Seminar:

MACROECONOMIC POLICY

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- PAUL DAVIDSON
- ROBERT EISNER
- JAMES GALBRAITH
- HYMAN MINSKY
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- INVITED QUESTIONERS

Economic Policy -Institute

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The Economic Policy Institute would like to thank the panelists and questioners for their participation in the seminar. Arne Anderson organized the seminar and was the primary editor of the transcript. Editorial contributions were also made by Robert Blecker, Jeff Faux, Larry Mishel, and Kevin Quinn. Carol Schwartz provided invaluable assistance in preparing the seminar and the transcript.. Melva Caswell and Lynn Berger also provided administrative support.

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Introduction

In December 1988, the Economic Policy Institute brought seven prominent economists together with a panel of informed questioners[1] to discuss whether or not the federal deficit had to be eliminated in order to achieve stable growth and prosperity. One purpose of the seminar was to expose the analyses underlying the different conclusions reached by economists who have had similar training, share similar values, and work with the same statistical data.

Macroeconomics, based on the analysis of statistical aggregates, has dominated economic policy in America for the last 50 years. Macroeconomic concepts (such as Gross National Product [GNP] and its components) are the prisms through which we measure economic performance. Indeed, they are the main elements of the language of modern economic policy. For most of the post-World War II period, it was assumed that the tools of macroeconomics were by themselves sufficient to generate growth and prosperity. The late prominent economist Arthur Okun declared in 1970 that recessions had become "fundamentally preventable, like airplane crashes and unlike hurricanes." All one had to do is get the macroeconomics *right.*

The oil-driven price shocks to the economy of the 1970s and the subsequent tight-money policies which produced the worst recession since the 1930s undercut the confidence that prompted Okun's optimism. The political reaction led to eight years of a government dedicated to so-called supply-side economics. Yet, although rhetorically hostile to macroeconomic stimulation of the economy (supply siders often used "Keynesian"[2] as a code word for the despised welfare state), the Reagan Administration proceeded to swell peacetime budget deficits on a scale that dwarfed the conventional Keynesian imagination. The legacy includes large, persistent fiscal and trade deficits, escalating private debt, a weakened industrial sector, and a dramatic loss of U.S. economic power in the world. These are the consequences, presumably unintended, of some unexamined but persuasively expressed simple solutions to complex problems.

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The experience has taught us once more that economic policy advice is only as good as its underlying analysis. Thus,

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as we attempt to recover our economic balance, to restore competitiveness, and to promote economic opportunities for this and succeeding generations, policymakers and citizens would do well to look at the assumptions-political as well as economic-upon which economists are basing their advice.

Among the assumptions underlying the macroeconomic policy debate which the EPI seminar sought to question were:

- How "tight" is the relationship between the so-called "twin" fiscal and trade deficits? More broadly, is a trade deficit always the effect of low national savings (public and private together:), or can the former cause the latter? What are the mechanisms (e.g., interest rates, exchange rates, incomes changes) through which this relationship plays out?

- Is cutting the fiscal deficit necessary in order to eliminate the trade deficit? If so, is it sufficient? That is, might the trade deficit also have "structural" causes (e.g. lagging U.S. productivity and innovation, foreign economic policies) and therefore also require structural solutions (e.g., industrial and trade policies, international coordination)?

- How valid is the thesis that the source of the problem is an "overconsuming" public? Do capacity constraints in the face of the need to expand exports require us to slow the rate of growth of consumer incomes and spending?

- Does lowering consumption raise the savings rate? Does increasing the savings rate raise the rate of investment for productive purposes? Do we know how to raise the savings rate?

- How much risk of recession is there in attempting to slow consumption?

- Is there a credible scenario of *accelerating* growth that would also solve the "twin deficit" problem?

The point of departure for the discussions was the federal budget deficit. Barry Bosworth and Larry Summers hold that the nation's primary economic goal should be to eliminate it. They maintain that U.S. savings is too small to finance the deficit, forcing us to import capital from foreigners, which has led to the trade deficit. Since we do not know how to raise the *private* savings rate, we must compensate by raising

the *public* savings rate (by lowering the government deficit and eventually running a budgetary surplus). According to this view, rising savings will spur domestic investment by reducing the need for high interest rates to attract foreign capital. Moreover, by reducing consumption, increased savings will lower the propensity of U.S. consumers to buy imports.

Wrong, say Robert Eisner, Paul Davidson, and Hyman Minsky. Attempting to increase savings by reducing consumption is self-defeating. Savings are a function of income, which expands with the demand for goods and services. At this stage in the business cycle, if we cut back on consumption by eliminating the fiscal deficit, employment and incomes will drop, leading to less total savings. The fiscal deficit is not our most important problem; economic growth is. Only at full employment can one argue that we need to shift the share of GNP from consumption to savings. At present we ought to raise the rate of income growth, primarily through a more expansionary monetary policy.

Whether or not we are at full employment is one of the critical points at issue here.[3] Bosworth and Summers believe that the 5.3 percent unemployment rate at the time of the Seminar represented full employment, and therefore, further growth would have resulted in more inflation. Eisner, Davidson, and Minsky believe that it did not, and that we had room to grow faster,

James Galbraith worries that faster income growth could ignite inflation. But the answer is not to restrain growth; it is to restrain prices. His strategy calls for government to step in with "direct intervention in wage and price-setting mechanisms" to dampen inflation tendencies and thus give the economy more room to expand.

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On the other hand, Ed Yardeni sees neither a savings nor a budget nor a growth problem. Whatever macroeconomic theory might say, there is no evidence that investments are not being made because of a shortage of financial capital. His answer to the fiscal deficit is to leave it be. Demographic changes will lower the unemployment rate and boost productivity, while international competition should keep prices down.

The lineup shifts a bit when it comes to the mechanisms through which the trade deficit can be eliminated. Eisner and

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Yardeni favor letting the dollar fall as low as it has to. Neither is particularly worried about a resultant increase in foreign ownership of U.S. assets or the increase in the foreign "debt." (According to Eisner's calculations, we are not a net debtor.) Summers, Bosworth, and Galbraith are also willing to let the dollar fall-to some degree. Summers and Bosworth believe that the strategy will collapse at the point at which foreigners will lose confidence in the dollar and demand even higher interest rates to buy U.S. securities, eventually causing a recession.

Davidson and Minsky are skeptical that we can or should solve the trade deficit with a falling dollar. They argue that the source of the problem is not undersaving in the U.S., but oversaving by surplus nations-primarily Japan and Germany-and that the solution lies beyond macroeconomics. One direction is toward managed trade policies that threaten to reduce the surplus nations' imports into the U.S. unless they grow faster and import more from us. Another is toward industrial policies that can increase the rate of productive investment and productivity growth in the U.S.

Indeed, throughout the day's discussion of deficits, savings, investment, monetary policy, etc., the boundaries of macroeconomic analysis were regularly reached and indeed, breached. For Summers, the elimination of the trade and budget deficits is, by definition, a macroeconomics problem. Structural policies might have some long term usefulness, but they are irrelevant to our present concerns. For Minsky, macroeconomic and structural policies are inseparable. He points out that the perception of what represents full employment fell substantially during the Reagan years, after having risen during the 1970s. Even further back, he says, "I remember three to four percent unemployment, two percent wage increases and no inflation. It depends upon society's institutions, not just the: 'numbers.' "

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Assumptions about monetary policy also differ. Although they admit there is a risk, Bosworth and Summers have faith that the Federal Reserve can be counted on to pursue sufficient monetary expansion to compensate for any slowdown caused by eliminating the fiscal deficit. Galbraith is less sure; he wants an explicit Federal Reserve commitment to be part of any budget deal. Eisner, Davidson, and Minsky think that existing monetary policy is too restrictive, even with current budget deficits.

A question on the meaning of "consumption" reveals another disagreement; this one over the degree to which econ-

omists should be concerned with the *composition, as* opposed to the aggregate levels, of economic activities. It also shows the misunderstandings inherent in the language of economics. Thus, the data from which Barry Bosworth concludes that America has been on a "consumption binge"—and which is widely assumed by policymakers and the press to refer to a rise in personal hedonism-include the massive expansion in military spending over the last decade. Yet, while he believes we should cut back on the share of the economy devoted to consumption, he shies away from making judgments about the appropriate share military spending should take of GNP-on the grounds that he is not a military expert, but an economist. Eisner, however, argued that economists were making judgments about how large the consumption share of national income should be, and could therefore make judgments about the military share as well.

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For those seeking to understand the source of differing views on fiscal and monetary policies, the value of the dialogue is in its disagreements. It reminds us that policy prescriptions are influenced by the values that underlie perceptions of risk. Thus, the dispute over the importance of the budget deficit to continued growth is, to some degree, a dispute between those who would first protect against the risk of unemployment and those who would first protect against the risk of inflation.

It is also a dispute between those who consider that economic policy is confined to a framework in which institutions and their behavior are "given," and those for whom economic policy includes strategies to change those institutions. There is, for example, no economic standard for what inflation rate is "acceptable." So when an economist makes assertions about inflationary dangers, or the lack thereof, he or she is inevitably making a social and political value judgment.

Similarly, assertions about the connection between the fiscal budget and the trade deficit often assume an unchange-

*The evolving debate **within** the profession is a good sign that **reality** is leading to some **rethinking** of propositions that a short time ago had the status of eternal truth.*

able institutional framework-productivity, innovation, trade, industrial policies of foreigners, labor-management relations, and foreign policy goals. But a change in one of these factors could dramatically change the macroeconomic problem. For example, to the extent that institutional policies can make U.S. firms more competitive in domestic markets, the propensity of U.S. consumers to buy imports will drop, raising incomes for domestic producers, increasing savings rates, and lessening the need to reduce consumption or the value of the dollar.

To be sure, the case must be made that such institutional policies can be effective. But just raising the question takes us beyond the limits of the conventional wisdom.

This is not, of course, an argument for abandoning macroeconomics. It is an argument for adding to it trade and competitiveness policies, to change institutional behaviors so that we might solve our trade problems by means other than lowering our wages and incomes. These are intellectually unchartered waters for many American economists and therefore a cause of anxiety But, as noted in the seminar, a switch from loose fiscal/tight money policy to a tighter fiscal/looser money policy also leads us into unchartered waters.

The evolving debate within the profession is a good sign that reality is leading to some rethinking of propositions that a short time ago had the status of eternal truth. We will need all the rethinking we can get to steer a passage through the dangers of debt and competitive weakness left us in the wake of the economic policies of the last decade.

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President
Economic Policy Institute

Participants

Economic Policy Institute
Seminar on Macroeconomic Policy
December 13, 1988

Panel Members:

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Brookings Institution

Paul Davidson
University of Tennessee

Robert Eisner
Northwestern University

Jeff Faux,
Economic Policy Institute

James Galbraith
University of Texas

Hyman Minsky
Washington, University

Lawrence Summers
Harvard University

Edward Yardeni
Prudential Bache

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Columnist,
Business Week
Economics Editor,
The New Republic

Milton Lower
Economic Policy Institute

Robert McGarrah
American Federation of State, County, and Municipal Employees

Larry Mishel
Economic Policy Institute

David Smith
Office of Senator Kennedy

Lee Price
Joint Economic Committee, US. Congress

Brian Turner
Industrial Union Department, AFL-CIO

Overview

BOSWORTH:

I would focus on four issues as an agenda for economic policy over the next four to eight years.

The first is the primary importance of sustaining the economic expansion and continuing to reduce unemployment without an acceleration of inflation.

The United States trade deficit and the need to borrow from overseas is the result of our country going on a consumption binge.
-Barry **Bosworth**

The second is the long term problem of economic growth and the disastrous decline in the national saving rate. The United States trade deficit and the need to borrow from overseas is the result of our country going on a consumption binge. If we save two percent of our income and invest six, by definition we have to borrow four. Of course, the identity and the causation could run the other way, but all the studies find the causative ***change*** in the 1980s has been in the domestic saving behavior. The change is not overseas.

The major reason for the decline in the national saving rate was the budget deficit, which was beyond the pale of historical experience. More recently, the private sector saving rate has also substantially declined. We now have a net national saving rate that's two percent of our national income. It used to be in the range of six to seven percent. About half that decline is due to the public sector and about half that decline is due to private saving.

The government, short of coercion, can do almost nothing to influence the private saving rate. Therefore, the private saving rate is something to be taken as a given, and public budgetary policy must adjust to it. The argument is that the U.S. has to aim for a surplus in the total budget over the next decade or so. Obviously our progress towards achieving that goal will have to be modified by the need to sustain the expansion.

The third economic issue is productivity growth. Many of the social problems of the country are due to the disastrous slowing of the improvement in the standard of living in the United States. Although we don't understand the full reasons for the productivity decline, economists can articulate an economic policy to improve productivity growth in the future. The problem which must be faced is that it will cost money.

The final issue is that the U.S. now finds itself in a dramatically changed international economic situation. It therefore has to seriously rethink its economic policies in the international sphere.

DAVIDSON:

I'll start with some controversy Deficits are not the problem. They were the solution to getting out of the second Great Depression of the Twentieth Century. Our deficits act as the engine of growth for the economies of the industrial free world. The industrial free world, including Germany, Japan and the NICs [Newly Industrializing Countries], will continue to grow as long as we are willing to solve *their* oversaving problems. The problem is not our undersaving, but their oversaving.

Reagan (for the wrong reasons perhaps) has acted like a good Keynesian. His deficit got the economy out of the recession. But unfortunately, because of the open economy, a lot of the economic growth spilled over to our trading partners who did not reciprocate by expanding their economies. The reason they didn't reciprocate is because under flexible exchange rates, there are three gains to be made from mercantilist export-led growth. One, you can export your own unemployment. Two, you can get an anti-inflation policy because the appreciation in the exchange rate lowers the price of imported goods. And three, you get a real wealth effect because as the exchange rate increases you can buy foreign assets at bargain prices. These advantages wouldn't exist under-fixed exchange rates.

As a nation we are not living beyond our means, because the definition of living beyond your means is ... how much you spend out of your full employment income.
-Paul Davidson

I question whether there is any relationship between budget deficits and trade deficits. I also deny that the fall in personal saving rate is very strong. In 1982, when we were running a goods and service export surplus, 65 percent of the GNP was in consumption. In 1988 we still have 65 percent of the GNP in consumption. We are no more on a consumer binge now than we were in 1982. You might argue that because imports are greater than exports, we are on a consumer binge, but I argue that that's the way we have been keeping the world out of a recession.

As a nation we are not living beyond our means, because the definition of living beyond your means is not how much you spend out of your actual income but how much you spend out of your full employment income. As long as you have unemployed resources, you can continually spend more

on goods. Keynesians don't say that the unemployed people who are spending are living beyond their means, and that they ought to tighten their belts. What we say is they ought to get more income. You can get more income by transfer payments, or you create jobs for them. You can use the same argument for a family of nations. You would get the same kind of conclusions.

Do real budget deficits lead to less real saving? The argument is that it's not the personal saving ratio that's low, but that the government deficit has absorbed all this saving. Well, compare the Eisenhower Administration with the Kennedy Administration. The deficit under Kennedy was about four times as great as a percentage of GNP as under Eisenhower. But the real national saving in the United States was much greater under Kennedy than under Eisenhower. Large government deficits can lead to large saving. It is a question of the distribution of saving. That gets back to the argument that unfortunately our trading partners have a great incentive to oversave. Under fixed exchange rates, under the Kennedy case, they would not have this incentive to oversave.

EISNER:

There are two major goals of macroeconomics: first, keep ing a high level of employment and prosperity, as Barry indicated, and second, providing for and investing in the future, also as Barry indicated. From there I may part company from the other participants.

> *There are two major goals of macroeconomics: first, keeping a high level of employment and prosperity. .. and second, providing for and investing in the future.*
>
> -Robert **Eisner**

For one thing, we don't measure our investment appropriately Economists have an awful time trying to match the theory in their analysis with the measurement of variables in their analysis. They don't stop to think that the theory and the measurement don't match.

Let's take this issue of lowered saving. Even in terms of standard definitions, the fall in net saving is very suspect. The four percentage point drop is almost entirely accountable to two things.

One is capital consumption allowances i.e., depreciation, which, according to the BEA, have gone up about four percentage points. They would have us believe that somehow there has been a huge decrease in the durability of our capital or a great increase in capital intensity such that a great deal more of our capital is being used up.

A second major element in the purported great decline in saving is that we have a negative trade balance and thus foreign investment. That is due overwhelmingly to what has happened to exchange rates. The remedy is clear; leave the dollar free. Stop encouraging the Japanese or the Germans to keep buying dollars, thereby keeping the dollar expensive. The whole foreign investment problem can be essentially settled by letting the dollar fall, although there will be a lag.

I would like to see a little confidence in the economy; I believe it can grow.
-Robert Eisner

But remember there is a kind of an automatic adjustment to the whole net international position of the U.S., as the dollar falls in value, the value of our foreign investments abroad increases. Thus, we're not the world's greatest debtor nation.

A basic point of difference I have with my colleagues at Brookings, and perhaps some others around this table, is that they all seem to be mesmerized by the notion that we are at full employment or at the natural rate of unemployment. They believe there is no more excess capacity and therefore, if you increase the money supply, thereby letting interest rates fall (which will bring down the deficit somewhat automatically because of lower government payments for interest on the debt), you will somehow get inflation.

I would like to see a little confidence in the economy; I believe it can grow. Take your chance that you can get below 5.5 percent unemployment. Remember, we had 3.5 percent unemployment 20 years ago. If I happen to be wrong, and we get an uptick of one percent in inflation, that's far better than having an uptick of one, two, or three percentage points in unemployment which you can well get by cutting the budget deficit.

Ultimately, I come back to the whole net investment/saving issue. What is normally called investment or saving is only the tip of the iceberg. The great bulk of investment and provision for the future is in government capital and infrastructure, and overwhelmingly in human capital. Business investment is only about 20 percent of total investment. What the focus on cutting budget deficits says is, "You can't spend more for education and you can't keep up your infrastructure." This deficit focus kills the future in the name of increasing saving for the future. Besides, I would agree with Barry, you can't change private saving much anyway.

GALBRAITH:

We need to sustain growth. I would emphasize export-led

growth. In the context of doing that, we need to move towards a smaller budget deficit and toward balance in the current account. The emphasis is properly on growth in the first place because there are ways to fix trade, in particular, without growth, but they are catastrophic for the budget and everything else.

Interest rates should be lowered immediately and there should be a reallocation in the federal budget to growth of public capital formation in the civilian sector in education, research, infra-structure, and the environment.
-James **Galbraith**

I would suggest the following elements: first, higher tax revenue for the U.S. government. Enact a tax increase now, but delay the effective date of the increase for say a year or two, until the other parts of the package have been put into place and have had a chance to take effect. The simplest and most effective way to do this is to enact a future rise in income tax rates.

Second, in return for enacting such a delayed tax increase, interest rates should be lowered immediately and there should be a reallocation in the federal budget to growth of public capital formation in the civilian sector in education, research, infrastructure, and the environment. These are the areas that have been most radically slashed in the last decade. They need to be restored. An appropriate target for the increase in these areas would be one percent of GNP.

Third, we need to move toward debt relief in Latin America to restore the purchasing power of those economies, allowing them to buy advanced investment goods which constitute our major export. A program of debt relief could be funded cooperatively with the Japanese, United States guarantees, and the compliance of commercial banks which could be solicited in a friendly way, or, if necessary, by using the regulatory powers of the U.S. over banking institutions.

Finally, we need, but may not get, an expansion in advanced countries now running large trade surpluses, in particular Japan and Germany. If this does not occur, Bob was right, we would have to tolerate a fall in the dollar to reduce our trade deficit. Certainly our willingness to let the dollar fall ought to foster a willingness on the part of the Japanese and the Germans to cooperate a little bit more in a program of global economic expansion. If we can't get that cooperation, then we will face a short term rise in our import price level. We will need to take steps in the domestic economy to prevent that from spreading into a renewed inflation spiral of wages and prices. So we will have to begin to construct some new institutions for direct intervention in wage and price-setting mechanisms, so as to keep an export-led expansion on track and to make the expansion truly sustainable.

MINSKY:

There is not very much of a problem with the internal deficit, The problem is the external deficit and the solution to the external deficit. The internal deficit is an operational thing. What we have to do is adopt the fiscal and monetary policy to keep us at full employment, and if a government deficit results, so be it.

The external debt has decreased the fiscal independence of the United States and increased the fiscal independence of the countries that have acquired U.S.-based assets. Their increase in fiscal independence, combined with their continued reliance on export surpluses to maintain their own domestic employment, is a classical "beggar thy neighbor" policy. We have the right to protect ourselves against "beggar thy neighbor" policies by creditor surplus economies. Yet we don't recognize the equivalence between a tariff and the depreciation of the dollar. A revenue-generating tariff is not such a bad thing, especially with our fiscal and trade problems. To say any tariff moves you to Smoot-Hawley immediately is saying there are no numbers between zero and one hundred.

We have had a successful fiscal policy that changed domestic behavior by the Reagan Administration. The policy mix has been and continues to be right wing Keynesianism. There is nothing written in the Scriptures that says Keynesianism has to be progressive. The Reagan Administration succeeded in containing wage increases by changing the NLRB [National Labor Relations Board] and other rules affecting the labor market. They did nothing about industrial organization, to contain firm market power. Market power policy has been a weakness of liberal and conservative governments ever since the third New Deal was abandoned after 1939.

We have the right to protect ourselves against "beggar thy neighbor" policies by creditor surplus economies.
—Hyman Minsky

Where do we go from here? I believe that a new definition of full employment is called for, a definition that allows for a smaller unemployment rate. What we have to be concerned about is not the aggregate demand relations as such, but whether increases are transformed into wage and price increases or into output increases. That means addressing the structure of product and labor markets.

SUMMERS:

I agree with Barry Bosworth. The four points he made are just about exactly right.

It is a myth that deficit reduction has to be associated with any significant reduction in the level of economic activity. It is true that with a constant money supply, an expansion in the budget deficit does tend to stimulate an economy. This effect is probably less important than it was in an earlier era when, for a variety of reasons, the money supply was more elastic with respect to interest rates.

But this is not the issue before us. The relevant question is: what are the economic consequences of budget deficit reduction, given the monetary policy that is likely to accompany such a change. Reducing the deficit will allow the Federal Reserve Board to adopt a more expansionary monetary policy. The resulting lower interest rates and increased investment will offset any lack of stimulus that comes from reduced consumption. If monetary policy is used to keep the economy growing, the Federal Reserve won't be able to use it to defend the dollar at some particular exchange rate target.

There is, of course, an issue of timing. Given that any deficit reduction program introduced in Congress will only be implemented after six months or a year, the Federal Reserve will have plenty of time to respond appropriately with looser monetary policy. Real interest rates remain substantially higher relative to postwar experience in the United States. The appropriate antidote is an employment-maintaining shift in our fiscal/monetary mix-tighter fiscal and looser monetary.

It is a myth that deficit reduction has to be associated with any significant reduction in the level of economic activity . . Reducing the deficit will allow the Federal Reserve Board to adopt a more expansionary monetary policy.
-**Lawrence** Summers

Second, it is simply wishful thinking to suppose that there are large output dividends available by driving the economy to higher levels of employment. There is nothing in our experience in the last several years, nothing in recent inflation behavior, and nothing that one observes in the labor market to support that idea. Such a dramatic reduction of unemployment from an expansionary policy does not mean a one time increase of one percent in the inflation rate-it means a shift to a permanently higher plane of inflation. Furthermore, it would likely mean a period of ***accelerating*** inflation if the reduction in unemployment continued.

Third, we need to put the deficit problem behind us to increase public investment. As long as huge budget deficits remain, they will be used as a powerful argument against new spending. Putting that problem behind us, preferably with much more emphasis on revenue than on spending, is a prerequisite to discussing serious public investment initiatives.

Fourth, it is an arithmetic identity that net domestic investment equals net domestic saving plus foreign investment and that foreign investment is the mirror image of our current account deficit. This tells us that the United States cannot invest a larger share of its GNP without saving more or running a larger trade deficit. It seems to me that those of you who do not share my passion for increasing national savings must believe that: (a) the current trade deficit and level of investment are acceptable; (b) investment should be allowed to decline as the trade deficit shrinks; or (c) through expansion the United States can reduce its trade deficit and invest more. I don't believe that the latter is a live option. The economy simply can't expand enough to limit the trade deficit and maintain a satisfactory level of investment.

The United States cannot invest a larger share of its GNP without saving more or running a larger trade deficit.
-Lawrence Summers

YARDENI:

Let me start by giving you my optimistic scenario for the next five years, and then I'll tell you what sorts of policies are needed to make it happen:

One, as world trade expands and global competition intensifies, inflation should trend lower. I see it down to two to three percent by **1993.**

Two, real GNP should increase three percent per year on average over the next five years. If global competitiveness forces successfully keep a lid on inflation, then economy-wide recessions are less likely than in the past. In my opinion, a prerequisite for a policy-engineered bust is an inflationary boom-no boom, no bust. Rolling recessions that hit different countries at different times are more likely than economy-wide recessions.

Three, demographic forces related to the aging of the baby boomers should push the unemployment rate down to four percent within the next two years. Yet wage inflation should remain low as managements continue to cut costs in an effort to remain competitive in global markets. Labor shortages should stimulate faster growth in productivity, particularly in the services economy.

Four, capital spending should boom for the next five years, because the economy is doing well, capacity is tight, and labor is in short supply.

Five, consumer spending, which rose four to five percent during the first few years of the current expansion, should

slow down to two to three percent per year. The savings rate should rise to ten percent by 1993 as the baby boomers age.

Six, the government bond yield should fall to five to six percent during the next five years.

My most optimistic scenario... is achievable, in my opinion, if our policymakers follow a pro-growth agenda.
—Eward Yardeni

Seven, the trade deficit should disappear with the exchange rates around current levels as long as our trading partners continue to grow and to open their markets to imports.

Eight, the federal budget should be in balance in five years without tax increases because of better than expected growth and lower than expected interest rates.

This is obviously my most optimistic scenario. It is achievable, in my opinion, if our policymakers follow a pro-growth agenda. So far in our discussion not much has been said about free trade. I think encouraging free trade should be first on our policy agenda.

Free trade increases global markets and creates enough prosperity for all to share. It also stimulates competition, which helps to keep a lid on inflation. Europe is moving toward freer trade by 1992. The Canadians have joined us in a free trade zone. Japan is developing more ties with Asian newly industrializing countries. Consumption is growing at a faster pace in the Pacific rim nations and trade restrictions are gradually being removed so that American producers can share in the Asian boom.

We should do everything we can to promote these trends. Our trade representatives must persuade our allies to open up their markets at a faster pace. We do have reasons to fear Fortress Europe and mercantilism in Asia. These tendencies toward protectionism must be resisted, but not to the point of sinking into protectionism at home.

Policymakers should continue to permit market forces to regulate more of our economic activities. We should move towards more "market conforming" policies, to use the Japanese phrase. The Japanese assist their industries with market conforming policies, and we should do the same.

Consumption Binge

FAUX:

Barry, you say that we've been on a "consumer binge." Defend that statement.

BOSWORTH:

The private saving rate is simply income minus consumption. Net national saving is the sum of private saving plus government savings or dissavings. I agree with Paul's statement about not finding a correlation between private saving and the trade deficit, or a correlation between government saving and the trade deficit. Those are not the correct correlations. You don't see an association between budget deficits and trade deficits. No economist should have expected one. It was a shorthand in the 1980s to express the idea that the national, saving rate has declined.

The government deficit, government dissaving, is well-documented. But private saving has also fallen in the 1980s. The net private saving rate was running in the neighborhood of eight to nine percent in the 1950s, 1960s, and 1970s. It was on a slight upward trend. But in the 1980s it fell sharply in the first half of the decade. That alone was not a cause for concern for the reasons Bob Eisner gave. Capital consumption allowances in a recession are a sharply rising share of the national income and net saving would always fall in a recession. But now we are back to a fairly normal level of output and the private saving rate is still at six percent.

The government deficit, government dissaving, is well-documented. But private saving has also fallen in the 1980s.

-Barry Bosworth

If you look into the numbers, there are some reasons why that has occurred. A lot of it has to do with the behavior of the private pension system which accounts for about 1.5 percentage points of the decline. When all these funds became over-funded because of the rise in interest rates, corporations dramatically decreased their contributions into their pension funds.

When you do the analysis on a basis of consumption, as Paul did, you want to look at consumption *net* versus the *net* national income. On that basis, the private saving rate is down in the 1980s. If you look at individual years, you find lots of fluctuations but its decade-long average is down.

That the private saving rate is down a notch is not actually fundamental. The fundamental issue is that the national sav-

ing rate is down. The government can't do anything about the private saving rate. So I just take that as given in advocating a tighter budgetary policy. We need more public saving.

I agree with Bob Eisner's statement about investment, except for one qualification. We can do calculations that include human capital, education and a capital budget for the public sector. If you do those calculations, the issue of declining capital formation is worse, not better, because the big cutbacks in the government spending in the 1980s have been precisely in the areas of human capital and physical infrastructure. To emphasize that those are important parts of capital formation and national wealth accumulation is just to tell you that the 1980s were even worse, not better.

EISNER:

I'm not making the argument that the situation is necessarily good on national saving. The important point is to keep up national saving, correctly measured. You keep talking about cutting budget deficits, but what you're talking about is essentially preventive action to raise the national saving rate.

Why should businessmen invest more when you are cutting their consumer markets and you haven't expanded their export markets?
-Paul Davidson

DAVIDSON:

Why do you want less consumption? There are only two possible reasons. One is external debt, you think you're living beyond your export earnings. The other is to change the mix between investment and consumption.

If you lower the interest rate and keep GNP at the same level, what makes you think our imports are going to fall? If imports are related to income, just changing the composition of our domestic demand from consumption to investment shouldn't automatically change our level of imports.

Suppose you cut consumption and you lower interest rates and you haven't changed your export-import balance at all, why should businessmen invest more when you are cutting their consumer markets and you haven't expanded their export markets. Why do they need more capacity? If anything, they will want to cut back. Under these circumstances, you've got to show that even though interest rates are lower, there are more sales out there somewhere. Where do you get these additional sales? Overseas? In that case, you are talking about an exchange rate change, not a change in the domestic mix through reducing the deficit. You don't have to reduce the deficit.

Now, take these exchange rates. Hyman is right about tariffs. You can look at the specific commodities traded be tween the U.S. and the rest of the world. You tell me where by cutting exchange rates by another 20 percent, you will find the necessary import-export changes. I defy you to find the $120, $130 billion shift to get the trade surplus down to some reasonable number by any 20 percent fall of the exchange rate. The reason for the trade deficit is that foreigners are saving too much and we somehow must get them to spend more.

The exchange rates won't do it. One of the reasons why exchange rates won't work is, of course, because $55 billion worth of our imports, oil, are in dollar denominations. Part of the gain in our external balance is because the oil prices have dropped since 1985. It has nothing to do with the exchange rate and nothing to do with the J curve. Oil prices are about as low as they are going to get, if anything, they are going to go up and you are going to see worse trade problems. Today's statistics on Japan's balance of payments shows that Japan's exports increased last month including exports to the United States. Bashing is the way to do it, but not bashing just by the exchange rates.

SUMMERS:

The basic difference between Paul and me is that I think that prices and interest rates affect decisions people make. Obviously he does not. My proposition is that to improve America's economic situation, we have to change the fiscal-monetary policy mix so as to keep the GNP at current levels and achieve lower interest rates. Significantly lower interest rates would have two effects. First, businessmen would find more profitable investments because the price of money would be lower. Equivalently, people would find it more worthwhile to buy capital assets. The value of these assets would be greater because the return from those assets is higher when discounted at a lower interest rate.

To improve America's economic situation, we have to change the fiscal-monetary policy mix so as to keep the GNP at current levels and achieve lower interest rates.
-Lawrence Summers

Second, lower interest rates would make the United States a less attractive place for foreign and American investors to park their capital. This would cause the dollar to fall, which would in turn increase U.S. exports and would encourage substitution of domestic production for foreign imports. In short, lower interest rates would address two of America's major economic problems: inadequate investment and a huge trade deficit. If the U.S. were a small country with a

negligible effect on the world economy, then one would expect all of the effect on the trade balance. Because the U.S. economy is so large, changes in the U.S. interest rates will affect interest rates worldwide. As a result, lowering the U.S. interest rate will affect both investment and the trade deficit.

YARDENI:

Presumably, we want a high enough saving rate so we can have a high enough investment rate. But I don't believe that financial capital is unavailable for companies that need to build plants or to buy equipment.

It doesn't matter where the money is coming from. Money saved by the Japanese is just as good as money saved by Americans. I agree with Paul that one of the sources of imbalance in the global economy is that the Japanese save too much. But that is all right as long as they are willing to channel some of those savings over here.

The main reason we have under-performed in terms of the investment rate is we have had too many recessions; we haven't been able to sustain good solid economic growth for a long enough period to stimulate higher rates of capital spending. We must have policies that promote economic growth.

I don't believe that financial capital is unavailable for companies that need to build plants or to buy equipment.
-Edward **Yardeni**

Demographic factors can also explain our sub-par investment, saving, and productivity rates. When the baby boomers flooded into the job markets during the late 1960s and 1970s, they drove up the unemployment rate. Many of them found jobs, particularly in the services economy. Interestingly, virtually all of the slowdown in nonfarm productivity since 1973 can be attributed to the services sector. Service businesses expanded by hiring the abundant and relatively cheap new baby boom workers. They were also inexperienced so productivity suffered.

Real family incomes suffered along with productivity My response to economists who claim that we don't save enough is that we haven't had enough income to save! But now as the baby boomers age they should become more productive workers and they should earn more. So they will have more income to save and odds are that as they age over the next five years they will be more inclined to save.

So I don't believe that policymakers need to meddle with our saving rate or our investment behavior. If my demograph-

ic theory is accurate, then productivity growth should soon rebound. Capital spending should boom as labor shortages persist, especially now that the baby boomers are mostly employed. As family income rebounds along with productivity, the saving rate should move higher.

Capital spending should boom as labor shortages persist, especially now that the baby boomers are mostly employed.
-Edward Yardeni

Foreign Investment

KUTTNER:

It seems to me that what Paul and Bob are leaving out is the open economy If you don't worry about your domestic saving rate in an open economy, you're going to end up borrowing from the Japanese, or from whomever. They are going to end up owning real assets. So my question for Bob or Paul is, explain why the open economy is not the major fallacy in your logic and why Japan won't end up owning our whole industrial infrastructure.

DAVIDSON:

Senator Bentsen proposed legislation that would have solved this problem. If you are cutting your exchange rate and you still can't increase your exports, you have to cut your imports. The question is how to cut your imports against those who are oversaving to encourage them to get rid of their oversaving. Bentsen proposed that any country with an export surplus of 65 percent against the United States and 50 percent against the rest of the world would have a differential tariff placed against them vis-a-vis everybody else. So, they have to reduce their surplus by a certain amount to avoid the tariff. Now, what that involves, for example, is Japanese cars versus Brazilian cars. Brazilians have the sixth largest automobile industry in the world. Plenty of excess capacity there. They would love to sell us cars, but we're buying Japanese. Let's put a tariff on Japanese cars and force the Japanese to act. In other words, there are ways of getting them to save less. If they spend more, that generates aggregate demand and the whole global economy benefits. There are no reasons why we should accept their saving ratio as the ground on which we operate our economy.

*Only if you have **global full employment** does saving and investment act as a constraint ...**But** there's plenty of unemployment around the world.*
-Paul Davidson

KUTTNER:

Doesn't S still equal I?

DAVIDSON:

Only if you have global full employment does saving and investment act as a constraint. Then, you can't expand. But there's plenty of unemployment around the world.

EISNER:

Let me put a slightly different stamp on this. Import tariffs

are simply halfway depreciation. It's simply making foreign goods more expensive to you without changing the price of our goods abroad. Exchange depreciation will make foreign goods more expensive to us and will also make our goods cheaper to foreigners. The danger of an import tariff is obviously that other countries will levy them on us and we won't get anywhere.

Import tariffs are simply halfway depreciation... Exchange depreciation will make foreign goods more expensive, to us and will also make our goods cheaper to foreigners.
-Robert Eisner

But suppose we keep running a $150 billion current account deficit for five years. Is that going to be a disaster? It means we run up our foreign "debt" by $750 billion. With a four percent real rate of interest on $750 billion, our interest payments are $30 billion. $30 billion in an economy of $7 trillion (by 1994) is less than one-half of one percent per year. That means that after five years of the current account deficit, we've got ourselves in such a terrible position, in hock to the rest of the world, that we are then paying them less than one-half of one percent of our GNP. And if we keep going on and on with a trade deficit, we are adding less than one-tenth of one percent of GNP to our burden each year. And now against that, my colleagues are going to take their chances on raising unemployment or at least are willing to give up on lowering it any further. But each one percent of unemployment lowers GNP by about two percent, and certainly one percent of GNP.

What you are presumably worried about on a current account deficit is that foreigners are investing in the U.S., that is injuring the international net investment position of the U.S. Remember we are talking about net investment. We have heard over and over again *ad nauseam* that we are the world's greatest debtor nation. We are not. We are probably not a debtor nation at all. What you must do is to look at the *market* value of our investments abroad and the *market* value of foreign investments here. The BEA does not adjust the direct investment component to market value. As a result of that, there is over a $400 billion shift, once that adjustment is made, so that we are not a debtor nation. Now if the dollar falls in value as it probably will if we leave it free, and we still keep running a current account deficit, then what happens? The value of our assets abroad goes up in dollar terms. So we still don't get into a net negative international investment position.

YARDENI:

We should stop using the concept of a trade deficit. It is a

very nationalistic notion that may be outmoded in a world of truly global markets with free trade. Economic borders cover more territory than political borders. We have a large trade deficit because many American companies are producing American products overseas. If those companies sold these goods directly from America to foreign markets there would be no trade deficit today.

We should stop using the concept of a trade deficit. It is a very nationalistic notion that may be outmoded in a world of truly global markets with free trade.
-Edward Yardeni

Rather than fearing Japanese direct investment in the U.S., we should welcome it. That is one of the best ways to restore some balance in world trade. We want them to sell us Japanese goods that are made in America just the way we sell them American goods made in Japan.

Macroeconomic Policies Versus Structural Policies

KUTTNER:

Larry, why do we have to be satisfied with 5 to 5.5 percent unemployment and two to three percent growth? Europe and Japan in the 1950s and 1960s and the United States in the early 1940s had lower unemployment and higher growth. Given all the poverty, all the idle capacity, all the productivity gains to be made, why can't we do better?

SUMMERS:

I wish the unemployment rate could be lower. We could discuss whether there are structural policies in the United States which would enable us to have faster economic growth and lower unemployment without having higher inflation. We could discuss whether we could be more successful in targeting growth to areas where capacity utilization is low, or whether we can be more successful in intervening in price setting mechanisms to enable us to drive the economy more.

But that is not relevant to today's macroeconomic policy. My remarks were directed at the effect of macroeconomic stimulus in the face of today's institutions and today's labor market-in the absence of new structural policies. Some people believe that if you stimulate the economy, the new natural rate of unemployment will magically ratchet down to three percent. I wouldn't bet money on this. If we expanded the economy by that much, inflation would explode. For that reason, running large deficits to expand the economy is a bad idea.

If we want to prevent another recession, it's important to avoid the precursor of all previous recessions-inflation.
-Lawrence Summers

If one examines America's post-war economic history, it's clear that recoveries don't die of old age or lack of zip. Every recession has started because a recovery was murdered by the Federal Reserve; murdered because of a concern that inflation was starting to spiral out of control. To me, that suggests that if we want to prevent another recession, it's important to avoid the precursor of all previous recessions—inflation. That's why the risks associated with excessive expansion are not just slightly higher inflation.

MINSKY:

Institutions are important. Over the Reagan years, the rela-

tion between aggregate demand and wage changes has changed. What had been the inflation barrier at 6.5 or 7 percent unemployment has gone to 5.5 percent. I remember 3 to 4 percent unemployment with very little inflation. It depends upon society's institutions, not just the "numbers."

The aggregates work their way into prices and outputs through to the structural. The impact of the consumption boom has been misinterpreted entirely. Reagan misinterpreted it. We gave more disposable income to the rich; they spent it. They don't save necessarily. They're going to make their money, as Keynes used to love to point out, in capital gains. In this environment they don't have to save out of disposable income. This is a structural problem.

The consumption boom has been misinterpreted entirely... We gave more disposable income to the rich; they spent it. They don't save necessarily.
—Hyman Minsky

One of the sources of our economic problems is that Keynesian aggregate demand policies were introduced after structural solutions to the Great Depression. The interpretation of the Great Depression at the time of the Keynesian revolution was that prices had fallen too fast. It was a common belief that price deflation had caused the Great Depression. Structural barriers to price deflation in minimum wages, agricultural price supports, trade unions, etc., were put in place to prevent another Great Depression. But eventually those rigidities became vices that could be exploited. We gave up on antitrust after it was found that firms could be used for war production. In the post-war period we used aggregate demand management in a structural setup where monopoly power led to price increases.

Car firms have power, and they use it. Trade unions were not blameless. There was a shared monopoly by the auto unions and auto companies. Inflationary pressures developed out of that formula. What Reagan did was cut into one of the links-he weakened trade unions. On the other hand, he did nothing about the companies' monopoly power. Some of the things you're seeing in LBOs, etc., is the capitalizing of market power into stock prices.

SUMMERS:

Pendulums swing and it seems to me that it is overdue to return to discussing how to bring down the natural rate of unemployment. But the purposes of discussing what macroeconomic policy in the United States should be over the next two years, the intelligent assumption to make is that over the next two or three year period the structural labor market will be pretty much the structural labor market of today. But that is not why we are here.

Trade Deficit

TURNER:

Is there agreement that you cannot achieve foreign balance through the exchange rate alone, that both foreign expansion and a fall in the dollar are required to reduce the trade deficit without falling into a recession?

GALBRAITH:

I'm nearly as unconcerned as Yardeni and Bob Eisner with the strictly financial question of U.S. indebtedness. I'm much more concerned with developing and sustaining a global economic expansion for which the U.S. would be a prime supplier of advanced capital goods because that's where our export industries are concentrated. We can see our domestic investments sustained and validated if we can get that kind of world expansion. Part of the problem with getting an exchange rate that is suitable to U.S. competitiveness lies in the geographic distribution of our trade. In particular we could get, by some estimates, $30 billion in new exports to Latin America. But, if you look at Latin American currencies in relation to the dollar, there's no appreciation there at all, because those currencies are clearly not responsive to movements in global world interest rates. Rather, they are held down by the necessity for those governments to run large current account surpluses to make payments on their debt.

So there are measures that go beyond macroeconomic adjustments that are required to sustain our world growth in a balanced way and in a way which is favorable for a sustained expansion of U.S. exports. One of the reasons for enacting fiscal restrictions now and having them delayed in their effective dates, is that international lags are longer than domestic lags. We would not want restraint of domestic spending to come into play until after other countries' economies have had time to adjust.

There are measures that go beyond macroeconomic adjustments that are required to sustain our world growth in a balanced way and in a way which is favorable for a sustained expansion of U.S. exports.
-James **Galbraith**

However, even if you have a smooth expansion of this kind based in part upon a more rapid recovery of manufacturing, you are going to find that there isn't a happy medium of a moderate but stable growth rate, steady unemployment rates and a stable rate of inflation. There is an implicit assumption in some of the discussion that if we can get all the other macroeconomic variables right, you wouldn't have to worry about inflation, But for the structural changes to occur, the high wage industries would expand in the U.S. economy by

drawing labor in through higher wage settlements than in other industries. Therefore, we would probably see inflation increase even if we manage to pursue a steady expansion rate.

DAVIDSON:

The key question is whether the exchange rate change will keep that expansion going in Japan, West Germany and the other big oversaver countries. There is a two-part answer. One, if the dollar falls, one cannot forget the impact on Latin America. Most of their exports are dollar-fixed and they would have terrible problems servicing their debt if we allow the dollar to fall. How much more coffee will they sell?

Two, do we have to get the Japanese to buy U.S. goods? The answer is no. Let them buy from Latin America. In fact, if they don't want to buy and they insist on saving, let them give it away to the Third World in a Japanese Marshall Plan. Some of it will flow back to us, and to the extent we can get the Third World into the flow of Japanese purchases or Japanese gifts, this will be a plus on a world scale. It is not difficult if one starts to use a Keynesian approach.

I think falling exchange rates are more threatening than good. . . We're not going to [increase our export markets] by exchange rates alone.
—Paul Davidson

Are exchange rate falls good? I think falling exchange rates are more threatening than good. Again, look at the particular commodities and tell me where we're going to increase our export markets. We're not going to do it by exchange rates alone. If anything we're going to increase our oil imports in the next few years and the dollar price is going to go up. This is going to create worse problems with the exchange rate and that's going to create worse problems for Brazil, Argentina, and maybe Mexico. You really ask for disaster if you think you are going to do it by relative price changes. Relative income changes are so much easier.

EISNER:

I have more faith in the market than Paul does. Business will find where to sell. Brian's questionwas on target about global demand as well as the exchange rate reduction. Letting the dollar fall is going to force foreigners to look to their own domestic markets.

Further, I think Jamie is on to a basic point on the whole Third World issue that needs to be considered as part of our macroeconomic policy. We are holding down global demand in the Third World by insisting that they try to pay debts they can't pay And the sooner we recognize this, and write the

whole debt off or have a very easy settlement, the better for them and the better for us.

PRICE:

But we don't control the exchange rate. We do talk to the Bank of Japan and the others on the extent of their intervention. But I have been very dubious about our intervention affecting the exchange rate over the years.

EISNER:

The confusion is that you can't keep your own currency expensive but you can keep it cheap by buying their currencies.

BOSWORTH:

Sometimes, there is too much emphasis on points of disagreement. For example, I fully agree with Paul Davidson that there are two sides to this story. The U.S. has a very low national saving rate and some industrial countries' saving rates have stuck at amazingly high levels. Both are part of the international adjustment. But we're talking about what U.S. economic policy ought to be. The way to make the Japanese and the Germans do something is to put pressure on them and the pressure comes on them from the falling exchange rate as they start to lose export markets.

The way to make the Japanese and the Germans do something is to put pressure on them and the pressure comes ... from the falling exchange rate as they start to lose export markets.
—Barry Bosworth

Therefore, I couldn't agree more with Bob Eisner's statement that the whole key to this is to keep your hands off the exchange rate and let it decline as necessary.

I would agree with Brian Turner that if you try to get trade balance solely through an exchange rate effect, it's a very big plunge. One rule of thumb to use is that with price elasticities of unity, which is what studies have shown, to reduce the U.S. trade deficit by one percentage point of national income will require a ten percentage point fall on the real exchange rate on a trade weighted basis. When you are talking about the trade deficits that are in the range of three to four percent the exchange rate adjustment is very large.

This explains why we have had a trade deficit in the 1980s. Up to 1980, we could plan on the fact that the rest of the world GNP would grow at twice the rate of the United States. We also tend to have an income elasticity for our imports that is twice the world income elasticity for our exports. Thus if

the rest of the world grows twice the rate we do, but our propensity to import is twice the world's propensity to import our goods, the trade balance stays roughly the same, at constant real exchange rates. But that it isn't going to happen in the future. If you try to project growth for the rest of the world, you're just not going to get the productivity differentials and population growth differentials that would allow the rest of the world to grow at twice the rate of the United States. That means a declining real exchange rate for the United States. On the other hand, the effects of that on our standards of living are grossly exaggerated and we ought to keep our heads focused on American jobs. If the exchange rate has to fall a half or even a percentage point a year on a secular basis to maintain U.S. trade balance, that is not a big problem.

If the exchange rate has to fall a half or even a percentage point a year on a secular basis to maintain U.S. trade balance, that is not a big problem.
-Barry Bosworth

So the rest of the world is part of the adjustment. The more we can do in the rest of the world the less we will have to do in changes in the real exchange rates. But the key is we can't control their policies. We can't let our economic situation be dictated by their preferences with respect to budget policy or other policy

FAUX:

Does it matter if our investment is financed by foreign saving?

BOSWORTH:

It does make a difference on how the investment that Mr. Yardeni sees on the horizon is financed. The difference is who benefits from the income flow generated by the new investment. That is why it's not a good idea for a nation to consistently borrow overseas.

Budget Deficit

MISHEL:

I just want to go back to a simple question: Do we need to be at budget balance and when?

EISNER:

We don't have a budget deficit if you measure it correctly We had a $155 billion unified budget deficit in 1988. Take away net capital investment, working from OMB estimates, that subtracts $70 billion from the $155 billion deficit, and gets you down to $85 billion. State and local government budgets have a surplus of about $55 billion getting the deficit down to $30 billion. Then, there's an inflation tax of four percent-four percent of $2,000 billion of debt held by the public is another $80 billion. By this measure you actually have a surplus.

Let's look at another important measure. For any individual or business you look at debt in relation to income. The meaning of a deficit is that it adds to debt. The question is not whether we have a deficit as we're measuring it, but whether our debt is growing too fast. Is it growing faster or slower than income? The GNP is growing about 7.5 percent per year. The debt held by the public now is some $2,000 billion. Seven and a half percent of $2,100 billion is $157 billion. That is approximately our actual current deficit. Therefore our debt/GNP ratio is stabilized.

Now you can ask, is it stabilized at too high a level? Larry and Barry might say, "Well, it was much less than that eight years ago." But it was much more than that 40 years ago. So now the question is, at what level do you want it stabilized? Answering that question comes down to addressing the impact of budget actions on unemployment and growth, on saving and investment correctly defined.

We don't have a budget deficit if you measure it correctly.
—Robert Eisner

The fundamental difference is on what we accept as full employment. What some of my colleagues have accepted as full employment seems to me to be much too easy a position.

We never have had, except in war time, an excess demand inflation in this country. To keep talking about inflation is to play into the hands of all of the people who for the 200 years of our history fought for tight money; fought for fighting inflation regardless of the impact on real output or the impact on working people.

I could ask Larry and Barry what they were calling the so-called natural rate of unemployment four or five years ago. Most of my colleagues at that time said 6.5 percent, some 7 percent. The whole concept is one of the most outrageous things we have developed in economics. It has no empirically sound basis. It shifts with every supply shock. What was your natural rate four years ago, Larry? Barry? I bet it was above 5.5 percent and if it was above 5.5 percent, how confident are you that 5.5 percent is the natural rate now? How many millions of the unemployed, how many hundreds of billions of output do you sacrifice on this faith that somehow we'll have more inflation?

SUMMERS:

Bob, have you ever favored *at any time* a policy that was not more expansionary?

EISNER:

It's a remarkable leap of some economic theorist's imagination to assume accelerating inflation at current unemployment levels.
--Robert Eisner

I have never favored less expansionary fiscal policy, except during the Vietnam War. It's ironic that it took a Vietnam War to get us 3.5 percent unemployment in this country. Are we always to be doomed to say that the only way to get unemployment to 3.5 percent is to have a war? And that war drove inflation to an astronomic height. What was it-four or five percent? And that level only in the last year. We have no basis for concluding that it was accelerating. It's a remarkable leap of some economic theorist's imagination to assume accelerating inflation at current unemployment levels.

GALBRAITH:

We need a tax increase package for two basic reasons. First, to nail down the Federal Reserve and get a commitment on monetary growth and lower interest rates at the earliest possible time. And second, to get the deficit off the table in the United States Congress, so that it will not stand as a barrier to increasing public capital formation. The size of that package should aim to give you a deficit in the range of two percent of GNP. This range, for some of the reasons Bob has given, corresponds to a stable debt/GNP ratio. The final deficit you actually achieve will depend on how successful you are in reaching the sustained global growth your program is designed to achieve.

FAUX:

Under your formulation, when we could begin making those public investments?

GALBRAITH:

From the moment you have a tax bill signed into law which puts a definitive deficit target into the forecast. You, then, can move to the next item on the agenda. The deficit no longer obstructs thinking clearly about the kinds of investment activities that we need to undertake.

DAVIDSON:

Jamie, if you have postponed income tax raises, you will see income switching between years. It will generate tremendous growth in the first year but as soon as the new tax comes in, there would be a sluggish economy.

GALBRAITH:

I am not terribly concerned about that problem.

MINSKY:

We finally got down to keeping our eye on the right targets, which are employment, growth, price levels, etc., rather than the budget issue *per se.* Maintaining aggregate demand, maintaining the U.S. deficit is a way of maintaining profit rates. Profit rates tend to be good for investment.

The big task is to maintain the linkage among profit-generating aggregate demand thrusts. The problem today is the trade. It is partly structural. We have had a 40 percent swing in the exchange rate. But while we have had a rise in the dollar supply price of Japanese cars, you haven't seen a 40 percent swing in relative prices in the U.S. Obviously, it has something to do with the structure of the automobile industry of the United States.

In terms of the natural rate of unemployment, the Reagan Administration labor policy was one of the reasons we had this shift downward in the noninflationary unemployment rate in the labor market. One cannot talk macro and micro policies in two separate compartments. One of the things to discuss is how to have a full employment policy without it being the type of full employment which generates inflation.

One cannot talk macro and micro policies in two separate compartments.
—*Hyman Minsky*

In the 1950s and 1960s we did have appreciably lower unemployment rates and lower inflation rates than we have now. The stronger trade unions did not lead to excessive wage increases.

We cannot ignore the financial implications of the deficit in trade and the ownership of dollar-based assets throughout the world. The Japanese aren't the largest owners of foreign assets in the United States. The British are. There has to be a distinction between the negative trade relation effect and international portfolio diversification. The British ownership is portfolio diversification. They purchase here, they purchase there. Their portfolio diversification is consistent with owning more U.S. and foreign assets. The Japanese direct investment here, on the other hand, has a negative trade relation effect.

FAUX:

What is your answer to Larry Mishel's question?

MINSKY:

The fiscal deficit is operational. If the only way we can maintain full employment is with a large fiscal deficit, then it stays. If you have enough private investment and your exports are up, then you don't need the fiscal deficit.

If I were a politician I wouldn't go out front for taxes to reduce the deficit. I would go out front for measures that would reduce our import dependence. In turn that would enable us to get along with less fiscal stimulus. Therefore, the fiscal deficit could come down.

I would welcome the opportunity to run a budget surplus.
—Lawrence Summers

SUMMERS:

My target would be a balanced budget by 1993, based on the economic assumptions made in current CBO forecasts. If the economy underperforms that forecast, I would accept slower progress. While it is quite unlikely the economy would perform better than that forecast, I would welcome the opportunity to run a budget surplus. This would move us closer to the goal of removing the Social Security Trust Fund from the consolidated budget.

EISNER:

I wonder how many around this table want to see the

private business sector balance its budget and how many want the household sector to balance its budget? And let me remind you that by conventional accounting, you're going to see that almost all private business is in deficit. What's so important about balancing the government's budget? You don't want to balance the business budget the same way.

I wonder how many around this tab/e want to see the private business sector balance its budget.
-Robert **Eisner**

YARDENI :

Coming from Wall Street I suppose many of you might expect me to say that the budget deficit is too large and that *we* must cut spending or raise taxes. Actually, the moaning and groaning you hear from New York seems a bit strange to me since many people on Wall Street make a good living selling the government's bonds.

So I guess I must confess to a certain conflict of interest when I'm asked to comment on what policymakers should do about the federal deficit. Again, my instincts are to recommend that less policy is better than more policy in this area. I just can't seem to understand why there is so much hysteria about. the so-called "twin deficits." I mentioned earlier why the trade deficit doesn't bother me. I believe that better than expected growth will reduce the federal deficit. Indeed, it should be in balance within five years. But even if it remains $150 for as far as the eye can see, so what? Relative to a growing GNP, the deficit will become a smaller and smaller problem, that is if it really is a problem.

I'm not convinced that'it is a problem at all. Economists say that government expenditures are roughly 20 percent of GNP That sounds like quite a lot. But the number adds apples and oranges. The government's spending actually accounts for eight percent of GNP, and most of that is defense outlays. This ratio has been on a downtrend since the 1950s. The government has been crowded out of GNP! Government outlays on transfer payments account for the remaining 12 percent.

If we really want to eliminate the trade deficit, it is within our power to either raise taxes or to cut spending. But maybe, just maybe, we currently have the best system and we don't even know it. Higher taxes might depress economic growth. Today's low taxes are probably having the same very positive supply-side effects on people's work ethic. Do we want to cut transfers? Here again, workers are probably more productive knowing that there are safety nets in our society to help them or their relatives if adversity strikes. How pro-

ductive would you be if you had to worry about taking care of your relatives if they became ill or lost their income?

DAVIDSON:

There is a difference between the saving rate and absolute saving. We usually think of saving as a portion of income, a saving rate, but the Japanese increased saving by their income expanding as the world income expanded. So the absolute size of saving increased even though as a percentage it may not have. The same thing is true in the United States in reverse.

If we can get a more locally stimulated economy and get the surplus countries spending more, you'd get more absolute saving even if you don't change the saving ratio.' Now, if you look at United States statistics in the last year, the unemployment rate has fallen to about 5.5 percent. Where did this come from out of the GNP? Consumption is still 65 percent of GNP as it was since 1982. The government share has fallen almost one percentage point and the exports, the net export shares comes to almost one percentage point more. So what's happened is that much of our growth in employment and output has occurred because of the changes in the world growth rate.

The Japanese hooked on to an expanding world GNP to increase their saving. That's what we've got to look for, not for changing the saving ratio within a constant world GNP.

-Paul Davidson

This is not a result of the exchange rate falling. Not that relative prices have no effect, but when you think of the 40 to 50 percent decline in the exchange rate the increase in exports is pretty small. You're not going to close a $120 billion gap by the exchange rate. But the Japanese hooked on to an expanding world GNP to increase their saving. That's what we've got to look for, not for changing the saving ratio within a constant world GNP.

EISNER:

I do find a connection between the budget deficit and the current account deficit. Budget deficits over the whole period from 1955 to 1984 were associated with increased current account deficits. Also, easier monetary policy tended to reduce the current account deficit. Now the lesson of this is that you're going to get a reduction to the current account deficit through reducing the budget deficit precisely by reducing our GNP and our demand. Americans will buy less. They will buy fewer Toyotas, fewer Mercedes, but also buy fewer Chryslers and fewer Buicks. The trade deficit can be cured in a year or so with a big enough recession.

KUTTNER:

Reducing the current fiscal deficit in order allow increased capital formation is well worth any risks on the downside. We are not talking about very large share of GNP, only $30-$35 billion a year over the next three to four years in a $5 trillion economy. The recession risks are real but are far exceeded by the need to restore a program of public investment on the order of $50-$100 billion a year.

EISNER:

First, if a policy is wrong, it's not going to get anywhere. Secondly, the deficit is already down as a percentage of GNP. The thing to focus on is do we want new taxes to finance public investment or do we start switching resources from the military to public investment.

DAVIDSON:

According to the Federal Reserve in St. Louis, another reason not to cut the federal deficit is that state governments are going to be cutting their expenditures.

McGARRAH:

The state and local fiscal situations are very serious. States that were doing fine a short while ago are now in crisis. On another issue, Jamie and Ed spoke of nailing down the Federal Reserve, how can we do this?

EISNER:

There is more hope in nailing them down than you think. That's where we should be putting our pressure. We need to insist on an easier monetary policy. Get the Fed to act. Boskin and Bush may be easier to move in this direction than some of the Democratic congressmen. The Administration is not going to have a tax increase and they can see the importance of looser monetary policy.

You're going to get a reduction to the current account deficit through reducing the budget deficit precisely by reducing our GNP and our demand.

-Robert Eisner

The Hard Landing Scenario

KUTTNER:

I want to get back to Hyman and ask if he is a basher or a crasher in relation to Japan.

MINSKY:

When people ask about bashing Japan, I ask, what actually do you want to do? You can threaten them with quotas, fewer imports. You talk or negotiate and you find that after awhile you may get something. In truth you may get very little.

I think there is room for tariffs. I don't find tariffs to be a problem for countries that have large holdings of international assets. They are not constrained in their fiscal policy the way countries are that have no such holdings of international assets. Deficit countries without international assets can't act unless they are willing to see their currency plummet. Even if you are willing to see your currency plummet you still have a problem. Is the rest of the world willing to buy assets denominated in your currency? If not, you have to denominate your liabilities in their currency. Then when your currency plummets, you have the Mexican situation, where it has become impossible for Mexican private business to borrow. The currency collapse makes things worse rather than better.

Countries have a right to protect themselves against creditor surpluses . . . There's nothing wrong with protecting your citizens and your 0 wn domestic prosperity.
—Hyman Minsky

One of the problems of being in our position is whether the Japanese are going to say, "If we are lending it to you, it has to be in yen." We could face the Mexican dilemma if the Japanese insist on lending in yen.

Basically when a country has fiscal independence like Japan and Europe have now, they've got to take greater responsibility for sustaining their own aggregate demand by domestic demands. Countries have a right to protect themselves against creditor surpluses because they are interested in their own employment, their own gross national product, their own structure of industry. There's nothing wrong with protecting your citizens and your own domestic prosperity.

EISNER:

The Keynesian lesson is that you did not have to protect yourself that way You just kept up your demand.

MINSKY:

You kept up your demand but you didn't like to see your demand go abroad.

BLACKWELL:

Before the National Economic Commission recently, some economists testified that we are in for a very hard landing in the U.S. economy unless there is a major change to reduce the budget deficit. Are they right?

The collapse scenario is hard to make sense of.
-James ***Galbraith***

GALBRAITH:

The collapse scenario is hard to make sense of. I don't quite see the consistency between a collapse in the dollar and a rise in interest rates in the U.S. at the same time. It seems to me the latter would prevent the former.

What they are getting at is a scenario in which there is a collapse of confidence of international capital in the United States. The subsequent attempt to defend the dollar in face of that event would then plunge the U.S. and the world economy into a recession.

Savings and Foreign Borrowing

KUTTNER:

I want to put this question to Hyman Minsky because I am most persuaded by what he says.

let's talk about what it takes to generate productive investments in this country.
—Hyman Minsky

Two historical examples. The U.S., in World War II, had a very high personal saving rate which was consumed by a very high government borrowing rate, much of which was invested productively. So you had both the demand side stimulus and the supply side stimulus. You had gains in productivity You had gains in real wages. You had high private saving, and high government borrowing.

MINSKY:

And the Office of Price Administration.

KUTTNER:

Right. And price controls and all kinds of institutional arrangements.

MINSKY:

Which forced saving.

KUTTNER:

After the war the countries who did the best had very high saving rates, high productivity growth, high growth and an occasionally fairly high public sector deficit which could be funded internally by the high saving rate. Now come back to the U.S. in the 1980s which has had so-so investment rates, so-so productivity growth, much of which has been funded externally. In an open economy, in order to grow at a reasonable rate, don't we need a higher saving rate internally than we now have? Can you really get a kind of pure, ultra-Keynesian system where somehow the saving rate is merely the residual of high growth and not the engine of high growth?

MINSKY:

The debate has been changed. The debate has changed *to* determinants of saving out of presumed full employment income from the determinants of productive investment in the economy, and how this productive investment will gener-

ate the saving that will offset the investment when you finally draw up the accounts of the period. What's happened is we've switched from the Keynes and Kalecki-Kaldor world in which investment called the tunes and the distribution of income between profits and wages took care of saving, to a world where everybody can borrow to finance consumption so that swings in debt-financed consumption affect saving. We've changed to a world where everybody can create money by using plastic, where getting into debt has become much easier. A country on the front line of that debt revolution may find that generating the investment that provides a rapid rate of growth will lead to historic inflation pressure through aggregate demand.

Let's talk about what it takes to generate productive investments in this country. Then ask, what does it take to have this productive investment financed so that the productive investment will stay productive investment. What is a financing structure which avoids a blowup in aggregate demand that results in open-ended inflation?

BLACKWELL:

It is commonly argued that the budget deficit, by claiming a large portion of savings, is causing the trade deficit. Is it not possible, as some economists in the Cambridge school maintain, that the causation runs the other way? Is it not the case that savings and tax revenues that would otherwise have been produced in the U.S. by the Reagan tax cuts accrued instead to our trading partners as a result of the current high propensity to import, leaving us with slow growth and simultaneous budget and trade deficits? Is not faster growth the best way to balance the budget deficit and provide the funds for increased investment?

[The] view. .. that we could expand the economy very substantially, and that investment will create its own saving or that trade will create its own saving ... was an instructive doctrine in 7933, but not now.

-Lawrence Summers

SUMMERS:

There are two arguments that could provide legitimate justification for not being concerned about the problem of U.S. saving, and it's important to keep them separate.

One is what I would call "Keynesian happy talk," and that term is consciously disparaging. This view says that we could expand the economy very substantially, and that investment will create its own saving or that trade will create its own saving. That was an instructive doctrine in 1933, but not now. This is my understanding of the argument of Paul Davidson, and British economists like John Eatwell. It is an argument that Bob Eisner moves close to.

The argument is that with all these unemployed resources, if you just invest, people will be richer. People will invest more and we will have more saving.

Even with the most optimistic assumptions, to claim that we can generate a substantial increase in saving through this line of causation is absurd. Even if the United States could reduce unemployment rates to 3.5 percent and increase GNP growth by five percent, and even if the United States saved a third of the increase in GNP, this would still only increase savings by 1.5 percent. That would mean the difference between a net national savings rate of 2 percent and 3.5 percent. That's nothing. If we can do it, great. But that was based on what are clearly extraordinarily optimistic assumptions about how far we could push the economy with the current institutional structure. You can't solve the savings problem with feasible amounts of demand expansion This is not 1933.

The second and more serious argument, which Bob Eisner raised this morning, is that there's nothing wrong with using foreign capital to finance our investment. I call this the "capital flows are OK" argument. According to this view, we want machines in America to create jobs and make our workers more productive, not so that rich Americans will earn profits from owning those machines. It doesn't really matter whether my apartment is built by Donald Trump or by the Sumitomo Bank, as long as there's housing for Americans. Trade in capital is no better or worse than trade in anything else. There is nothing wrong with the U.S. as a low saving country to borrow heavily from others to maintain a particular rate of investment.

[The argument that] we can increase savings by stimulating the economy. .. makes no sense because the numbers don't add up.
-Lawrence *Summers*

This line of reasoning is at least plausible. The questions one would then ask are, "How long can this continue?" and, "What are the risks and instabilities that go with that course?" The answers to these questions may change one's mind about the advisability of borrowing heavily from abroad.

It's important that we be clear about these different arguments. One says we can increase savings by stimulating the economy. Even with wildly optimistic assumptions, this argument makes no sense because the numbers don't add up. The other says that we can borrow from abroad to finance our investment. This strategy makes me nervous, but I can at least understand it.

MINSKY:

It isn't whether Trump or the Japanese build the apartment

building, but who owns the mortgage. Whether it is a Japanese bank and a Japanese pension fund that holds the mortgage or a U.S. bank and the U.S. pension fund that holds the mortgage. It's no different than when Harvard invested its pension endowment in California mortgages rather than in New England mortgages. The problem is that the California-New England imbalance is eventually solved by New Englanders migrating to California carrying their portfolios with them.

PRICE:

Larry, wasn't one of your arguments tied to the cost of capital from borrowing from abroad?

SUMMERS:

Our level of borrowing affects the cost of capital in three ways. One, we're a large country So when we are not saving, it reduces the supply of capital worldwide and raises the cost of capital worldwide.

Two, while capital is mobile in the global world economy, it is not perfectly mobile. There are large pools of domestic saving that inevitably find their way into domestic investments. That's true both here and in Japan. That's why the price of office buildings in Tokyo is bid up 60 times one year's rent, whereas it's ten times one year's rent in New York. A high saving rate in a country spills over into a low cost of capital in that country.

The third effect, which I tend to discount, is that when we borrow heavily from abroad it strains the willingness of foreigners to hold American assets, and that too raises American capital costs.

*A high saving rate in a country spills over into a low cost of capital in that **country.***
-Lawrence Summers

Public Investment

FAUX:

Some people have suggested that returns to the economy from investing in the public sector might be greater than returns to investment in the private sector. Is part of the solution to increasing our growth rate increasing investment in the public sector?

EISNER:

I also have results indicating greater productivity not merely from public investment, but from intangible investment in general. It is very important to broaden the scope of public investment discussion. Certainly, bridges, roads, harbors, airports, and preserving natural resources are investment, but to an economist investment is any economic activity that contributes to future productivity.

There is nothing greater to bolster future productivity than basic research and education. Education is overwhelmingly publicly financed. The productivity changes from trying to increase the conventional saving rate are trivial compared to the potential gains from education. That's where the potential productivity growth is.

There is nothing greater to bolster future productivity than basic research and education... The productivity changes from trying to increase the conventional saving rate are trivial compared to the potential gains from education.
--Robert Eisner

A sensible administration would push for huge public investment. I estimate your whole total tangible private capital stock (largely what we call business capital-business plant and equipment) is something less than 20 percent of the total capital stock on a cost basis when it includes education. We have to get away from the current focus on private investment which reflects a curious ideological bias in our economy. I'm not anti-capitalist, but all people ever think of when speaking of investment is private investment.

My big quarrel with Larry is that I would let people save as much as they want. The Japanese are a young population so they have to save more for their retirement. With growing income, you can save more. So, fine. But there's no reason why we should save any more than we feel like. What we call government saving is very much beside the point. The question is what is government investment. The one form of investment that we can make a social decision on is public investment. We're not making a good decision now.

SUMMERS:

It's obvious that there's a need for more public investment. But it is possible to exaggerate the magnitude of that need. No one seriously questions that the American educational system is terrible. Half the teachers are retiring in the next decade, and people are less attracted to teaching because of the low salaries, so there is room for more money to be constructively spent. But it would be a big mistake to think that the education problem was entirely or primarily a matter of not enough money. I also don't question the need for more investment in infrastructure. But if public investments are needed, one can raise taxes to finance them. It's only a matter of when and by whom those investments are paid for. In a world free of political constraints, there is no reason why decisions about public investment and the deficit have to be linked. We can pick a budget deficit target based on an appropriate stabilization strategy, and prudent levels of private investment and borrowing from abroad. Then we can decide on the right level of public investment, and raise taxes to finance it.

It would be a big mistake to think that the education problem was entirely or primarily a matter of not enough money.
-Lawrence Summers

In the real world, political considerations are very relevant. There are two possible approaches if one believes that encouraging public investment is an overriding priority One is to minimize the importance of the deficit problem. Advocates of this approach believe that it is better to raise taxes to finance them, but that public investments are so important that they should be made even in the absence of a tax increase. The alternative strategy is to eliminate the budget deficit as the central economic issue. By raising revenue and reducing defense spending, we can return to the situation prior to 1981. Before 1981, a five-year forecast always showed chronic budget surpluses, and Presidents could think about how they were going to spend that money constructively

My reading of the political process is that putting the deficit behind us is likely to lead to more public investment over the next ten years than an approach which tries to minimize the deficit problem.

GALBRAITH:

I agree. Put the deficit behind us. As a political matter, it is the essential first step. That means setting out the appropriate course for deficit reduction.

KUTTNER:

Two points, both political and real-worldly If you follow Jamie's or Larry's strategy and establish a deficit reduction path, you shouldn't have to wait until 1993 or 1992 to start increasing your public investment. There's a charming quirk in the Gramm-Rudman law that lets you increase new outlays at the margin if you finance them in the same piece of legislation. You can be doing that on one track and you can be having deficit reduction on the other track. That I think makes good public policy sense.

MINSKY:

A dedicated tax?

KUTTNER:

It doesn't have to be. For example, in the welfare reform bill last year, Senator Bradley wanted $1 billion a year for day care and training. To avoid a point of order under Gramm-Rudman, they proposed that anybody who makes over $200,000 can't deduct entertainment expenses. And everybody dodged under their desks. But that quirk in Gramm-Rudman, which requires any new proposed program not to bust the budget guidelines, allows for creative loop-hole closing to finance new programs. It allows you to juxta-pose the welfare mother who's going to get trained versus the guy who's going to deduct a $100 lunch. It's very good politics. It allows pay-as-you-go spending on the margin for new programs with or without dedicated revenues.

Put the deficit behind us. As a political matter, it is the essential first step.
*-James **Galbraith***

DAVIDSON:

Do you want to lower total consumer expenditures?

KUTTNER:

Separate and apart from your debate with Larry about whether a deficit reduction is necessary and at what rate, it's also possible to take a dollar out of the private sector, put it into the public sector and make it deficit-neutral to increase spending.

DAVIDSON:

What about Ronald Reagan's last speech where he said, "If you allow them to tax more, they'll spend more."

KUTTNER:

That's the point. Yes, tax and tax, spend and spend, absolutely.

You shouldn't have to wait until 1993 or 1992 to start increasing your public investment.
-Robert Kuttner

Social Security

FAUX:

What about the Social Security surplus? Does it have a role to play in increasing investment? Should we segregate Social Security from the budget debate, as Barry suggests?

Any society that's aging and doesn't want to increase the burden of its own retirement on future generations, increases its saving.
-Barry **Bosworth**

SMITH:

The argument that somehow removing the trust fund from the consolidated budget is independently valuable is rooted in the following logic: we don't know what to do about private saving yet we have a saving problem. We need, therefore, a trick, because we can't increase private saving. So let's segregate and separate Social Security. We really can't.

BOSWORTH:

We sure can. If you can segregate out my private pension fund from the federal budget, you can segregate my public pension fund. Just because this pension fund is run by the government doesn't make it any different than any other pension fund.

SMITH:

We are going to continue to finance whatever public deficit we run by issuing treasury bonds and purchasing them with the proceeds that are going into the Social Security trust. The real issue isn't whether that trust fund is separate, the real issue is the total level of the public deficit. Solving that problem is the only way to increase the national saving rate. We will not do it by segregating the trust fund, but only by decreasing the consolidated deficit. One doesn't yield the other. One may help grease the political process, as Gramm-Rudman greased the political process. But I am not looking at the political process.

BOSWORTH:

Either you can try to tell the public that in the old days you had a budget target of balance, but now because the budget includes two percent of national income in the form of the Social Security surplus-a retirement fund, the appropriate budget target is a two percent surplus. Or you could explain it in terms most people will understand. You don't want to spend on consumption income that you are accumulating or

saving for retirement. The argument is easier to explain to people if you do accounting the way state and local governments do. They exclude the private pension funds, and the public sector workers would be outraged at the suggestion that you could raid those funds to pay for public services.

Any society that's aging and doesn't want to increase the burden of its own retirement on future generations, increases its saving. If you have an optimal saving rate, it's a function of the society's demographic characteristics. We know the baby boom is going to retire. Nobody is suggesting a fully funded Social Security fund, we are talking about a partial fund. It just turns out that the amount of this fund is the amount of saving that will generate the increased capital that will generate the increased income to future workers that will pay for the increased costs of Social Security caused by the demographic shifts.

Other countries worry about this all the time. The Japanese justify their high saving rate because they see this coming down the road. Separating Social Security is not just a gimmick. It says what you do in a society where we have been used to steadily getting younger, and is now steadily getting older, is important.

The issue is not investment here but saving here. If you're saving was invested overseas, it wouldn't matter to you. You would receive the same income. The issue has nothing to do with investment. The issue has to do with the accumulation of wealth and the income from that accumulation.

The issue has nothing to do with investment. The issue has to do with the accumulation of wealth and the income from that accumulation.
--Barry **Bosworth**

SUMMERS;

Granting that proposition: is it the level of American saving or the level of American investment which matters? In an open economy, there is still a difference between the two. The argument that Barry was making is that capital is paid its marginal costs. If you invest an extra dollar, capital is paid the extra output it generates, so that everybody else is left indifferent. In that simple case, it doesn't make any difference whether the investments take place here or abroad.

That view should be qualified by two considerations. First, if we're not considering a small increase in investment, but a 25 percent increase in U.S. capital stock, then capital will not capture the whole benefit or output of that 25 percent increase. Labor will get some of that output. To that extent, we care about investments that take place in the United States and not abroad.

Second, in a world in which capital is taxed, investment flows will be determined by after-tax rates of return. Social benefits from investment are determined by pre-tax rates of return. If the US. taxes capital at a higher rate than the rest of the world, we should prefer to have investment here rather than abroad.

BOSWORTH:

You just said that old capital will lose because it is no longer the scarce factor. And workers will gain. There's a redistribution between old capital and workers. But the return to society as a whole of the investment is the same. If capital investment takes place here in the United States, it will depress the rate of return on old capital. Those capitalists don't like that. They will lose. And American workers will gain because capital is relatively more plentiful. But that's just a redistribution between the three groups of society, owners of new capital, owners of old capital and workers. What you want to compute is the social rate of return to all of society To a first approximation the percentage output gain to society of a given percentage increase in capital is invariant to the size of the capital stock or its underlying rate of increase.

If capital investment takes place here in the United States ... American workers will gain because capital is relatively more plentiful.
--Barry **Bosworth**

GALBRAITH:

Following that point, Barry, then you have domestic factors capturing some of the return on foreign investments. So that it does not follow that the Japanese are getting the full benefits of their increased saving.

BOSWORTH:

American workers should want that investment here and American capitalists should not want that investment there. The issue is which will become the scarce factor, labor or capital.

SUMMERS:

It is true if a huge pool of capital comes here, all that capital will be paid the marginal price in the presence of the last bit of capital. The return to America will include all the inframarginal return and that will be captured by Americans. To that extent, we would rather have the investment take place here.

DAVIDSON:

With a 25 percent change in the capital stock within a period of time, under the law of diminishing returns you are going to argue marginal productivity theory? Heavens!

It** does **not follow** that the Japanese **are getting the full benefits of their increased saving.

-James ***Galbraith***

Monetary Policy

> *The federal Reserve should target GNP. The exchange rate is going to have to go down for this to be effective.*
> *-Barry Bosworth*

FAUX:

How confident are we that we can cut the fiscal deficit and offset the fiscal contraction with monetary stimulus? It is interesting to me that people are quite clear about their fiscal policy goals-for example, how much they want to cut the budget deficit-but less clear on monetary policy goals. For example, what interest rate target are we talking about?

EISNER:

We don't really know how much monetary offset you need which is why I keep insisting on getting the monetary reduction first. Don't take your chances, precisely because none of us can guarantee how much easing is needed. We have been arguing for 30 years on how much impact you get from monetary versus fiscal stimulus without a clear resolution of the picture.

BOSWORTH:

But I think the way we would normally want to go on monetary policy is not in terms of an interest rate target. Just as years ago, we argued that we didn't want a money supply target. What you want is to try to maintain the growth of GNP along the same full employment path. The Federal Reserve should target GNP. The exchange rate is going to have to go down for this to be effective. Yes, there will be a small reduction in the American standards of living as a result of reduced items of trade, but it will be overwhelmed by the jobs that will be created in the manufacturing sector and the improved opportunities in those sectors.

FAUX:

Do the jobs get created from trade through the lowering of the exchange rate or from investment through lower interest rates, or both?

BOSWORTH:

Little of it, this time around, will be in the investment area. The big push will be in the trade sector. Timing is very important because of the lag of trade flows behind the exchange rate change. On the existing empirical evidence, the major impact in the real terms won't hit until at least a year

later. So you have to act way ahead of time on monetary policy. That's why most people have said, don't try to do this overnight. I think a maximum tolerable speed on deficit reduction is something in the range of $30-$40 billion a year. And if Bob Eisner turns out to be right and we see the economy faltering, I'd step back.

Ultimately what we are talking about is that we should try to move on a path with a plan. If it's not working because we don't know the precise mechanism, back off. To say it might not work and therefore we're not going to try, would give up all the enormous long term benefits of restructuring the U.S. economy towards a high investment, export-oriented economy.

EISNER:

Barry and I almost agree, but I bet we won't. I'm not going to tell you that the $20-$30 billion deficit reduction will cause a recession. Only, it increases the risk of one. Because Barry said he wants the Fed to be committed to a policy of full employment and growth, I want to ask, at what definition of full employment and what definition of growth? You've got 5.5 percent unemployment official measure, 2.5 percent growth. Is that what you're satisfied with?

BOSWORTH:

No, but I also recognize that in our profession there's enormous disagreement over this. I remember going through another episode of the 1960s in which people, on the one hand said, don't worry about inflation-keep on going. And those, on the other hand, who said the policies would be inflationary

The biggest danger to sustained expansion is an outbreak of inflation that triggers the Fed with another restrictive policy. I'm willing to keep the unemployment rate temporarily right around five percent a year and see if inflation develops. If not, then we can move ahead with a lower rate of unemployment even without job training programs. But about four to five percent unemployment we will need to get into some upscaling, job retraining programs to equip the labor force to adjust to a lower level of unemployment. Macroeconomic policy can not do it alone.

I'm willing to keep the unemployment rate temporarily right around five percent a year and see if inflation develops.
—Barry Bosworth

I do see some merit in Jim Tobin's argument that keeping the labor market tight (but not so tight that you get wild

inflation) will stimulate a lot of private sector activity to train workers. But here again, that calls for a pause. You want to get the market tight to encourage training, but not shoot past it to the point where you start to generate future inflation pressures. You want to keep it just tight enough to keep job training programs in the interest of employers.

GALBRAITH:

The question of how much mileage you get out of monetary stimulus usually comes up in the depths of a recession. Then you have a lot of excess capacity in construction, and there is a pent-up demand for housing, automobiles, and consumer durables. In those circumstances you get fairly rapid recovery of domestic demand in response to the reduction of interest rates. That's probably not as true in present circumstances. We've had five years of growth and fairly high capacity utilization in those industries. Since 1985, we've seen that a further round of monetary easing does produce a very substantial response on trade. That's encouraging. There is probably room for a third round of monetary easing which will have still more effect on the trade picture.

It probably needs to be supplemented by measures to reach parts of our trading world which are not strongly affected by changes in our exchange rate. First is the question of the Latin debt, Second is the threat relationship which we have with Europe and Japan over their internal macroeconomic policies, for which the exchange rate and our willingness to let it drop is an excellent weapon. And third, we should think in terms of taking advantage, to the extent possible, of the emerging export markets to the Soviet Union and China.

Monetary easing does produce a very substantial response on trade. ..It... needs to be sup plemented by measures to reach parts of our trading world which are not strongly affected by changes in our exchange rate.
—James Galbraith

Military Spending and the Language of Macroeconomics

FAUX:

One of the problems is that the language of macroeconomics tends to confuse politicians and voters and even economists on this question. When most people hear the word "consumption," they think in terms of the private sector, or as private consumption plus government transfers. Then, there is the $300 billion military budget. Some economists consider it consumption, some investment, and for many, it is somehow placed beyond the limits of discussion.

It's not just a "consumption binge," but a consumption binge by the Pentagon and a binge of tax expenditures for the rich.
---Lawrence **Mishel**

BOSWORTH:

I call it consumption.

KUTTNER:

Some of which, by the way, is invested.

EISNER:

Paradoxically, a lot of the military spending is investment. You and I may consider it worthless investment, but Star Wars is an investment. All of the missiles 'are investments. I wonder politically if you want to keep walking down that road of more taxes. If you look at public opinion polls, the public is much more ready than the people here to make the switch from the military to the other kinds of public investment.

MISHEL:

Barry, regarding this question of language, why can't we be more precise? It's not just a "consumption binge," but a consumption binge by the Pentagon and a binge of tax expenditures for the rich. We know that the increase in consumption and government spending per person was primarily due to the increase in defense spending and the tax cuts.

BOSWORTH:

And private consumption.

MISHEL:

There are no good data on whose consumption is going up by income group. My guess is that the people who are consuming more are those to whom income was redistributed. That is, those who benefitted the most from the tax cuts. So is it not true that what we are talking about is a consumption binge by the Pentagon and the rich?

I'm sorry, I'm not a defense expert. I have a personal view, but I don't have an economic view, about the right level of defense spending.
-Barry ***Bosworth***

BOSWORTH:

I don't know who the people are who spend. All I know is that the overall private saving rate has declined and that consumption spending growth has outpaced the growth of the nation's income. On the other hand, I happen to think that the defense is consumption. It is consumption in the sense that spending on defense does not add to the nation's future productive capacity

Within that category of public consumption, I'm sorry, I'm not a defense expert. I have a personal view, but I don't have an economic view, about the right level of defense spending. As an economist I believe you should pay for defense if you want it. If Reagan wanted it, he should have raised taxes to pay for it. I'm not going to go any further than that.

I say we are spending more than we used to. It is not investment because the investment rate is below the rate of the 1970s. Therefore, if your spending is up and investment is not part of it, it must be consumption.

MISHEL:

OK, the reason I am asking this is that it has a lot of implications for how the public understands the issue.

BOSWORTH:

Yes, they are living beyond their means.

MISHEL:

But they are not, the Pentagon is. The rich are.

BOSWORTH:

The public receives public services they are not paying for.

SMITH:

The Pentagon is not living beyond its means anymore than the Department of Education. You and I would agree about

how we ought to reallocate public consumption. But it's absurd to say that there is a Pentagon budget which is somehow the reason that the federal budget is in deficit.

FAUX:

Wait a minute! Some of you were just blaming the private savings decline on consumers in general because you say they've been spending too much. In terms of the public sector, we know that the spending has been coming in the military sector. Why are you so eager to pin the blame on consumers-even though you don't know for sure who is spending-but so why be shy about pointing a finger at defense spending? Especially when the numbers are so clear.

SUMMERS:

As people who profess to be economists rather than sloganeers, I think it behooves us to say that we don't actually know, as professional experts, the "right" level of defense spending.

EISNER:

But you know about private consumption, You know what and how much they should consume. That you do know. You know their welfare functions better than they do, right?

SUMMERS:

What we spend on defense is the amount that makes sense for our national security. The fact that we have a budget deficit doesn't really have much bearing on the right amount to spend on defense. If you want to argue that we should cut the defense budget, more power to you. I happen to be on your side. But that is a different issue than the issue we as economists are in a position to defend.

But you know about private consumption. You know what and how much [people] should consume.
-Robert Eisner

KUTTNER:

Forget the defense speech. When economists and investment bankers say we have been consuming too much, the only appropriate retort to that is, what do you mean, "we"? I think that is a part of this debate. When you say America has been consuming too much and statistically eight out of ten people are consuming less, that's a perversion of the King's English, and sensible economics.

Glossary of Terms

Capital Consumption Allowances: The government's measure of the physical depreciation of the nation's capital stock. Capital consumption allowances are not the same as the depreciation allowances used for tax purposes.

Current Account: In a_ nation's accounting of international transactions, generally referred to as the balance of payments, the current account measures the net flows of goods, services, and transfers. It does not include asset transactions such as loans or direct foreign investment, but it does include the net returns (interest, etc.) on foreign assets as payments for "factor services."

Discount Rate: The rate at which future income streams are reduced to present dollars. Often the interest rate is used as the discount rate.

Elasticity: The ratio of the relative change in one variable (e.g., quantity demanded of a good) in response to a relative change in another variable (e.g., price of a good). The demand for a commodity is said to be price elastic if the absolute value of the ratio is greater than one, inelastic if less than one, and unity if equal to one.

Exchange Rates (Fixed and Flexible): Exchange rates are the prices of foreign currencies in terms of domestic currency (e.g., one pound equals two dollars) or equivalently, the foreign currency prices of the domestic currency (e.g., one dollar equals .5 pounds). After World War II, under the so-called Bretton-Woods system, exchange rates were "fixed" and countries were responsible for maintaining the established rates, devaluing only in response to chronic balance of payments difficulties. After 1971, exchange rates were made "flexible" where, theoretically, market supply and demand for currencies established their rates. However, central banks often intervened to affect the supply and demand relationships. An exchange rate depreciation or appreciation refers to the fall or rise in the value of a currency in terms of other currencies.

Gross National Product (GNP): The total value of the flow of currently produced goods and services in the economy, generally measured on an annual basis.

J-Curve: A description of the trend in the trade balance after a fall in the value of a country's currency. Because prices adjust faster than quantities of exports and imports, the initial effect of a currency devaluation is a rise in the trade deficit because the price of imports rises relative to exports. Later, in most cases, as the quantity of imports falls and the quantity of exports increases (in response to the price changes), the trade balance improves. Map-

ping the level of the trade balance against time on a graph, this overall pattern resembles the letter J; the trade balance gets worse before it gets better.

Mercantilism: An approach to economic policy which tries to increase national wealth by restricting imports and promoting exports. This term is often applied to countries which pursue economic strategies based on trade surpluses.

Net National Product (NNP): Gross National Product minus the capital consumption allowances (economic depreciation).

Regression: A statistical technique used to estimate the functional relationship between two or more variables.

Smoot-Hawley: Restrictive U.S. trade legislation passed in 1929, which some economists claim caused or worsened the Great Depression.