equipment and software in 2002 was at the fourth-highest annual rate since 1968, despite the investment boom and bust of the late 1990s. Higher productivity has been the result of massive capital spending, which has begun to grow once again. He noted that 70 percent of business capital spending is in the service sector, the relative price of capital goods is rapidly declining, and interest rates are low.

The big surprise and disappointment in the global economy last year was weak growth in the European Union. According to the Taylor Rule, the Fed has been doing what is expected of it in the

realm of monetary policy. In the same area, the European Central Bank has been fairly aggressive, as a result of relatively low potential growth and high inflation. In terms of fiscal policy, however, marked differences between the United States and the euro area have been evident since 1995, as the U.S. surplus has allowed more aggressive fiscal action without creating an unbalanced policy.

The financing gap—the percentage of capital spending not covered by internal cash generation—spiked at the beginning of the last recession, but quickly reverted to its normal range. By contrast, the euro area's corporate sector has just begun to adjust, despite the presence of economic imbalances as large as those seen in the United States. Faster adjustments in growth and profit margins have occurred in the United States. The risk is that the euro area's employment adjustment in the corporate sector is unfinished.

Lipsky found that the correlation between the business cycles of the United States and emerging Asia has tightened, while such a correlation hardly exists between the euro area and emerging Asia. This difference is creating a two-speed globalization, in which less than 20 percent of U.S. bilateral deficits are with countries whose currencies float against the U.S. dollar. That explains why the expansion in the current account deficit has been easily financed. Lipsky noted that the current account balance and the federal budget balance (the “twin deficit” problem) are unrelated and therefore are poor predictors of the economy. Net capital outflows from American investors have declined sharply, mitigating the decline in foreign investment in the United States.

JAMES W. PAULSEN observed that the outlook for the U.S. economy in the near term is very different from that in the long term. His historical review of the stock market since 1800 showed that the market declined during only one four-year interval. Therefore, he said, the probability that the stock market will fall this year is one-half of one percent, noting that the government has launched a policy assault to alleviate the dot-com meltdown and the 2001 recession.

The most notable development in the past year has been a change in government policy. Previously, there had been, essentially, one “easy” policy and three “tight” policies. After the dot-com stock market peaked in March 2000, nine months elapsed before a problem—its steady decline—was evident, followed by a year and a quarter during which monetary easing was the only policy used to stimulate the economy. Finally, in 2002, policies in the form of fiscal stimulus, a weaker dollar, and lower long-term Treasury yields were enacted. If it seems that these policies are not working, it is because a lag must occur before their effects are apparent.

The focus in the past 10 years has been on the Fed (i.e., monetary policy) rather than on the total impact of policy on the economy. By combining monetary, fiscal, and trade stimuli into one variable, as a percentage of nominal GDP, Paulsen showed that there was a very tight range, 55 to 65 percent, for this variable from 1960 to the mid 1990s. Thereafter, the variable declined to a highly contractionary level, reflecting extraordinarily tight policies and resulting in the 1997 East Asia crisis, the dot-com meltdown, and the 2001 recession. The new corporate culture had no pricing flexibility and was constantly cutting costs, leading to deflation. Fortunately, this situation has begun to improve. The Goldman Sachs nonenergy commodity price index (with a three-year lag) indicates that core pricing is likely to rise, implying a more normal policy response and recovery in the coming year.

On the subject of economic traction, Paulsen cited the turnaround and growth in industrial production, commodity prices, personal disposable income, and total (household survey) employment. In

addition, he noted higher annual growth in S&P 500 operating earnings, capital spending, inventories, and bank loans. The economy, he concluded, is in better shape than news reports might suggest.

The trade deficit (5.25 percent of GDP) is distorting the interpretation of the economic recovery. Since real GDP growth is weak by historical standards, employment, income, and profits are also weaker. A comparison should not be made between policy and the economy, but between spending and production. Real gross domestic purchases are growing at an annual rate of 4 percent, but nearly 1 percent goes overseas, as a huge trade leakage affects production, jobs, and income in the United States. The trade deficit is having such a substantial impact at this time because 22 percent of total demand is lost abroad—a percentage that is more than twice as high (and more than 3 to 4 times higher in nominal terms) as the average during the first five quarters of expansion after recession. However, because the dollar has declined by approximately 20 percent on a trade-weighted basis, some improvement in the import-to-export ratio is likely to occur in the next year. Even if the trade deficit remains flat, real GDP will likely rise, along with jobs and income. The task is not to stimulate spending, but to close the trade window.

On a net basis, no jobs have been created for the past three years. According to Paulsen, jobs are perhaps overrated in terms of their impact on consumption because as a result of deflation, households have enjoyed two unique forms of stimulus in this cycle: an absence of CPI inflation (with tremendous growth in the real purchasing power of wages and real consumption) and lower mortgage payments. Consumers thus are expected to contribute their standard 2 to 2.5 percent to economic growth this year. Swing factors in other sectors of the economy may help produce a relatively high real GDP growth rate in the second half of the year.

Paulsen foresaw a couple of years of optimism and stronger growth before worries about inflation again set in. The current, massive policy stimulus is postponing a confrontation with several secular disinflationary problems (e.g., aging demographics, indebtedness, lack of saving) that have so far resisted solution.

SESSION 2

The Macroeconomic Prospects for the U.S. Economy



Randall S. Kroszner; Michael Mandel; J. Alfred Broaddus Jr.; Martin Mayer; William Poole

MODERATOR:

MICHAEL MANDEL

Chief Economist

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J. ALFRED BROADDUS JR.

President

Federal Reserve Bank of Richmond

RANDALL S. KROSZNER

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President's Council of Economic Advisers

MARTIN MAYER

Guest Scholar

Brookings Institution

WILLIAM POOLE

President and CEO

Federal Reserve Bank of St. Louis

According to **J. ALFRED BROADDUS JR.**, the near-term outlook for the U.S. economy is extremely uncertain, and financial market perceptions are extremely volatile. The latest Blue Chip consensus forecast is for real GDP to increase at an annual rate of 1.8 percent in the first quarter of 2003, 2.2 percent in the second quarter, and more than 3.5 percent in the second half of the year and in 2004. The unemployment rate will rise modestly before declining gradually to 5.5 percent, and the inflation rate (the chained GDP price index) will remain steady at 1.5 to 2.0 percent. However, said Broaddus, the probability that the economy could be appreciably weaker or stronger than the consensus is higher than usual.

A weaker economy could result from geopolitical risks, perhaps related to Iraq or North Korea; negative economic fundamentals, as in a loss of financial wealth by businesses and households; lower company earnings and stock prices; excess productive capacity; and high productivity growth rates that restrain job growth. In the view of some economists, the recent spate of soft monthly economic reports is evidence of an eroding recovery.

In contrast, a stronger economy could result from considerable monetary and fiscal policy stimulus, with a zero or possibly negative real funds rate; favorable financial conditions, such as stronger household balance sheets due to refinancing of mortgages; and favorable lending conditions for banks (i.e., they are well-capitalized, profitable, liquid, and free from significant credit problems).

In terms of monetary policy, the Fed must be particularly vigilant and anticipatory. Broadbuss noted that the Fed has developed an increasingly well-defined strategy for monetary policy that consists of two interdependent elements: a strong commitment to maintaining permanent price stability, and active interest rate management to stabilize the economy in the short run. A credible commitment to long-term price stability is a necessary condition for effective short-term stabilization policy, he said. Broadbuss credited the Fed's monetary strategy for the two exceptionally long business expansions that have taken place in the United States over the past 20 years, and voiced the expectation that this strategy would maximize U.S. economic growth in the long run. The strategy has already reduced the effect of recent shocks to the economy, he said.

Convincing evidence of price stability reflects public confidence that inflation will be contained and excessive disinflation or deflation successfully confronted. Broadbuss observed, however, that credibility about inflation does not necessarily extend to disinflation and deflation. The absence of a track record and the current proximity of the funds rate to the zero level are obstacles to full antideflationary credibility.

Broadbuss noted a number of steps that the Fed has taken to enhance the credibility of its opposition to deflation. These include participation in public conferences and discussions about the merits of various approaches, such as reducing longer-term interest rates by purchasing large quantities of longer-term Treasury securities in the open market, and substantially increasing the volume of cash by purchasing Treasury bills and other short-term securities. A drawback to the former approach is the practical difficulty of holding down the Federal funds rate. A shortcoming of the latter approach is its minimal impact as short-term rates reach zero: cash and Treasury bills would become perfect substitutes at zero nominal interest rates. In Broadbuss's view, purchasing long-term Treasury securities is probably the most effective way for the Fed to undercut deflation at the zero level, as it would increase broad liquidity and stimulate economic activity via portfolio rebalancing and the credit channels of monetary policy transmission. If this approach were employed, it would be important to ensure that the supply of Treasury bonds was sufficient to meet the Fed's needs; Broadbuss considered the current outstanding supply sufficient. Alternative approaches would involve Fed decisions regarding the allocation of credit across the U.S. economy and would risk undermining the efficiency of the private credit markets and jeopardizing the Fed's independence in conducting monetary policy.

RANDALL S. KROSZNER noted that the April Blue Chip forecast showed uneven but positive growth in 2002: weaker-than-potential growth in the first half, stronger-than-potential growth in the second half. He stated that one of his duties at the President's Council of Economic Advisers was the preparation of a 10-year economic forecast, using an interagency process. The forecast is set in early December and is based on the following February's budget. Kroszner estimated a long-term growth rate of 3.1 percent annually, of which 1 percent would result from an increase in labor hours and the remainder from productivity.

A number of challenges and downside risks confront the U.S. economy, which is in a recovery, but one that lags behind typical postwar recoveries, he said. Whereas the equipment and software sector

has begun to recover, structured investment has fared poorly and employment growth has been tepid. According to the nonfarm payroll survey, employment growth was negative over the past two months. Kroszner noted that manufacturing employment is in a very long-term decline, and that the overall unemployment rate has been essentially unchanged, as the size of the labor force has shrunk.

Consumer spending has been stronger than is typical of postwar business cycles, but a decline in consumer confidence ratings is a cause for concern. The challenge, he said, is to maintain consumption levels.

According to Kroszner, one way to meet the challenges faced by the U.S. economy is to raise investment. He noted that capital taxation is more distortionary than the taxation of labor because it leads to less capital accumulation and formation, amounting, in effect, to a tax on business investment and growth. Double taxation of dividends therefore is a double taxation on economic activity, which distorts corporate investment decisions and adversely affects productivity. Capital taxation also may confound corporate governance because the tax system introduces a bias into business decisions about retaining earnings or paying them out in the form of dividends. Decisions should be based on sound economics rather than tax implications, which involve factors such as earnings reports, free cash flows, and audits. Thus, he said, double taxation is bad for capital, corporate governance, and workers.

Other government measures aimed at stimulating the U.S. economy include an increase in the expensing limit for small and medium-sized firms (from \$25,000 to \$75,000) and a reduction of the marginal tax rates, achieved by accelerating the tax cuts passed in 2001.

One innovative approach to alleviating unemployment relates to how people respond to incentives; for example, when their unemployment benefits are about to expire, their success in finding a job increases markedly. The administration has thus proposed the creation of personal “reemployment accounts” for the long-term unemployed. These accounts, containing approximately \$3,000, could be used in any way that is compatible with finding a job (e.g., for training, relocation, or child care). Similar small-scale experiments, in such states as New Jersey, have lent credence to this approach.

Short-term measures proposed by the government to put cash in people’s pockets include accelerating the elimination of double taxation on marriage and child care credits, in addition to lowering the marginal tax rates. If the administration’s job and growth package is ratified by Congress, GDP growth (on a fourth-quarter-to-fourth-quarter basis) is expected to rise by an additional 1 percentage point in 2003 and a 0.8 percentage point in 2004, translating into approximately 500,000 additional jobs this year and 900,000 next year.

By improving the tax structure, devising new back-to-work incentives, and putting cash into people’s pockets in the short run, an environment for a robust economic recovery can be created, said Kroszner.

In response to previous presentations, **MARTIN MAYER** stated that if corporations could account for dividends as payments of interest on debt, distortions in the current tax system would be eliminated. He expressed doubt that corporate executives would change their behavior if dividend tax breaks were given to shareholders. Institutions can pressure corporate management, but they have no stake in the government’s proposal to eliminate the double taxation of dividends. Eliminating double taxation should therefore occur on the corporate rather than the personal side.

Mayer noted that the avoidance of inflation in the United States is closely related to imports’ exceeding exports by about 4 percent of GDP. This imbalance was financed by autonomous capital

flows into the U.S. marketplace, but Treasury paper held by the Federal Reserve Bank of New York for foreign official accounts has increased in value by more than 1 percent of GDP (\$800 billion) in the past year. It is unhealthy for foreign central banks and governments to hold more Treasury securities than the Federal Reserve, and the notion that the Fed should purchase Treasury paper and fund the deficit through the central bank violates every modern rule of central banking, he said.

Mayer considered the question of why monetary policy works and surveyed some targets chosen by central banks, such as free reserves, exchange rates, and interest rates. Whether the Fed should target asset prices has recently been debated. The “official” view is that this target violates the “laws of nature” because the government cannot ascertain the correct level of asset prices. Mayer pointed out, however, that changes in asset prices occur when the central bank changes interest rates and, subsequently, the price of short-term paper.

The period of the 1950s was the Fed’s heyday because its tools exactly matched its tasks. The banking system was controlled by the Fed and accounted for 60 percent of U.S. financial intermediation, so actions that changed the behavior of banks rapidly changed spending patterns. Changing reserve requirements, lending at the discount window, or open market operations activated multipliers that affected the total economic system to a predictable degree. The key was that 50 percent of banking assets were in Treasury securities. Lower interest rates induced the sale of Treasury paper, which increased profits, funded loans, and financed economic expansion. Higher interest rates choked off the credit supply. The target of Fed policy was a change in asset prices, an approach that does not suit present theories and is therefore absent from current textbooks.

Banks today account for one-seventh of the nation’s financial intermediation; large banks fund themselves by borrowing rather than soliciting deposits; the repo market is unimaginably large; the discount window and the power to change reserve requirements are gone; the multiplier is virtually infinite; and the money supply is unmeasurable. When the Fed pumps money into the economy to lower the interbank overnight lending rate, four outcomes are possible: (1) economic activity may expand; (2) consumer prices may rise (people spend but the supply does not increase); (3) asset prices may rise (people spend on securities or real estate); and (4) the income velocity of money may drop, leaving the real economy and price levels the same. There is no way to predict which outcome, or combination thereof, may result from a change in the interbank overnight interest rate. A fifth possibility—an increase in the trade deficit and a reduction in the exchange rate of the currency—is determined more by capital flows than by trade flows, noted Mayer, so interest rates are a very blunt tool for influencing capital flows. He further noted that a decline in the dollar exchange rate benefited the United States more than other countries.

The Fed’s problem, he said, is to find the factors that will determine how, at given times, a change in the price of short-term financial assets will affect the prices of other assets, including the value of collateral. When dealing with human opinions, beliefs, and fashions, however, the correlations between monetary policy and its effects are unstable. Historical responses are not indicative of how changes in monetary policy will influence economic activity, consumer prices, asset prices, or income velocity. The Fed thus requires disposable models, so that its policy prescriptions are less doctrinaire, more flexible and effective, and less prone to disaster.

WILLIAM POOLE focused on the shocks that have affected the U.S. economy (e.g., terrorism, corporate governance scandals, and bankruptcies) and the economy's resilience as a result of four features: (1) vigorously competitive markets, which promote an adjustment to new circumstances; (2) a robust financial system; (3) a sound fiscal position despite current deficits; and (4) low inflation and monetary stability.

Poole viewed a continuation of modest economic growth, as experienced in 2002, as the most likely outcome for the U.S. economy. He noted that none of the 53 members of the Blue Chip panel of economic forecasters expected a decline in real GDP this year or next. Monetary policy is working, he said, citing such indicators as zero-interest financing and the persistence of the housing and mortgage-refinancing boom. An entrenched environment of low and stable inflation rates over the past five years, along with remarkably low inflation expectations, has played a central role. Disciplined monetary policy has created a conviction that inflation will remain low because the Fed will do what is necessary to achieve that result. Free from uncertainty regarding inflation, the economy has adjusted quickly and efficiently. Survey evidence on inflation expectations and the yield spread between conventional and indexed Treasury bonds does not support the view that deflation concerns have affected the way people behave.

An important positive shock to the U.S. economy is the sustained growth in labor productivity in spite of a slowdown in 2000, a recession in 2001, and a slow recovery in 2002. Given the pace of output growth, the productivity performance meant that employment growth was significantly negative during the recession and flat last year, but it bodes well for employment and output growth in the long run.

Poole subscribed to the belief that the Fed responds as needed to changing circumstances, in order to maintain low inflation and a financial environment consistent with maximum sustainable growth in employment and output. Monetary policy and its direction are driven by new information, such as statistical releases, anecdotal reports, and new research. Better economic conditions will arrive, he said, but when more rapid growth will begin is unknown.

Participants

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