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Explaining the U.S. Trade Deficit

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Policy Notes 2000 / 1

Explaining the U.S. Trade Deficit

Anwar M. Shaikh

Conventional theory makes the curious assumption that, in international trade, movements in the real exchange rate negate cost differences so as to make all countries equally competitive. But quite the contrary, it is absolute cost advantages that determine competition between countries, just as they determine the relative price of two sets of goods within one country.

The recent rise in the absolute level of the U.S. trade deficit has generated much worry. However, it is important to note that as a percentage of GDP, the current trade balance, at about 2.5 percent of GDP, is about the same as it was in the late 1980s (Figure 1). That fact may allay some fears, but, in any case, our primary concern should not be the absolute level of the deficit but the overall trend of the trade balance. To examine that trend, we must distinguish between the trade balance's components: the *structural* trade balance, which is related to long-term patterns in relative competitiveness and growth, and the *short-term* balance, which is linked to cyclical and historical fluctuations in exchange rates and relative growth rates.

The structural balance has been improving because the United States has been closing the cost gap between itself and other advanced nations. Thus, in spite of the substantial fluctuations in the trade deficit over the last decade, the trend (the dotted line in Figure 1) has stabilized. The fluctuations, on the other hand, can be traced back to the short-term balance—movements in the relative growth rate of the United States (most notably the import-boosting effect of its sustained expansion since 1992 and the export-reducing effect of the more recent Asian crisis) and to the extraordinary gyrations of the U.S. exchange rate in the mid 1980s.

In this paper, I first show that the cause of the long-term decline in the U. S. trade balance is substantially a decline in its terms of trade. I argue that, contrary to conventional economic theory, the terms of trade of a nation are regulated by the *real* costs of its tradable goods relative to those of its trading partners (a much fuller development of the thesis is provided in Shaikh and Antonopoulos 1998). I will show that the United States has been catching up to its trading partners in terms of its relative real unit labor costs,

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which is why the trend of the trade deficit has stabilized. But, an absolute gap still remains, and this gap, combined with shorter-term factors arising from the U.S. boom and the Asian crisis, accounts for the existence of a trade deficit. A central policy implication of my alternative thesis is that it is crucial to maintain a high rate of productivity growth in the United States, so as to turn the present cost disadvantage into a cost advantage, which would, in turn, convert the structural trade balance from deficit to surplus.

The Trade Balance and the Terms of Trade

A country's *trade balance* is the difference between the value of its exports and the value of its imports, which can equally well be captured by the ratio of the value of exports to the value of imports, or the *trade balance ratio*. When the trade balance ratio is greater than one, the country is running a trade surplus; when it is less than one, the country is running a trade deficit. The trade balance ratio has the virtue that it can be written as the product of two components: the *terms of trade* or *trade price ratio* (export price/import price) and the ratio of real exports to real imports or *trade quantity ratio* (export quantity/import quantity).

trade balance ratio = value of exports/value of imports
= (terms of trade) • (real export-to-import ratio)
= (export price/import price) • (export quantity/import quantity)

Slower growth at home tends to raise the real export-to-import ratio (the trade quantity ratio) because the demand for imports from abroad grows relatively more slowly. A decline in a country's terms of trade also stimulates the trade quantity ratio, since a fall in the terms of trade signifies that exports are relatively cheaper and imports relatively more expensive. But, a decline in the terms of trade also worsens the balance of trade. What then has been the dominant factor contributing to the decline in the U.S. trade balance ratio?

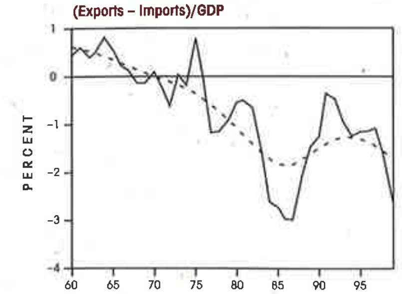
Between 1960 and 1985, the U.S. terms of trade (trade price ratio) declined sharply and then stabilized (Figure 2); the real export-to-import ratio (trade ratio) exhibited a rising trend and then stabilized, albeit with substantial fluctuations (Figure 3); and the ratio of the value of exports to imports (trade balance ratio) declined sharply and then stabilized (Figure 4). *In other words, the dominant factor in the decline in the United States's trade balance ratio is the decline in its terms of trade (trade price ratio).*

Explaining the Terms of Trade

The fact that the decline in the U.S. terms of trade is the central factor behind the decline in the U.S. trade balance ratio leads us directly to the question, What drives the *international* terms of trade?

The argument that follows has three components. The first component begins with the recognition that a terms of trade is simply a relative price of two sets of goods. Let us consider how relative prices are determined within a country. Within any one country, the relative price of two sets of goods is largely determined by the relative cost of these goods. If we use relative unit labor cost (nominal wage rates divided by productivity) as a proxy for relative cost, at first approximation we can say that within any one country the relative price of two sets of goods

FIGURE 1
U.S. Trade Balance Relative to GDP
(Exports – Imports)/GDP



Dotted line is the Hodrick-Prescott filter trend.

Source: Haver Analytics Database

FIGURE 2
U.S. Terms of Trade (Trade Price Ratio)
(Export Price/Import Price)

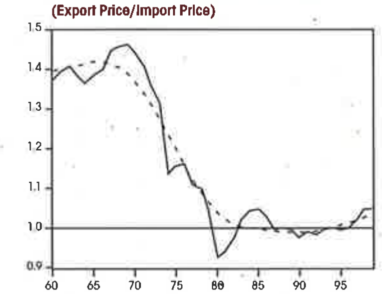


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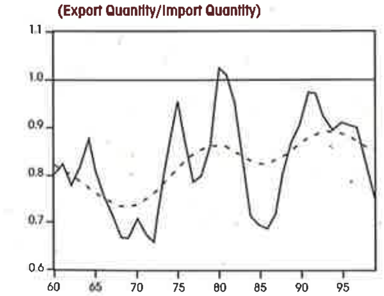
FIGURE 3
U.S. Real Export-to-Import Ratio
(Trade Quantity Ratio)
(Export Quantity/Import Quantity)



Dotted line is the Hodrick-Prescott filter trend.

Source: Haver Analytics Database

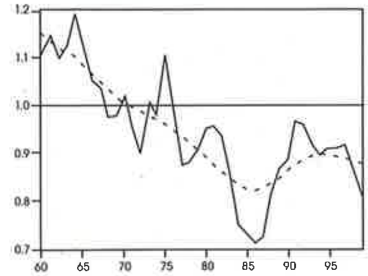
is related to their relative unit labor cost.[1] Dividing each wage rate in any relative unit cost ratio by the consumer price index, we also can say that within any one country the relative price of two sets of goods is strongly conditioned by the relative real unit labor costs.

The second component of the argument is to consider what would happen in trade between two regions within a country. Conventional economic theory says that internal competition is driven by absolute costs, that is, firms with a lower unit cost of production enjoy an absolute competitive advantage. High-cost regions within a country suffer from a competitive disadvantage. Their higher costs make it difficult for them to sell their products outside the region ("exports") and leave their markets vulnerable to products originating in lower-cost regions ("imports"). If engaged in free trade within the country, firms in such a region would tend to have declining shares in the national market. To use our original term, regions with higher costs would tend to have structural trade deficits. This in turn implies that in unregulated trade with more competitive regions, the high-cost regions would tend to suffer job loss and real wage declines—at least until they caught up or their labor migrated elsewhere.

The curious thing is that when conventional economic theory considers free trade *between* countries, it abandons this eminently sensible analysis of competition. In international trade, it is argued, it is not absolute but comparative costs that regulate trade (Krugman 1991). In short, it is assumed that if two initially unequally competitive countries were to open trade with one another, any initial trade deficit suffered by the higher-cost country would eventually be negated because its real exchange rate would depreciate until trade was balanced. This would happen because the assumed depreciation of the real exchange rate would reduce the international prices of the country's products and raise the prices of its trading partners' products, thereby enhancing its exports and restricting its imports. This process is assumed to continue as long as a trade imbalance remained. This same mechanism would erode the trade surplus of a country with an initial competitive advantage until it, too, arrived at balanced trade. Thus, in the end, all nations are equally competitive (Arndt and Richardson 1987, 12; Dornbusch 1988; Dernburg 1989, 3).

[1] This result has sound empirical foundation (Bienenfeld 1988; Ochoa 1988).

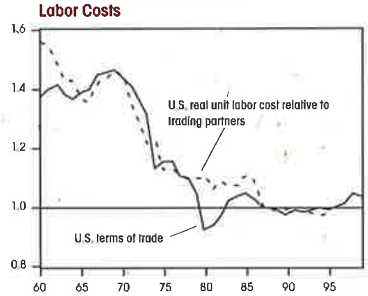
FIGURE 4
U.S. Trade Balance Ratio
(Value of Exports/Value of Imports)



Dotted line is the Hodrick-Prescott filter trend.

Source: Haver Analytics Database

FIGURE 5
U.S. Terms of Trade and Relative Real Unit Labor Costs



Source: Haver Analytics Database. Shaikh and Antonopoulos (1998)

Now, the third component in my argument, in contrast to the conventional theory, is that *absolute cost advantages regulate competition both within a country and between countries* (Shaikh 1995; Shaikh and Antonopoulos 1998). In other words, international terms of trade, just like intranational ones, are strongly conditioned by the relative real unit labor costs of the goods being traded.

Figure 5 depicts the relationship between the U.S. terms of trade and the real unit labor costs of tradable goods of the United States relative to its OECD trading partners. (Tradable goods costs were used as a proxy for export costs because of a lack of adequate data,[2] and coverage was restricted to the OECD countries.) It should be emphasized that whereas the terms of trade contains the exchange rate, the real cost measure does not, since it is defined here as nominal unit labor costs in each country's local currency divided by the consumer price index in the country. It is also worth noting that these are index numbers, not absolute levels. In light of the approximations involved, it is quite striking how strongly the movements of the U.S. relative real unit labor costs correlate with movements in its terms of trade. Even the significant deviation in the early 1980s fits well with the more general argument that incorporates the short-term effects of international capital flows: an extraordinarily high interest rate differential between the United States and its trading partners attracted large international capital flows, which raised the nominal exchange rate and temporarily drove the terms of trade and the real exchange rate off their long-term trends (Friedman 1991; Shaikh and Antonopoulos 1998, 17).

The decline in the U.S. terms of trade from 1960 to 1985 actually reflects a secular improvement in its relative competitive position. I would argue that it is precisely because of this that the structural trade balance falls until 1985 and stabilizes thereafter (as shown in Figures 1 and 4). But then, why is the United States still running a structural trade deficit? The basic answer, I believe, is that it has not yet fully caught up. The absolute levels of U.S. labor costs in common currency now appear to be within striking range of those of many of its advanced country trading partners (van Ark 1995), but seem to be significantly below those of its Asian and other trading partners.

The thesis outlined here can explain several widely documented features of international trade patterns that appear quite puzzling from the point of view of conventional theory (Rogoff 1996; Arndt and Richardson 1987). The terms of trade is a real exchange rate, and we expect real exchange rates to have persistent trends as relative competitive positions change over time. We also would expect the real exchange rate of a country to *depreciate* as

[2] Tradable goods costs were defined here as manufacturing unit labor costs times an adjustment for tradable-to-nontradable goods, the adjustment being the ratio of the consumer price index (representing tradable and nontradable goods) to the producer price index (representing tradable goods), as explained in Shaikh and Antonopoulos (1998, Appendix B).

its competitive position improves because its falling real costs will permit a reduction in its relative international prices. Finally, relatively rapid inflation in a country will tend to drive up its nominal exchange rate so as to keep the terms of trade in line with the change in real costs (Barro 1984, Table 20, 542; Shaikh and Antonopoulos 1998, 13–15).

Some Practical and Policy Implications

A significant practical implication of this thesis is that it allows us to derive a rule-of-thumb by which to judge whether a real exchange rate is overvalued or undervalued. Because the terms of trade is regulated by relative real costs, the real exchange rate is sustainable when it keeps the terms of trade in line with these real costs (Shaikh and Antonopoulos 1998, Figure 3). Note that this is quite different from the conventional conception, which tends to view a real exchange rate as being "correct" when trade is balanced. According to my alternative thesis, there is no intrinsic tendency toward a zero balance of trade, though the overall balance of payments must be zero.

It is a direct implication of the thesis that a focus on productivity growth should be an essential component of trade-related policy. But since more advanced technology can be put into place only through new investment, it requires ongoing economic growth. Economic growth therefore has a double character: it stimulates imports directly and it also stimulates exports by putting lower cost methods of production into place. As the United States showed at the beginning of the postwar period and Japan and Germany showed subsequently, strong economic growth can be a perfectly sound footing for a robust balance of trade.

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Policy Notes

2000 / 2

Is the New Economy Rewriting the Rules?

Remarks by James K. Galbraith at the White House Conference on the New Economy, April 5, 2000

Mr. President, the question before this panel is, in effect, "Can full employment without inflation endure?"

According to the "old rules" and those who believe them, the expansion will not last. Growth is too rapid, unemployment too low, stocks too high. There are deep and mysterious reasons why wage inflation is sure to explode someday soon. Even more mysteriously, some have even suggested that the rate of productivity growth is too fast.

A second view holds that the New Economy has changed the rules, cutting costs and creating opportunities that never existed before. In part, this is surely correct. The new technologies are today contributing about 8 percent of employment and 35 percent of growth, the Commerce Department reports. They are important, but they are not the whole story.

A third position is that the old rules were wrong all along. This viewpoint, which I hold, is that, for the first time in 30 years, we are now seeing the fruits of full employment.

Many economists have lived for decades in fear of full employment. They imagined hidden terrors, like runaway inflation. They did not sufficiently listen to those few, like the great Robert Eisner, who taught that the real rules aren't so grim. Eisner taught that growth could raise wages and yet also spur investment and productivity, in effect, that full employment in the Old Economy would bring the New Economy to life.

Mr. President, the historic merit of your administration—and of Mr. Greenspan—was to put this proposition to the test. *And now we know.* In every year since 1993, unemployment has fallen and real growth has exceeded speed limits widely announced in advance. In almost every year, productivity has accelerated. Now we know.

Many also fret that today's prosperity was purchased by high inequality and particularly that information technologies are inequality producers. But, in fact, since unemployment fell below 6 percent, pay gaps have narrowed. Improvements so far are modest. Still, the movement is in the right direction. Today we know that rising pay inequalities are not a price of progress, nor are they a social cost of full employment.

Let us therefore set aside shopworn worries and the self-immolating doctrine of the preemptive strike. If there is a ceiling for growth or a floor for unemployment or a limit to this expansion, the truth is that no one knows where it is. Why borrow trouble? Why not take a positive view? Full employment and strong growth are great achievements. Let us celebrate and defend them. Let no one say that the unemployment rate is too low. And especially let no one say that the productivity growth rate is too high.

Are there dangers? Yes. However, inflation, apart from oil prices, is not one of them.

High interest rates are a danger. American households have too much debt. They will become vulnerable when interest rates rise.

Stock market speculation is a danger. Margin lending is exploding, and those loans will be exposed if stock prices decline. Some of that is already happening. Rising interest rates and speculation on credit are an explosive mixture.

In my view, excessive budget surpluses may also come in time to pose a danger. Too much taxation and too little public spending weaken private disposable income; economists used to call this "fiscal drag." For this reason, I do not favor rapid reduction of the public debt for its own sake.

Can the dangers be managed? Yes, they can.

We can offset household debt burdens, and the declining personal saving rate, by raising wages and family income. We should raise the minimum wage, expand the EITC as proposed, and support collective bargaining. On average, earnings should keep pace with productivity—a bit more at the bottom, a bit less at the top. We should also modestly expand public services—education and health care and the environment, I would urge, rather than defense—and even consider modest tax relief, carefully targeted and carefully timed.

For its part, the Federal Reserve Board, instead of setting off to fight an inflation that is a pure product of academic imaginations, could control margin lending. Raising margin requirements is the direct approach to a stock bubble, more targeted than raising interest rates and more effective than jawboning the lenders. If a crash comes, sooner or later, a failure to have acted on margins will weigh on the record, and not for the first time.

But a crash need not come. Despite the nervousness of the markets, these are good times. With the right leadership, with prudent policy changes when they are needed, and with cooperation from all branches of government, the good times can endure. We can continue to grow and prosper, to enjoy full employment and strong productivity growth and a rapidly expanding New Economy. Not forever, but for another four, another eight years into the future. Yes, we can do that. And we should.

James K. Galbraith is a professor at the Lyndon B. Johnson School of Public Affairs at the University of Texas at Austin, a senior scholar at the Levy Institute, and the chair of Economists Allied for Arms Reduction. He is the director of the University of Texas Inequality Project, whose work may be viewed online at http://utip.gov.utexas.edu. Galbraith is the author of *Created Unequal: The Crisis in American Pay* (Free Press, 1998) and the co-editor of *Inequality and Industrial Change: A Global View* (forthcoming).

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Policy Note

2000 / 3

WELFARE COLLEGE STUDENTS: MEASURING THE IMPACT OF WELFARE REFORM

THOMAS KARIER

The rules and regulations that were developed to reduce welfare rolls through immediate employment discourage the achievement of economic independence through the pursuit of higher education.

DURING THE PAST FEW YEARS federal and state governments have made a concerted effort to reorient welfare from income assistance to employment assistance. With the passage of the Personal Responsibility and Work Opportunity Reconciliation Act of 1996, immediate employment became the primary goal of welfare programs across the nation. However, the rules and regulations that were developed to create incentives for immediate employment have created equivalent disincentives for pursuing higher education as a means to achieve economic independence.

The new welfare laws present a particularly difficult hurdle for aspiring college students. For example, under the federal law, students enrolled in college who do not meet the strict work requirements are typically not considered as engaged in an approved work activity. The law allows some community college experience as a form of "vocational educational training," but there are caps on the number of months permitted for any one individual and on the total number of people permitted in these programs. No individual may count vocational education as part of work activity for more than 12 months, and no more than 30 percent of the population that a state reports as engaged in work activities under Temporary Assistance to Needy Families (TANF) can be participating in vocational education. In the year 2000 the rule became even more restrictive as additional categories of recipients were swept into the 30 percent cap. The states face penalties from the federal government if they do not meet these mandates.

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According to the federal law, 25 percent of single parents had to be working by fiscal year 1997 (rising to 50 percent by fiscal 2002), with the definition of "work" rising from 20 hours per week in fiscal 1997 to 30 hours per week by fiscal 2000. For two-parent families the participation requirements rise from 75 percent to 90 percent over the same time, with work defined as a cumulative 35 hours per week. These work standards are hard for a full-time student to meet, but they are especially difficult for a full-time student who is also a single parent, as are many welfare recipients. States often add to the burden imposed by the combination of school, work, and parenting by denying child care assistance for welfare recipients during the time they are attending college.

Many of these obstacles to college exist in Washington State, as they do throughout the country. State welfare reform, called Work First, was passed in early 1997 and became effective in August 1997. The law allowed a welfare recipient to continue in a college program through June 1998 if the recipient's work plan included the program and the plan had been approved by November 1997. In practice, students who did not finish by June 1998 have been allowed to continue in college, although they must meet the 20-hour work requirement and are not given child care assistance for class time. Work-study positions are counted as work effort, but unpaid internships are not. (In a special concession, the state counts 16 hours of work study as equivalent to 20 hours of work necessary to meet the participation requirement.) These are the same conditions that apply to welfare recipients who do not have a college program in their plan. Welfare students who do not meet the 20-hour work rule are subject to the same penalty as anyone else, typically a 40 percent reduction in their normal grant. As a general rule, no new plans that include a two- or four-year degree program will be approved.

Although investment in higher education is discouraged by the Washington State regulations, investment in short-term training is not. Short-term training programs can still be included in plans for welfare recipients. The state announced in early 1998 that it was making $1 million available to waive tuition for welfare recipients and other low-income individuals for short-term training. The program pays for a course or courses at a community college for a term (one quarter) and child care assistance is provided, but welfare recipients still have to meet the 20-hour rule.

Research Results

In an effort to understand the effects of welfare reform, a research program was developed that monitors a specific population of welfare recipients, those attending Eastern Washington University—a regional, comprehensive institution offering baccalaureate and master's degrees and located in Spokane County. A previous report on this research (Karier 1998) evaluated the economic success of welfare students who graduated from EWU between 1994 and 1996, prior to the passage of welfare reform at the state and national levels. It was found that the median wage for these graduates after 5 to 17 months in the labor market was $11 per hour. This was enough for most families previously on welfare to attain economic independence. A year and a half after graduation only 6 percent of these graduates continued to receive benefits under Aid to Families with Dependent Children (the precursor of TANF). The conclusion was that a college degree led to successful economic performance for welfare recipients.

The sample for this phase of the research consists of all students at EWU who identified TANF as a source of income between fall 1994 and fall 1998. Samples of students were extracted for each fall during these years. This report focuses on changes in the number of welfare students and their subsequent economic performance after the passage of welfare reform.

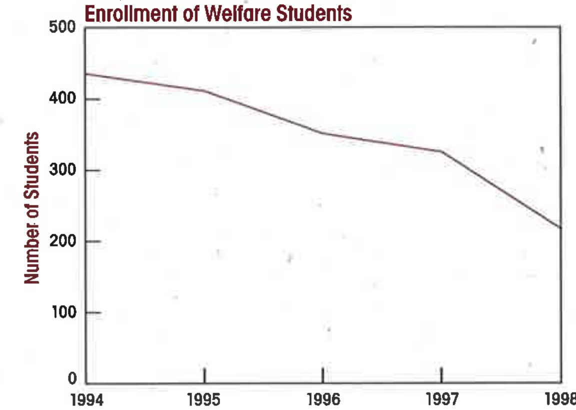
The number of welfare students attending EWU was declining prior to the implementation of Work First in August 1997. It dropped from 435 in fall 1994 to 325 in fall 1997, declining by an average 37 students a year (Figure 1). However, from fall 1997 to fall 1998 the university lost an additional 108 welfare students. The rate of decrease clearly accelerated after the implementation of welfare reform.

Because of fluctuations in university enrollment during this time, it is useful to look at the ratio of welfare students to total enrollment. Welfare students constituted between 4.5 and 5.5 percent of all students from 1994 to 1997, but less than 3 percent by 1998 (Figure 2). Despite an increase of 4.6 percent in total enrollment between 1997 and 1998, the percentage of welfare students fell 33 percent. From 1997 to 1998, the welfare caseload in Spokane County fell 20 percent. There are many reasons for the lower caseload, but it should be clear that this reduction is not sufficient to explain the faster decline in welfare students at EWU.

In fall 1994 most of the welfare students at EWU were in their third year (38 percent) and fourth year (41 percent); the remaining were first- and second-year students (10 percent) and in master's or certificate programs (11 percent). This distribution mirrors the general student body, which is composed primarily of transfer students from community colleges. In fall 1998 the composition of welfare students by class standing changed relatively little, with the significant exception of the third-year class, which fell to 28 percent (Figure 3). This is to be expected if there was a decline in new welfare students, who, like the general student body, normally enter the university as transfer students in their third year.

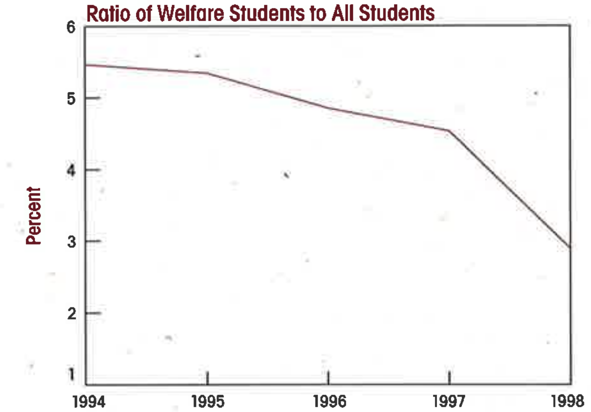
What happened to the welfare students? Of the 132 first-, second-, and third-year students enrolled in fall 1997, 70 percent

Figure 1
Enrollment of Welfare Students



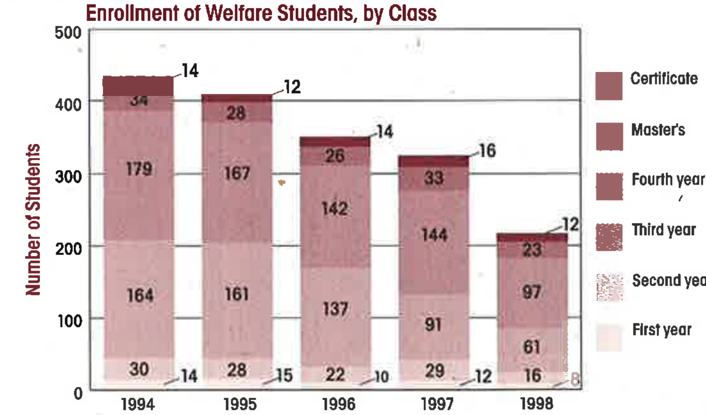
Source: Eastern Washington University.

Figure 2
Ratio of Welfare Students to All Students



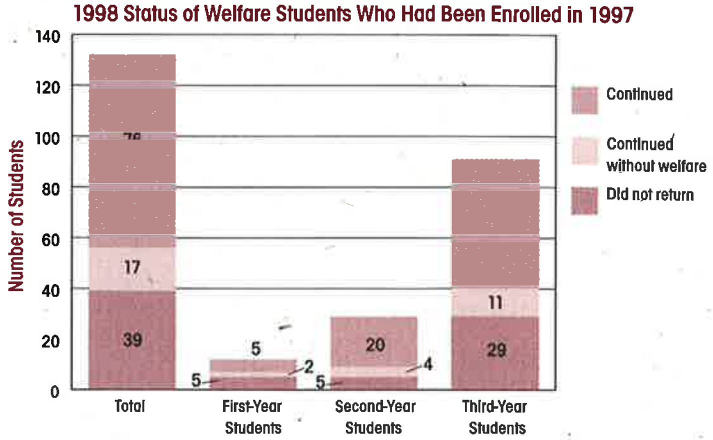
Source: Eastern Washington University.

Figure 3
Enrollment of Welfare Students, by Class



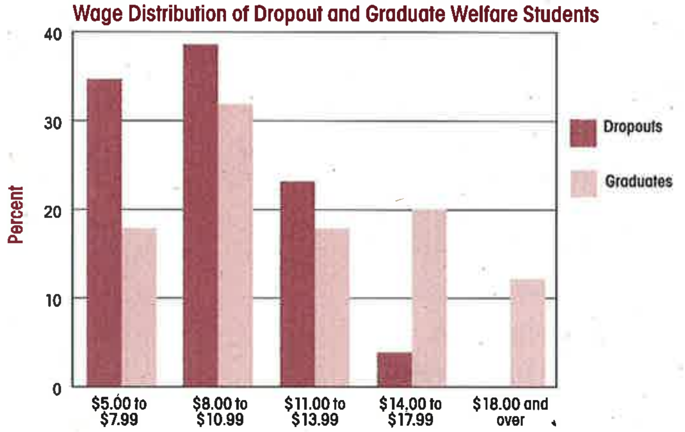
Source: Eastern Washington University.

Figure 4
1998 Status of Welfare Students Who Had Been Enrolled in 1997



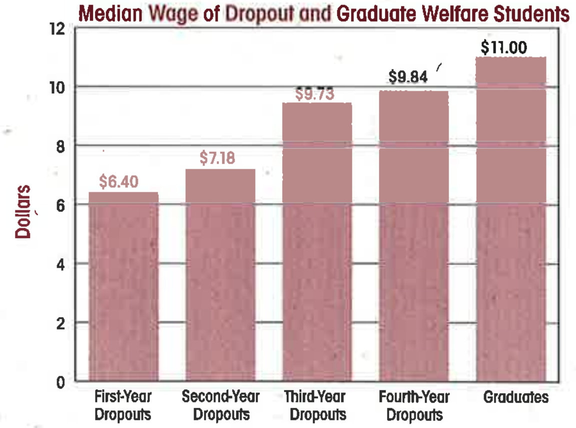
Source: Eastern Washington University.

Figure 5
Wage Distribution of Dropout and Graduate Welfare Students



Source: Eastern Washington University; Washington State Employment Security Department.

Figure 6
Median Wage of Dropout and Graduate Welfare Students



Source: Eastern Washington University; Washington State Employment Security Department.

remained at EWU and were enrolled in fall 1998. Although these students stayed in college, more than a fifth were no longer reporting welfare as a source of income. The remaining 30 percent of the students, a total of 39, did not return to EWU. (These results are summarized by number of students and class standing in Figure 4.)

Most of the reduction in the number of welfare students was due to a reduction in the number of new welfare students, particularly transfer students in their third year, but some of the loss was related to a reduction in the number of continuing students. An effort was made to follow the 39 welfare students who left the university after fall 1997 without graduating. It is assumed that these students dropped out of the university for a variety of reasons, including the more restrictive guidelines and rules governing welfare eligibility.

With the help of the Employment Securities Department of Washington State, it was possible to track the wages of 70 percent of these departing students. The median hourly wage of the dropouts five quarters after leaving school was $9.06, compared with $11.00 four quarters after graduation for those who completed school.

It was also possible to compare the wage distributions of these two groups. Figure 5 shows that the wage distribution of dropouts is skewed to the low end of the scale, and the distribution for graduates is more spread out, especially at the higher wage levels. Only 3.8 percent of the dropouts earned hourly wages in excess of $14.00, compared with 32.0 percent of the graduates. The economic condition of welfare recipients who left the university was clearly inferior to that of those who graduated.

Figure 6 shows that the number of college years completed is related to economic performance. Students who dropped out during their first year averaged only $6.40 per hour, compared with $9.84 for those who dropped out during their fourth year. As expected, the median wage of second- and third-year dropouts fell between these two levels, and the median of all categories of dropouts fell below the median of graduates ($11.00 per hour). This pattern suggests that real economic benefits are associated with each year of college education, even when a degree is not obtained.

A final component of this research tracked the welfare status of dropouts. Even though the median wage was considerably different for dropouts and graduates, the percentage continuing on welfare fell dramatically for both groups. Approximately a year and a half after entering the labor market, 90 percent of the dropouts were no longer receiving welfare; after a comparable period of time, 94 percent of graduates were no longer receiving welfare (Karier 1998).

Policy Recommendations

The introduction of welfare reform in Washington State seems to have created disincentives for attending college and to be a major factor in explaining the declining number of welfare students attending Eastern Washington University. Thus, in order to retain college as a feasible means for welfare recipients to achieve economic independence, this report makes four basic recommendations.

1. Provide child care and other appropriate services for welfare recipients while they are engaged in college activity.

2. Allow welfare recipients to participate in college degree programs as an approved category of work activity.

3. Include the hours of college education, work study, and unpaid internships in the work requirement. It may not be necessary to reduce the minimum work requirement for welfare students as long as their education hours count, perhaps in proportion to the number of credits.

4. Make accommodations to extend support beyond the time limits to those welfare recipients who make normal progress in a degree program.

All of these recommendations could be implemented through changes in federal legislation, but it is also possible for states to implement them within the context of current law. The Center for Law and Social Policy (CLASP) completed an excellent study (Greenberg, Strawn, and Plimpton 1999) showing how states can meet the mandates of federal welfare law and still develop innovative programs to permit welfare recipients to pursue higher education. Although federal law certainly makes it more difficult for states to support postsecondary education, states wishing to provide a higher education alternative—through cash assistance, child care, transportation, other services, and even tuition and other related education expenses—have several options.

There are ways states can structure their program within the TANF system and still avoid federal fiscal penalties. If they choose to operate within TANF, they must address the requirement that benefits stop after 24 months unless recipients are "engaged in work." States should be prepared to define work, as is their right, to include postsecondary education. The second hurdle is to meet TANF's required participation rates. While there are limits to including college as participation, states may not have to worry if they are already exceeding the requirement. The number of qualified adults willing to attend college may not be enough to push a state's participation rate below the federally required level. This is especially true for states that have experienced a sharp reduction in welfare rolls since 1995—which includes most of them. A lower caseload not only makes it easier to meet the targets, it also lowers the targets because participation rate requirements are calculated as a formula that includes caseload reductions.

States that included higher education as part of a previous state program may have yet another option. If they were originally granted a waiver from the federal government, they may find that their postsecondary alternative has been grandfathered in. There are also options to tailor TANF funds for "nonassistance," which do not entail the same regulatory burden as funds for "assistance."

States may also operate programs outside TANF. They can establish separate state maintenance of effort funds. The savings many states have enjoyed from reductions in welfare rolls are an obvious source of funding to pursue this option. By operating outside TANF, states have far more discretion in how they structure their programs and are unhindered by TANF regulations. A particular advantage for recipients is that they need not have to lose ground in the 60-month lifetime limit on benefits.

Maine and Wyoming are two prominent examples of states that have found ways to provide for higher education while avoiding federal penalties. In Maine, Parents as Scholars provides TANF-like support outside the TANF program. Participation is open to needy parents in two- and four-year college programs that meet certain requirements. Wyoming has a similar program and also allows a college option within TANF. Twenty-one other states allow some postsecondary education for more than 12 months under varying conditions.

This report does not claim that college is a panacea that will eliminate poverty and welfare in the United States, but higher education is still the best strategy for achieving economic independence and getting out of poverty for some people. Rather than placing obstacles in the way of these poor, hard-working individuals, the state and federal governments should applaud their efforts and provide meaningful support.

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Policy Note

2000/4

HEALTH CARE FINANCE IN NEED OF RETHINKING

WALTER M. CADETTE

Hospitals have been squeezed by the Balanced Budget Act; the uninsured population is still on the rise; long-term care is paid for largely by welfare grants. The nation's flawed structure of health care finance ultimately will adversely affect the quality of care for all.

NOT LONG AFTER THE FAILURE OF THE CLINTON HEALTH PLAN in 1994, Henry J. Aaron, senior fellow at the Brookings Institution, published a book entitled *The Problem That Won't Go Away*. The conventional wisdom at the time was that health care policy would be off the nation's agenda for a long time to come. But Aaron knew better.

It took no special gift of prophesy, though, to conclude that the problems building in health care several years ago were deeply entrenched: a rising number of uninsured, inordinately high out-of-pocket costs (for prescription drugs, in particular) for many who are otherwise well insured, loss of patient and physician autonomy with the ascendancy of managed care, and the resistance of third-party payers, government and employers alike, to pay for health care with the openhandedness of old.

Aaron, unlike many others, clearly foresaw that these and other increasingly characteristic features of American health care would put it back in the headlines before long. And so it is. Patients' rights are now the subject of a House-Senate conference; adding a prescription drugs benefit to Medicare is high on the administration's agenda; and access to medical care was central to the insurgency candidacy of Senator Bradley. Even Harry and Louise are back—this time not to tell you how terrible it would be for them if government helped pay for health insurance for people who cannot afford it (their message just a few years ago), but to tell you what a fine idea that is, after all.

WALTER M. CADETTE is a senior scholar at The Jerome Levy Economics Institute. This policy note is adapted from his statement at the Levy Institute panel on social and economic policy at the annual meeting of the Eastern Economic Association, Crystal City, Virginia, March 26, 2000.

The proposition I would put to you today is that the problems not only will not go away, they will worsen, unless there is a major rethinking of health care finance. Five issues need to be addressed:

- The responsibility of government, as the major payer of hospital bills, to ensure that the delivery of health care is not compromised by increasingly tight-fisted Medicare reimbursement
- An appropriate role for Medicare in a background of unfavorable demographics
- A suitable model for the financing of long-term care, this, too, with sharply increased demand on the horizon
- A role for government in patient advocacy in response to the rise of managed care
- The misallocation of tax subsidies to health care

THE KEY PROBLEM hospitals face is a sharp cutback in Medicare reimbursement under the Balanced Budget Act of 1997—this, it should be stressed, at a time when managed care has been increasingly successful in exerting its own market power. On the in-patient side, hospitals may bill Medicare for increased costs, but they are able to recover even less of those costs than before. Stripped to its essentials, the act provides for a 1 percent increase in Medicare reimbursement over the five-year period 1998 through 2002, as against a projected cumulative rise of 16 percent in the estimated cost of hospital services.[1] The decline is even steeper for academic medical centers because Medicare has also reduced, by some 30 percent, the adjustment intended to compensate teaching hospitals for public goods like medical education and research. Concentrated in inner cities and specializing in high-risk cases, teaching hospitals account for as much as three-quarters of the nation's uncompensated care.

On the out-patient side, Medicare is moving to a prospective payment system, mimicking the fixed fees in place for in-patient care since the mid 1980s. Payment is to be fixed at a given rate for procedure X or Y, irrespective of the actual cost of treating an individual patient. Payment for home care, meanwhile, is to be capped at a set rate per beneficiary per year. Skilled nursing facilities are already being reimbursed on a per-case basis.

In short, the next shoe has begun to drop in a long-term strategy of shifting from cost-based reimbursement to fixed fees. The underlying message: "There is a limit to what Medicare will finance; live within it or suffer the financial consequences." The subtext: "We will squeeze out the remaining excess capacity in the system, even if that pulls under viable institutions in the process."

While still largely beneath the surface, the consequences are worrisome, not just for hospitals but for the people they serve. Several years ago, the projection was for a five-year savings under the Balanced Budget Act of $116 billion (almost half of which represented forgone acute-care hospital revenue). The savings were against then-current law, which itself was for less than full indexation to the cost of providing hospital services. Significantly, the estimated savings over the five-year period are now almost $200 billion. Clearly, the financial burden on hospitals was grossly underestimated. But the added savings also reflect the implicit threat hospitals face under fraud and abuse regulations designed to ensure that the savings are, indeed, forthcoming. The safe response to Medicare's byzantine billing code regulations is to undercharge, even if—Catch-22—that means compromising financial soundness itself.

[1] This policy note is based on data detailed in a series of briefs in which these and other issues relating to health care are discussed at length (see Cadette 1997, 1998, 2000).

American hospitals, in fact, now earn virtually no income in the care of the sick. The CFO of a midwestern hospital system I work for on the finance committee did a canvass of the financial performance of Catholic health systems in the country, and he found that on average just about every dollar of net income in the last fiscal year came from investment accounts. Operating margins were under 1 percent. The latest data for health care systems as a whole cover 1998 and show an operating margin of just under 2 percent, based on Moody's numbers. The ratio today is probably close to, if not at, zero, to judge by up-to-the-minute data for Catholic systems.

The implications of numbers like these—especially at a time of uncommon prosperity—are sobering. As capital-intensive institutions, hospitals will be unable to adopt emerging technology unless they dip heavily into endowment-like reserves—a short-run strategy at best. Failing institutions will no longer be salvaged by larger systems, which themselves have come under financial stress. The threat of closings is greatest in already medically underserved areas, inner city and rural alike. The investment cushions in those areas are much too thin even for short-term survival. And let us be clear about this: The financial stress hospitals face will adversely affect even those well-insured Americans who can afford the best of care. All in one boat, they cannot be sheltered from the economies a hospital is forced to make.

As capital-intensive institutions, hospitals will be unable to adopt emerging technology unless they dip heavily into endowment-like reserves—a short-run strategy at best. Failing institutions will no longer be salvaged by larger systems, which themselves have come under financial stress.

IRONICALLY, WASHINGTON IS forcing hospitals into economies that threaten their financial soundness at the same time it is advocating extending Medicare to prescription drugs. The cynic in me is tempted to conclude that deterioration in the quality of American medical care will take years to become apparent to the public at large, whereas the prescription drugs benefit will be seen posthaste (and, more important, applauded at the voting booth).

This is not to argue against adding that benefit to Medicare. It is to ask whether the federal government is thinking clearly about health care finance. Yes, there is a limit to what is to be spent under the Medicare banner. What resources fall under that limit, and what fall outside it and must therefore be paid privately, is the much more difficult question.

One thing is sure, though: The shift in the population's age composition alone will add several percentage points to the share of GDP dedicated to health care in the next few decades. Most, if not all, of the increase is slated to be financed by government. Against that background, Washington has no good (in the sense of no good politically) choice.

One option is higher Medicare tax rates—never a good choice politically, but an even worse one now since Social Security retirement is similarly affected by the aging of a large generation.

Another option—the Balanced Budget Act approach—is less and less reimbursement for the same health care service, joined to a hope that the "less and less" will bring forth efficiencies rather than a deterioration in quality. Anyone who has been hospitalized of late (even more than someone who sits on a hospital finance committee) is apt to suspect that the hope is misplaced. It is whistling past the graveyard, to borrow from Mark Twain an image that is all too close to home. Official Washington's recent concern about medical errors is simply not credible (not to say disingenuous) against the background of its funding strategy.

A third option would be to key benefits and premiums paid by beneficiaries under Medicare Part B to income. That, I know, is heretical for a program structured as an entitlement. But it is perfectly reasonable to move Medicare in that direction, especially for new ventures like prescription drugs.

Many elderly, notably single women in their eighties, live in poverty. And many of them are deprived of modern medicine in the form of drugs for life-threatening illnesses or they are forced to choose between those drugs and food on the table. For others, though, drugs are a small expense, either absolutely or relative to income. Subsidizing the one group, but not the other, would be the sensible application of the principle that the function of insurance is to protect against low-probability, high-consequence events. The Clinton administration's proposal to subsidize prescription drugs for all beneficiaries is not sensible by that standard.

INEVITABLY, MUCH OF the rise in the share of GDP dedicated to health care in the next several decades will reflect increased need for long-term care. Not only will an unusually large generation approach old age, life expectancy will continue to rise with medical advances. Many more Americans, the prospect is, will fall victim to the chronic diseases of old age and will require years of home care and, in all too many cases, years of institutionalized care.

By default rather than design, the nation has fashioned a welfare strategy for long-term care, pushing Medicaid far afield of its original purpose of financing the medical care of the indigent, in particular those on Aid to Families with Dependent Children and successor welfare programs.

The nation is not equipped to deal with this eventuality. Nor is there public discussion about the problem, in contrast to the attention paid to the long-run actuarial deficits Medicare and Social Security face. And, yet, the problem arises out of the very same demographics.

Currently, most long-term care is financed either out-of-pocket, which can be done only by thos[e] with substantial savings, or by Medicaid, which pays for nursing-home care for those who are too poor to begin with or who have spent down their assets to the level allowed for Medicaid eligibility. Private insurance finances only a small fraction (7 percent or so) of long-term care.

By default rather than design, the nation has fashioned a welfare strategy for long-term care, pushing Medicaid far afield of its original purpose of financing the medical care of the indigent, in particular those on Aid to Families with Dependent Children and successor welfare programs. Strikingly, more than a third of the Medicaid budget is dedicated to long-term care, most of which finances the stay of disabled elderly in nursing homes. The care of two out of three nursing-home residents is paid, in whole or in part, by Medicaid.

A welfare model has also led to two-tier nursing-home care. Private payers, irrespective of their need for care, are typically given preferential treatment in admissions; Medicaid beneficiaries are often consigned to second-rate facilities because the budgets set by state governments (albeit with heavy federal funding) do not stretch to pay comparable fees.

A welfare model, moreover, has been an open invitation to transfer assets to heirs in advance of the need for nursing-home care. To be sure, asset and income limits are an inherent part of any welfare grant; they are designed to ensure that the available resources go to those with the greatest need. In practice, however, Medicaid finances the nursing-home care of many others. Asset and income limits have given rise to a whole industry of estate planners adept at helping people meet the letter, although not the spirit, of the limits.

Insurance—public or private or some combination of the two—would be a greatly better answer to th[e] nation's long-term care needs. Indeed, long-term care is almost perfectly suited to an insurance model.

Two out of five Americans over age 65 will spend some time in a nursing home. For most, their stay will be only for a few months, say, for rehabilitation following hip replacement or a stroke. Medicare ordinarily pays most of the costs associated with such stays. However, one in ten Americans over 65 will require care for five years or more and will incur costs that if paid directly from individual or family assets would bankrupt most families. If every family were to try to save to meet the cost of such a stay, the resulting saving would be excessive. Pooling of the needed saving through insurance premiums is the natural economic response, but one frustrated by apparent market failure.

It is not a failure of the insurance market per se. Easy access to Medicaid all but forecloses the chances of developing a broad market for long-term care insurance. And, absent adequate public funding for alternative forms of care, easy access to Medicaid for nursing home care has led to excessive institutionalization of the disabled elderly.

The challenge for government is to shift the financing of long-term care toward an insurance, and away from a welfare, model. The well-being of all the disabled elderly in need of Medicaid benefits is at stake because of two-tier care practices—a problem that promises to worsen as economies mandated by the Balanced Budget Act, for Medicaid as well as Medicare, take full effect over coming years. At stake also is "honest government"—one that not only does not fund inheritance protection but that also genuinely protects those with greatest need. Clearly, however, an insurance model cannot be developed as long as most Americans needing long-term care can turn to a safety net in the first instance.

ALL IS NOT WELL in private health care finance either—far from it. Understandably, employers have embraced negotiated rates to control their health care costs, using their market power just as government has.

This, after all, is the essence of the main managed care model—the preferred provider organization or PPO—that has taken root in this country in the past decade. The PPO has been able to negotiate prices for physician and hospital services in ways that most employers, acting on their own, could never have done.

Employers have also embraced, although to a lesser extent, the new-network-type HMO, with its strictly enforced practice guidelines as well as its power to discount fees. The HMO is thus both provider and insurer, in contrast to the old fee-for-service model in which these are separate and distinct.

The shift to managed care is a response to the extraordinary rise in health insurance premiums employers had to grapple with for years. It has been a major force behind the deceleration in the price of health care in recent years (and ultimately the much better behaved broad indexes of both price and labor cost). And it has given rise as well to recent stability in the health care share of GDP at about 15 percent.

All of this has come at a price, though—loss of the freedom people once had to choose their physician and hospital and loss of the autonomy physicians once had to pursue a particular course of treatment for a patient. The debate in Congress over a patient's bill of rights is ultimately a debate about restoring these freedoms. And it is about making health plans accountable when decisions adopted for cost reasons do serious harm. As it is now, under ERISA, health plans escape accountability if they are seen to be acting on behalf of self-insured employers. The interpretation has been that modalities of care or denials of care that have resulted in serious harm are a benefit determination—

not an occasion for a malpractice suit. Yet, no HMO can claim that all it does is implement the benefit decisions of employers. If only because HMOs can deny care, they are active in the delivery of care. That makes them fiduciaries, in the same way physicians are fiduciaries. They should be held accountable as such.

THE TAX EXCLUSION of employment-based health benefits has had enormous impact on health care finance in this country. It has linked health insurance to employment. It has given decision-making authority to employers, not to individuals as health care consumers; health insurance is thus not portable and cannot be made portable by law except for short periods. It has made health insurance more comprehensive than it ought to be, thus broadening the arena over which moral hazard holds sway, and, in turn, has raised costs. It has violated every canon of tax equity.

What is more, it is at the heart of the problem of the uninsured. The majority of the uninsured work, but at wages too low to have health insurance fit within the overall pay packet. Ironically, these are the very same people who benefit least from the roughly $100 billion a year subsidy to health insurance flowing from tax exclusion of this form of income. The tax exclusion has drained resources from what ought to be the real object of tax preferences in health care: support of those who cannot afford it.

A tax credit, along with a requirement that people carry health insurance (as they must carry car insurance), would achieve universal health care, as the exclusion never did and could not have.

GETTING FROM THE existing financial structure to something sensible will not be easy politically. Herein lies the explanation for Washington's willingness over the years to do nothing more than tinker around the edges of health care policy (the ill-fated Clinton plan aside)—its unwillingness to confront basic design issues.[2]

The design I would favor (along with many others who have studied the issue; see, for example, Pauly, Danzon, Feldstein, and Hoff 1992) is to end the exclusion and use the proceeds to fund an income-scaled, refundable tax credit. That would attack frontally the underlying problem: large numbers of people who earn too little to have health benefits fit within the overall pay packet. Here, too, food on the table comes first. A tax credit, along with a requirement that people carry health insurance (as they must carry car insurance), would achieve universal health care, as the exclusion never did and could not have.

The tax credit approach would also remove employers from health care decision making (a role they have assumed for no reason but the opportunity to pay employees with some tax-free dollars). That, in turn, would restore a measure of freedom to health care decisions. Ultimately, it is individuals, not employers, who pay their medical bills in the form of forgone compensation of some other kind. They are the real buyers of health services, and it is they to whom health plans should be accountable.

Finally, tax credits in lieu of the exclusion would push the health insurance market in the direction of catastrophic coverage, featuring high deductibles and other co-payments, thus economizing on the claims processing and other administrative costs now associated with the use of insurance for the payment of routine and predictable expenses. It thus would reduce moral hazard and, in turn, the

[2]Incremental changes hold out much less promise. Efforts over the years to ensure poor children are a case in point. States have been required since the mid 1980s to extend Medicaid benefits to all children who are below the federal poverty line. And the CHIPs program expanded coverage further. Even so, a higher percentage of children are uninsured today than ten years ago—the result of such more than offsetting forces as the growth of contract employment and growing employer reluctance, despite the tax exclusion, to provide health benefits, especially for low-income workers.

pressure on costs ensuing from the illusion that medical care is somehow free or, at the very least, not to be valued at its full cost. Individual, high co-payment policies would offer a good alternative to an HMO or PPO to those who now have little, if any, choice.

Design changes for Medicare are also needed. The financial stress Medicare faces as the baby boom ages is an opportunity to rethink Medicare's status as an entitlement. A heavily subsidized health care plan that is blind to income for all over the age of 64 may have made sense in the mid 1960s. Health care was less than half the share of GDP it is now, the incidence of poverty among the elderly was relatively high, and life expectancies were much lower. Conditions are now markedly different, and yet the entitlement principle has never been seriously reexamined. The Medicare debate has focused on fiscal aggregates rather than on the level of subsidy that beneficiaries ought to receive. In practice, that means top-down budgeting and continued squeezing of the incomes of hospitals at the risk of harm to not only Medicare beneficiaries but the population at large.

Whatever else is done, the administration of a President Gore or a President Bush will have to take a hard look at the problem of the uninsured. As many Americans see it, health care is a basic human right, not to be parceled out like Chevrolets or other goods and services best distributed by the laws of the marketplace. But the issue is even broader than that. Not so long ago, the consequences for health care of a nation with a large minority of poor people were muted by cross subsidies from both government and employers. No longer. The consequences now are apt to show up in hospital income statements and, in turn, in quality indicators, linked as they are to the availability of resources.

It is not just cross subsidies that are gone, but the revenue that ought to come from levying reasonably full costs on both government and employers for the care they themselves are agents for. At the very least, no one should be surprised if, in time, this confluence of forces yields a marked deterioration in the quality of American health care.

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Policy Note 2000/5

CAN THE EXPANSION BE SUSTAINED? A MINSKIAN VIEW

L. RANDALL WRAY

Hyman P. Minsky's insights into the relationship between profits, economic growth, and the public and private financial balances are particularly relevant to today's conditions. How can a Minskian view be applied to explain the processes that brought the economy to its current state and to recommend a policy stance for the future?

IN A SERIES OF IMPORTANT PIECES, WYNNE GODLEY has demonstrated the necessary implication of a public sector surplus—a private sector deficit. He has also, rightly, questioned Congressional Budget Office projections that presume that the federal government's surplus not only will continue, but will grow over time. What I will focus on here is the processes that brought us to this point and prospects for the economy. My discussion is informed by the teachings of Hyman P. Minsky, who was a distinguished scholar at the Levy Institute until his death in 1996. All who had the pleasure of knowing him recognize that his views on the state of the economy at this time would have been uniquely insightful. While the following cannot substitute for the analysis he could have supplied, it is hoped that it can contribute to a Minskian understanding of the dangers involved in the current expansion.

IN THE EARLY 1980S, when I was one of Minsky's students, he introduced us to the Kalecki equation, which he, and we, later found to be similar to Jerome Levy's profits equation. In the Kalecki version,

aggregate profits = private sector investment + government deficit
+ trade surplus (– trade deficit) + consumption out of profits (capitalists' consumption)
– saving out of wages (workers' saving)

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In his exposition, Minsky quickly jumped to what is called the classical case, in which capitalists do not consume and workers do not save, so that aggregate profits would be equal to investment plus the government deficit minus the trade deficit.

The early 1980s was interesting because the United States was struggling to break free from the Reagan recession, with almost no private investment and a growing trade deficit. Thus, according to the equation, the only source of profits was the burgeoning federal budget deficit. In *Stabilizing an Unstable Economy*, Minsky noted that the deep recession of the early 1970s was the first recession in which personal income never fell—and it did not fall because government transfers and deficits rose sufficiently to maintain private income (Minsky 1986). I later showed that the Reagan deficits maintained personal income in a similar manner so that it continued to grow in spite of the 1980 and 1982 recessions (Wray 1989). In Minsky's view, the floor to aggregate demand provided by a deficit's maintenance of personal income is a key stabilizing feature of the postwar big government economy we have inherited; indeed, Minsky counted it and central bank intervention as lender of last resort as the two main stabilizers of the modern economy.

What would happen if the government budget moved toward surplus? In the U.S. case, with a trade deficit, profits would have to be generated by capitalist spending (both on investment and consumption) as well as by worker deficit spending.

As the Reagan deficits continued to climb through the 1980s, the economy recovered and profits boomed, even though investment remained sluggish. This expansion thus provided a new wrinkle in the Keynesian macro model, in which investment is assumed to be the driving force of the cycle. In fact, neither the Reagan expansion nor the Clinton expansion can be attributed to investment. The early stages of the Reagan expansion can be explained almost entirely by the exploding government deficit; the deficit was similarly important early in the Clinton expansion, but then growth continued primarily because of private sector spending.

One day in 1984, as the economy was recovering and consumers were becoming sufficiently confident to increase debt, Minsky and I discussed a nonclassical version of the Kalecki equation. Minsky had emphasized the role that government transfers play in fueling consumption, but what if consumers simply borrowed to keep consumption up? In other words, the Kalecki equation subtracts worker saving from aggregate profits, but what if worker saving were negative, that is, what if workers spent more than their income? In that case, even with a trade deficit and sluggish investment, aggregate profits could be positive without a government deficit.

We even considered a more extreme version of the Kalecki equation. What would happen if the government budget moved toward surplus? In the U.S. case, with a trade deficit, profits would have to be generated by capitalist spending (both on investment and consumption) as well as by worker deficit spending. Minsky recognized that theoretically this could happen, but he doubted that it was sufficiently likely to warrant further investigation. Steve Fazzari and I did spend some time trying to get estimates of saving out of wages, but it proved to be too difficult to allocate personal saving between profits and wages. In other words, worker saving may well

have been negative in the mid 1980s, with all measured saving actually coming out of profits, but it was impossible to know for sure.

Fortunately for our analysis, two things happened over the next 15 years. First, Wynne Godley came up with a much more fruitful way of looking at the whole matter. Godley simply consolidates all levels of government into a public sector, similarly consolidates households and firms into a domestic private sector, and, for completion, adds a foreign sector. It is clear that if the public sector is spending more than its income (that is, is running a deficit), at least one other sector must be spending less than its income. The United States has been running a trade deficit over the past two decades, and one that has generally been rising. A public sector in deficit tends to generate a private sector surplus—some of which is drained off through a trade deficit. In theory, all of the government sector's stimulus could be drained off that way, but, in practice, the trade deficit has not generally been large enough to do so. With Godley's approach, we do not need to allocate saving between profits and wages; the relevant breakdown is between households and firms, and those data are readily available.

In fact, neither the Reagan expansion nor the Clinton expansion can be attributed to investment. The early stages of the Reagan expansion can be explained almost entirely by the exploding government deficit; the deficit was similarly important early in the Clinton expansion, but then growth continued primarily because of private sector spending.

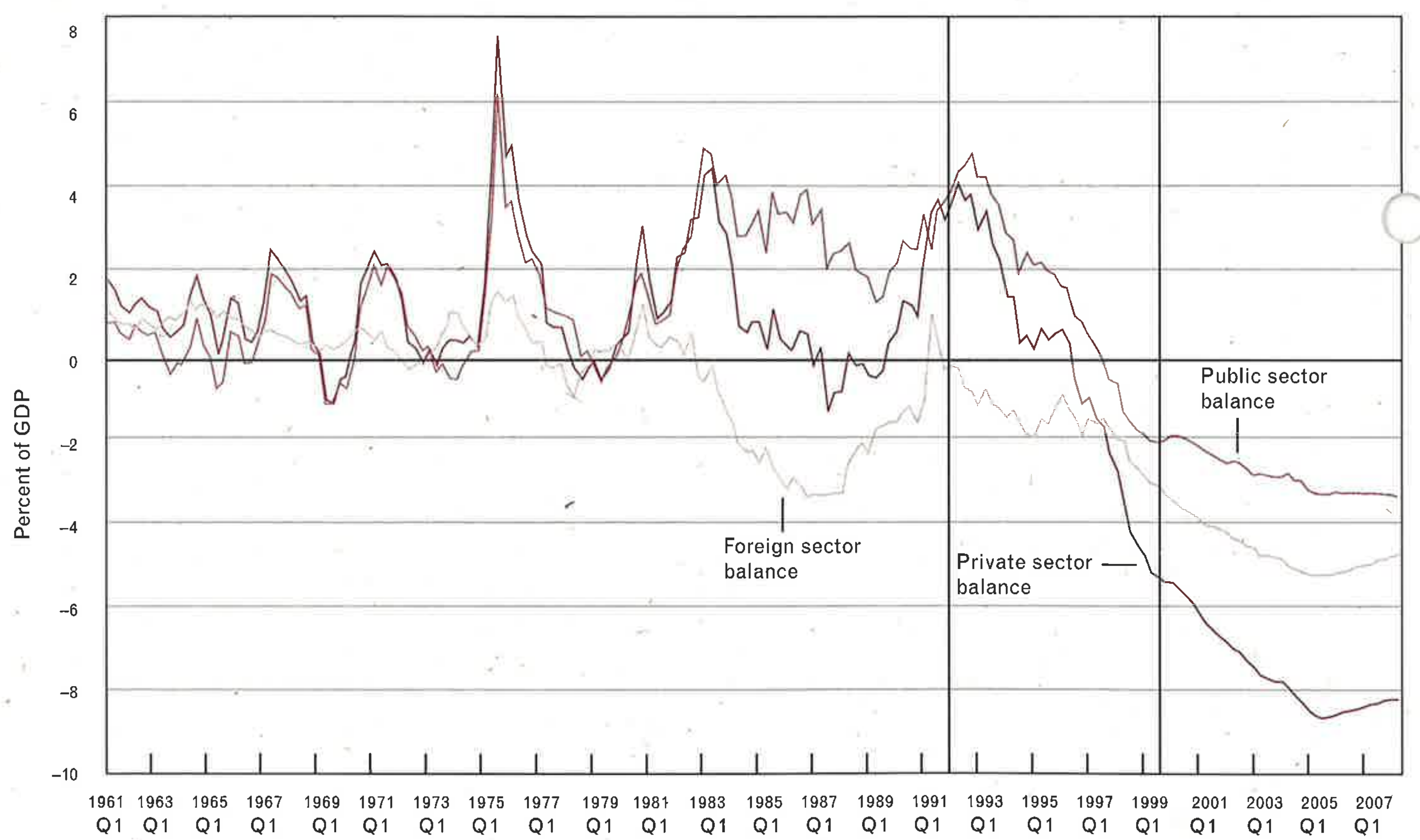
The second thing that happened is that the real world cooperated by generating unprecedented private sector deficits. As Figure 1 shows, the private sector deficit was approximately 5.5 percent of GDP in 1999. What seemed unlikely to Minsky in 1984 became a reality, albeit in a slightly altered form. However, I do not want to imply that Minsky was mistaken in arguing that the real world outcome was highly improbable; indeed, the current situation is virtually beyond the realm of the probable and is almost inexplicable, even from the vantage of hindsight.

If one compares the 1980s expansion with that of the 1990s, one can see that large government deficits helped initiate both. In both cases, once the expansion was under way, the private balance dropped from large, recession-period surpluses toward deficits. In the 1980s the private balance fell from a surplus of about 4.5 percent of GDP to a deficit of about 1.5 percent of GDP—a swing of 6 percentage points. In the 1990s the private balance fell from a surplus of 4 percent of GDP to a deficit of 5.5 percent (and still growing)—a swing of almost 10 percentage points. A swing of such magnitude is entirely unprecedented in the postwar period. It was brought about by the combination of a large trade deficit (although the 1980s expansion saw a similar deterioration in the balance of payments) and an unprecedented shift of the government budget toward large surpluses. How can the economy boom in the presence of large and growing government surpluses, and how can we explain the willingness of the private sector to spend in excess of its income to the tune of 5.5 percent of GDP, and rising?

For most analysts, the current situation is not difficult to explain. The government surplus is adding to the nation's saving, fueling investment in productivity-enhancing technologies.

Wall Street is capitalizing future income streams, generating unprecedented private sector wealth. This is a type of saving that is not captured in income and product account figures. Households are devoting a portion of capital gains to consumption, but wealth is growing faster than consumption. Similarly, household debt-to-income ratios are high, but this is not the relevant measure because wealth is growing faster than debt. Government saving is keeping interest rates low so that the burden of servicing debt, even out of measured income flows, is not excessive. The only two black spots these analysts see on the Goldilocks economy are the negative household saving rates (which they explain away, in large part, as a measurement problem) and the growing trade deficit. In any case, they are confident that Chairman Greenspan will be able to sustain Goldilocks in spite of depressionary influences caused by the government surplus and the trade deficit. Of course, most analysts are still more concerned

FIGURE 1 THE THREE FINANCIAL BALANCES



NOTE: The period between the two vertical bars, from 1991Q2 to 1999Q1, corresponds to the current expansion. Data after 1999Q1 are projections made by Wynne Godley based on Congressional Budget Office analysis.

SOURCE: National Income and Product Accounts; Congressional Budget Office; Wynne Godley's Levy Institute macroeconomic model.

with the possibility that Goldilocks will grow too fast than with the likelihood that she will slow excessively.

HOW WOULD MINSKY explain the processes that brought the economy to this point, and what would he think about the prospects for continued Goldilocks growth?

First, I think he would observe that consumers became able and willing to borrow to a degree not seen since the 1920s. Credit cards became readily and widely available; lenders expanded credit to subprime borrowers; publicity about redlining provided the stick and the Community Reinvestment Act provided the carrot to expand the supply of loans to lower-income homeowners; deregulation of financial institutions enhanced competition. All these things made it easier for consumers to borrow.

Consumers were also more willing to borrow. As memories of the Great Depression faded, people became less reluctant to commit future income flows to debt service. The last general debt deflation is beyond the experience of almost the whole population and the last recession was almost half a generation ago. With only one recession in nearly a generation, it is not hard for people to convince themselves that downside risks are small. Add to that the stock market's irrational exuberance and the wealth effect, and you can pretty easily explain consumer willingness to borrow.

With only one recession in nearly a generation, it is not hard for people to convince themselves that downside risks are small. Add to that the stock market's irrational exuberance and the wealth effect, and you can pretty easily explain consumer willingness to borrow.

I would add one more point, which is that until recently the average American family had not regained its real 1973 income. Even during the Clinton expansion, real wage growth has been low. Americans are not used to living through a quarter of a century without rising living standards. The first reaction to the slow growth was to increase the number of earners per family, but that has resulted in only a small increase in real income. Thus, it is not surprising that consumers ran out and borrowed as soon as they became reasonably confident that the expansion would last.

The result has been consistently high growth of consumer credit. The debt service burden (see Table 1) increased by about 1.8 percentage points, from about 11.7 percent of disposable income in 1992 to 13.5 percent in 1999; almost all of that growth was due to growth in servicing consumer debt and almost none to changes in servicing mortgages. Still, thanks to relatively low interest rates, the burden is not at record highs. It was above 14 percent at some points during the late 1980s. Of course, interest rates are rising, and everyone expects the Fed to continue to tighten, so we might yet break the 1980s record. In addition, margin debt has been growing rapidly and, with the turnaround on Wall Street, has become a cause for concern. Falling prices lead to margin calls and problems for investors and hurt brokers who have come to rely on interest paid on margin borrowing for as much as a quarter of their income.

The private sector balance is expected to continue to deteriorate. Looking to the public sector, the consolidated government balance is over 2 percent of GDP. The federal budget surplus was 1.4 percent of GDP in 1999, but, according to CBO projections, that will increase to 2.8 percent by 2010. By then, government spending will equal only 16.9 percent of GDP and tax revenue will still equal nearly 20 percent. The federal debt held by the public will decline from 40 percent of GDP to a little over 6 percent by 2010. It is important to note that this growth of the surplus is projected to occur as economic growth slows down—from about a 4 percent growth rate today to an average of 2.7 percent. In other words, fiscal policy is supposed to tighten substantially over the next 10 years, so that it will be heavily biased toward running government surpluses even when the economy grows far below its long-run average, which is closer to 3.5 percent. So the public sector has gone from a budget that was biased toward huge deficits at moderate rates of growth during the peak of the 1980s expansion to one that is biased toward huge surpluses at even lower growth rates.

TABLE 1 DEBT SERVICE RATIOS, DELINQUENCY RATES, AND CHARGE-OFF RATES, 1985–1999

	Household Debt Service Ratios (payments as % of disposable personal income)			Delinquency Rates, 100 Largest Banks			Charge-off Rates, 100 Largest Banks			
							Consumer Loans			
	Total	Consumer	Mortgage	Leases	C & I Loans	Agricultural Loans	All	Credit Cards	C & I Loans	Agricultural Loans
1985	13.74	8.29	5.44	na	na	na	1.72	3.11	1.13	4.56
1986	14.18	8.50	5.69	na	na	na	1.82	3.46	1.15	0.36
1987	13.71	7.92	5.79	1.58	6.36	14.20	1.89	3.50	0.89	2.15
1988	13.36	7.58	5.77	1.26	4.82	10.24	1.86	3.38	0.71	–1.32
1989	13.51	7.57	5.44	1.77	5.03	8.34	1.99	3.23	1.73	–0.23
1990	13.25	7.11	6.14	2.27	5.99	6.47	2.46	3.85	1.22	0.07
1991	12.57	6.51	6.05	2.19	5.83	6.62	2.90	5.26	2.10	0.15
1992	11.70	6.03	5.67	2.18	4.59	5.65	2.57	4.79	1.07	0.29
1993	11.60	6.13	5.46	1.15	2.67	4.05	2.00	3.75	0.50	0.28
1994	12.01	6.52	5.49	0.78	1.84	2.99	1.90	3.40	0.12	0.97
1995	12.70	7.05	5.65	0.98	1.72	2.45	2.24	3.87	0.22	0.06
1996	13.09	7.44	5.65	0.87	1.49	3.52	2.59	4.44	0.08	–0.08
1997	13.17	7.47	5.70	1.08	1.34	2.94	2.89	4.96	0.24	0.22
1998	13.29	7.57	5.72	1.06	1.59	2.47	2.68	4.87	0.52	0.30
1999	13.51	7.58	5.93	1.27	1.82	3.21	2.54	4.37	0.70	0.22

NOTES: C & I = commercial and industrial; na = not available.
All data are for the fourth quarter of each year and are seasonally adjusted.

SOURCE: Debt service ratios: www.bog.frb.fed.us/releases/housedebt/default.htm (March 24, 2000).
Delinquency rates: www.bog.frb.fed.us/releases/chargeoff/del_ lg_sa.txt (March 2000).
Charge-off rates: www.bog.frb.fed.us/releases/chargeoff/chg_lg_sa.txt (March 2000).

I am sure Minsky would reject the notion that retirement of the outstanding debt stock is a worthy goal. Removing the most liquid asset from the economy (as the government destroys nearly $3 trillion of private sector wealth) cannot be a good thing. Further, I am sure he would argue that the budget is far too biased toward a restrictive stance because it probably will not move toward substantial deficit unless we are far into a deep recession. At that point, it will be too late for the budget to perform its stabilizing function. Minsky would be skeptical about any claims that the Fed will be able to prevent a downturn. For Minsky, the primary role of the Fed in bad times is to prevent asset price deflation through intervention as lender of last resort. I can find nothing in Minsky's work that indicates that he thought that lower interest rates alone can do any good when spending turns down. While he emphasized that rising interest rates can be a bad thing because they can cause present value reversals (that is, force discounted net revenue streams below zero), he never accepted the notion that there is a simple downward sloping demand schedule for credit.

In some ways, the position of the United States looks even worse than that of Japan in 1989. Households have never had much savings and are much more indebted. The economy cannot export its way to growth, and any reduction of household income is going to make it difficult to service debt.

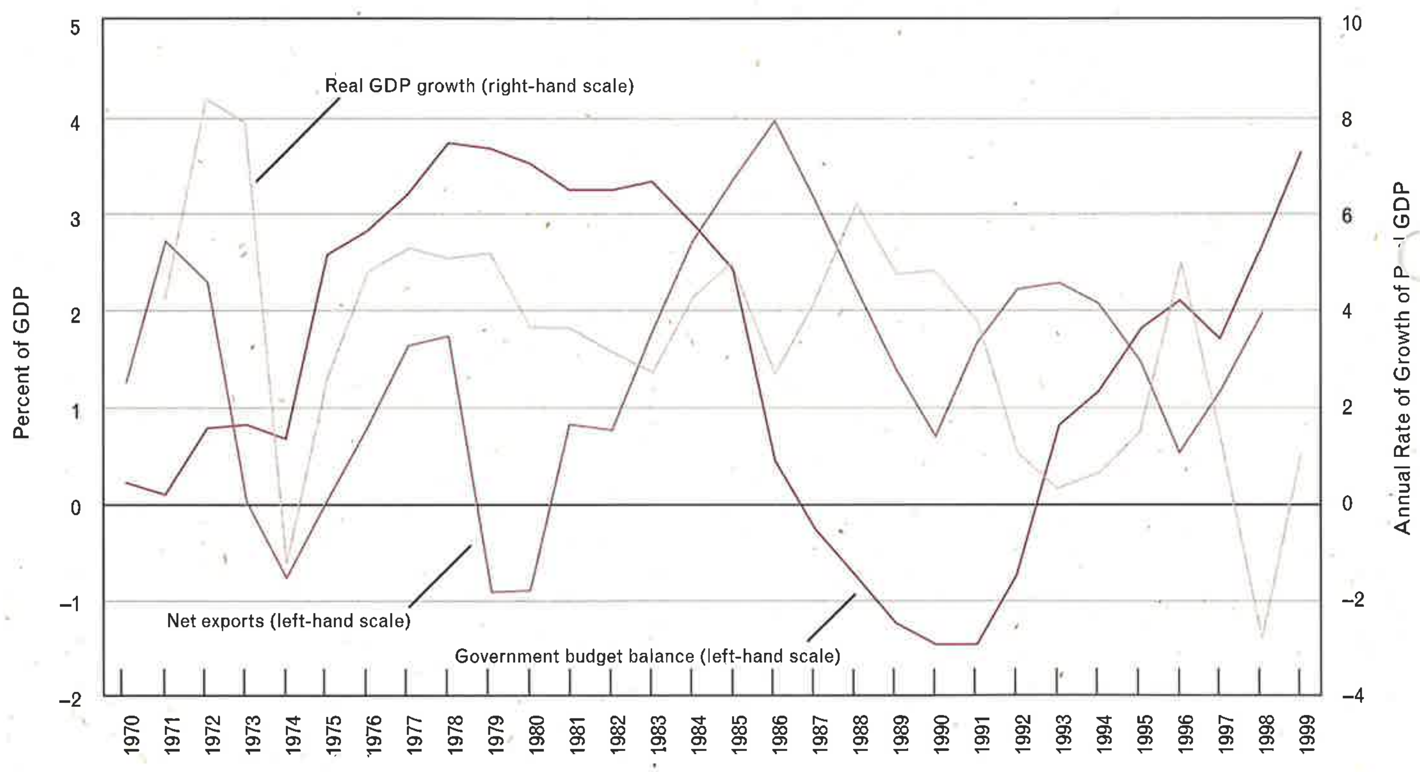
I am sure that Minsky would point to the case of Japan for support. The Japanese budget balance similarly became biased toward surplus by the end of the 1980s (see Figure 2). The government ran a surplus for six years after 1987; even after the economy turned down, the budget remained in surplus. With the easiest monetary policy the world has seen since World War II (that is, zero interest rates for more than four years), the economy still has not recovered. Japan's budget deficit returned in 1993 and in 1999 was close to 8 percent of GDP. However, the earlier surpluses destroyed the private sector to such an extent that in spite of these huge budget surpluses, monetary ease, and net exports running at 2 percent of GDP, the private sector just absorbs any potential stimulative effects by saving to the tune of 10 percent of GDP. In some ways, the position of the United States looks even worse than that of Japan in 1989. U.S. households have never had much savings and are much more indebted. The economy cannot export its way to growth, and any reduction of household income is going to make it difficult to service debt. Stock market excesses are probably worse than Japan's (although it does seem unlikely that the real estate sector is overvalued to the extent that it was in Japan at the end of the 1980s). Even if one does not think that the situation is as bad as Japan's was, the depths of the Japanese recession should raise alarm about the risks faced by the economy.

I believe Minsky would point to several additional danger signs:

- Charge-offs for consumer loans, especially for credit cards and leases, have been rising since 1996 (see Table 1). Charge-offs on agricultural loans are rising. Delinquency rates have recently been rising for leases and commercial and industrial loans. I know that these rates are not yet inordinately high and that they are to a large extent discretionary (for example, extremely low delinquency rates are taken to be evidence that management is too risk-averse, leading to purchases of riskier pools of customers). But the rising rates may be an indication of problems to come.

- Bankruptcy law is now being reformed in a way that will make it harder for debtors to default. While that will make it easier to collect on debts, it also means that indebted consumers will have to cut back spending elsewhere. This will make it harder to get out of recession.
- The Fed is pushing up interest rates. Although private sector debt ratios are well above any previous level, debt service burdens have been moderated by low interest rates. Higher interest rates will eventually increase debt burdens sufficiently that households will begin to default.

FIGURE 2 ECONOMIC GROWTH IN JAPAN: COMPONENTS OF AGGREGATE DEMAND



NOTE: Deficits are assigned a positive value and surpluses a negative value.
Budgetary data prior to 1986 are for the Budgetary Central Government only;
budgetary data for 1986 and forward are for the Consolidated General Government.

SOURCE: Export and GDP data: International Monetary Fund, International Financial Statistics CD-ROM.
Budgetary data prior to 1986: IMF, International Financial Statistics CD-ROM.
Budgetary data for 1986 and forward: IMF, World Economic Outlook, May 1994 and December 1998.
(The author thanks Marc-André Pigeon for help in preparing this figure.)

- The stock market has probably already started on the way down. Note that if it is true that the wealth effect has been driving consumption, it is not necessary to have a crash to kill the expansion. As Godley has argued, stock market capital gains provide only a one-time boost to consumption levels; continued economic growth requires rising stock prices.
- While GDP growth rates have remained above expectations, some areas of the economy slowed perceptibly in March—real earnings were down 0.4 percent, and business inventories were growing faster than sales. March retail sales were up by 0.4 percent, but they had grown by 1.8 percent in February.
- Since the middle of 1997 profits growth has consistently been below GDP growth and capital spending by firms, opening up a growing financing gap in the corporate sector. The financing gap is the difference between capital spending and available internal funds; it reached 19 percent in the third quarter of last year, its highest since the mid 1980s.
- Business net interest expense is already rising and will increase sharply as the Fed raises interest rates. A cutback of consumer spending combined with rising interest rates will increase the financing gap and cause firms to reduce their own spending.

The expansion might not stall out in the coming months, but continued expansion in the face of a trade deficit and a budget surplus requires that the private sector's deficit and thus its debt load continue to rise without limit. Minsky cautioned us that government deficits cannot continue to rise relative to GDP without limit, and I think he would argue even more forcefully that neither can private deficits rise without limit. Is it not strange that although many economists agree with Minsky's statements about government deficits, they do not recognize the dangers in private deficits? Minsky's writings on the importance of debt load structures (and his tripartite classification of financial positions as hedge, speculative, and Ponzi) should make analysts and policymakers even more concerned about private deficits that are already well above 5 percent of GDP than they were about the Reagan-Bush budget deficits that peaked in that range. I know of no reputable economic theory that concludes that growing private sector deficits are any more sustainable than are growing public sector deficits, and Minsky would have concluded that rising private sector deficits are far more risky!

WHAT WOULD MINSKY RECOMMEND? As long as private spending continues at a robust pace, he would probably recommend that we do nothing today about the budget surplus. He would oppose any approaches that would limit fiscal policy to maintenance of a surplus. Rather, he would push toward recognition that tax cuts and public spending increases will be needed as soon as private spending falters. That recognition would imply that now is the time to begin discussing the types of tax cuts and spending programs to be put in place rather than rushing them through as the recession begins.

For the longer run, he would recommend relaxing the fiscal stance so that surpluses would be achieved only at high growth rates (in excess of the full employment rate of economic growth). For the shorter run, he would oppose monetary tightening, which would increase debt service ratios and push financial structures into speculative or Ponzi positions. He would support policies aimed at reducing the irrational exuberance of financial markets; in particular, he would insist that increased margin requirements on stock markets would be far more effective and narrowly targeted than are general interest rate hikes that have been the sole instrument of Fed policy to this point.

Most important, Minsky would try to shift the focus of policy formulation away from the belief that monetary policy alone can be used to fine-tune the economy and from the belief that fiscal policy should be geared toward running perpetual surpluses. In his view, such policies would be high-risk strategies with no strong theoretical foundation.

Acknowledgment

I would like to acknowledge the substantial debt I owe Wynne Godley for the insights that inspired this policy note.

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Policy Note 2000 / 6

DROWNING IN DEBT

WYNNE GODLEY

The U.S. expansion has been driven to an unusual extent by falling personal saving and rising borrowing by the private sector. If this process goes into reverse, as has happened under comparable circumstances in other countries, there will be a severe recession unless there is a big relaxation in fiscal policy.

THE UNITED STATES is widely believed to have acquired a New Economy, having achieved the longest economic expansion in its history and the lowest unemployment rate in 30 years. Untold wealth has been created, productivity growth has accelerated, and inflation has been dormant.

It is generally agreed that the growth of the U.S. economy must soon slow down—or be slowed down by Chairman Alan Greenspan—because unemployment cannot fall much further without awakening inflation. The question of the moment is whether growth will slow to a rate that just accords with the rate of productive capacity, in which case there could be a "soft landing." Most people seem to think that if this happens, the good times can continue forever. I, however, doubt that the expansion can continue at all during the next few years unless there are major changes in the stance and structure of policy.

HOW PRIVATE SPENDING HAS BEEN ABLE TO INCREASE SO FAST

Although the U.S. expansion has been unusually long, it has not been unusually fast. Growth since 1991 has averaged 3.7 percent per annum, only 0.2 percent faster than the average during the whole postwar period. There have been many nine-year periods during which growth was much faster. It is the growth of private expenditure, taking consumption and investment together, that has been unusually high, averaging 4.6 percent per annum.

How could private expenditure have risen so much faster than total output, seeing that it accounts, by itself, for 85 percent of all the expenditure that makes up the GDP? How was a quart extracted from a pint pot? In an arithmetical sense the answer is simple. Private expenditure grew faster than total domestic output mainly because there was a large deterioration in the balance of payments. The pint pot was supplemented by imports of goods and services, which rose at an average rate of 10.4 percent per annum. Imports have risen, that is, nearly two-and-a-half-fold since 1991.

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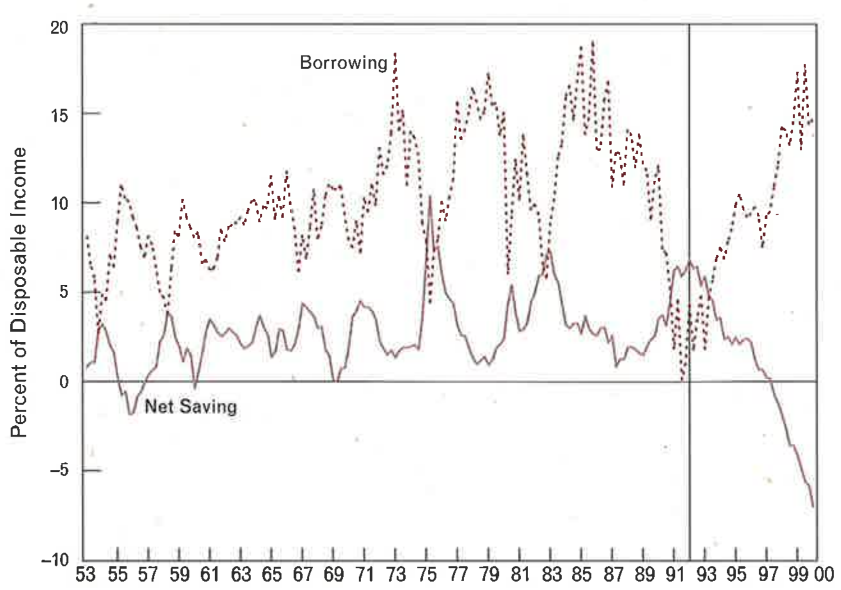
However, the deterioration in the balance of payments and a big improvement in the budget were both factors tending to drive private disposable income downward. So, again, how was the private sector able to increase its spending so fast? An answer is suggested in Chart 1, in which the solid line shows net private saving—the gap between private disposable income and private expenditure. For a great many years income consistently exceeded expenditure, as one would expect; net saving fluctuated quite narrowly, averaging nearly 3 percent of income. Since 1992 expenditure has risen continuously relative to income. Net saving fell through the zero line in 1997 and has been falling more and more deeply into negative territory ever since. In the first quarter of this year net saving reached minus 7.0 percent of income and was 9 to 10 percent below what used to be normal. Whatever this private deficit may portend for the future, it is certainly entirely different from anything that has ever happened before—at least in the United States.

The general view seems to be that private expenditure has risen because capital gains are being spent; so everything should be all right as long as the stock market holds up. But it is impossible literally to "spend" capital gains. Either liquid balances must be run down or securities must be realized (that is, sold to another sector since selling within a sector only shifts money from one pocket to another)—or additional funds must be borrowed.

Figures published by the Federal Reserve reveal that it was borrowing that was the main source of the funds needed to finance excess spending. Borrowing makes it possible to enjoy capital gains without selling shares and thereby incurring a liability for capital gains tax; also, the interest payable on loans is often tax deductible. The private sector as a whole has not been realizing equities on a substantial scale. Households have been selling equities, but these have been largely mopped up by corporate purchases. And corporations could only buy equities and simultaneously pay for investment in capital equipment by borrowing more themselves. According to the Fed's figures, the net flow of credit (advances less repayments) to the nonfinancial private sector taken as whole rose from a negligible quantity in 1991 to over $1 trillion in 1999, by which time (as the dotted line in Chart 1 shows) borrowing was augmenting disposable income by about 15 percent.

As the flow of lending to the private sector has been so large, the level of debt has risen in a spectacular way, reaching a record 165 percent of disposable income in the first quarter of 2000. Household debt (even if "margin debt" used to finance speculation on the stock exchange is excluded) reached nearly 100 percent of personal disposable income—an all-time high. And corporate debt reached 74 percent of corporate GDP—another record, slightly above the previous peak at the turn of 1989–1990, just before the last credit crunch.

CHART 1 PRIVATE NET SAVING AND BORROWING AS PERCENT OF DISPOSABLE INCOME



SOURCE: NIPA and Flow of Funds

WHY PRIVATE DEBT CANNOT INCREASE INDEFINITELY

It seems fair to conclude, at a minimum, that the high level of debt now poses a risk; if there were a big fall in asset prices or a significant further rise in interest rates, weak positions might be exposed, which could generate a downward spiral of forced selling. More important, as I shall argue, the combination of the private deficit and the administration's fiscal plans makes it highly doubtful that the future can be anything at all like the past. The danger of severe and prolonged recession is being seriously underestimated.

In its April report, the Congressional Budget Office (CBO) published projections of the federal budget through the next 10 years, all based on the assumption that growth is maintained at about 2.7 percent per annum, a rate slightly below that of productive capacity, implying that unemployment rises to just over 5 percent. All these official projections show the budget surplus continuing to rise throughout the next decade, and recent reports suggest that the rise in the surplus may be substantially larger than what was projected in the April report.

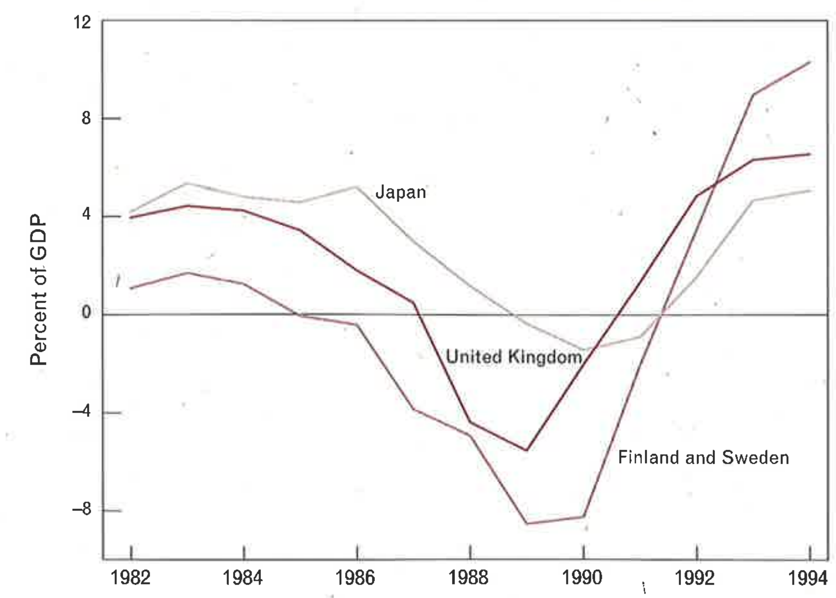
At the same time the U.S. balance of payments deficit looks set to worsen if the economy continues to expand while the dollar remains strong. There has for many years been a trend deterioration in the U.S. balance of trade, which has been exacerbated, perhaps temporarily, by slow growth in the rest of the world. However, even if the balance of trade were now to stabilize as the rest of the world recovers, the foreign debt the United States is now incurring is likely to generate a growing outflow of interest income large enough to make the balance of payments as a whole go on deteriorating.

If the balance of payments does continue to deteriorate, a rise in the budget surplus can occur, as a matter of accounting logic, only if private expenditure continues to rise relative to income (see box). It is impossible to overemphasize that the entire fiscal plan the authorities have set forth, since it combines a rising budget surplus with continued economic growth, can form part of a coherent macroeconomic strategy only on the assumption that private net saving continues to fall into increasingly negative territory. If saving does not continue to fall—if private expenditure rises less than income in the years to come—this must (by the laws of accounting) be

BOX SOME BASIC FORMULAS DEFINING NATIONAL INCOME IDENTITIES

Total private income from production of goods and services plus net property income from abroad (Y) is equal, by definition, to private expenditure (PX) plus government expenditure (G) plus the current balance of payments (BP). Deduct taxes and transfers (T) from both sides and rearrange to yield the identity $[Y - T - PX] = [G - T] + BP$. This formula states that private net saving, the expression on the left-hand side, is logically equivalent to the government deficit plus the balance of payments surplus.

CHART 2 PRIVATE NET SAVING IN VARIOUS COUNTRIES AS PERCENT OF GDP



SOURCE: IMF

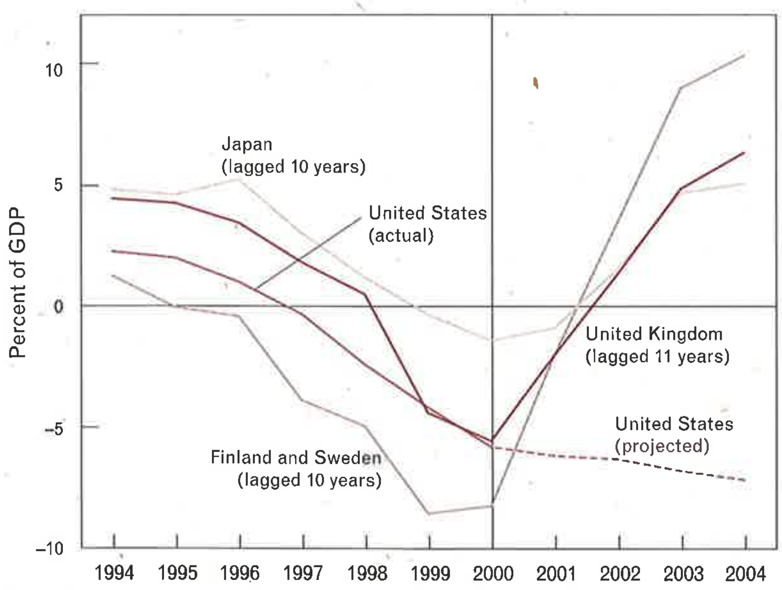
accompanied by some combination of a deteriorating budget (that is, a move away from surplus) and an improving balance of payments. And this could happen (given fiscal stance and trade propensities) only if demand and output in total were to stagnate or collapse. Without a continued stimulus from private expenditure in excess of income growth, there would be nothing to keep the expansion going. It is theoretically possible, if hardly credible, that a fall in the dollar could result in a rise in net exports large enough to keep the U.S. expansion going, as happened in Britain after 1992—after two years of recession.

Yes, but why shouldn't private net saving go on falling, thereby validating the official scenario? Why shouldn't the future, for an indefinite period, be a "calmed down" continuation of the past? While the United States has never before (at least not in modern times) had a large private financial deficit, there have occasionally been such deficits in other countries. The IMF's most recent World Economic Outlook points to three instances of private deficits—in Japan, the United Kingdom, and Finland and Sweden (Chart 2). In each of these cases, having reached a negative position not very different from that in which the United States now finds itself, the deficit recovered over a period of years and regained its habitual state of surplus. In each case, the rise in net saving overshot, so that for a time the private surplus was unusually high. The period during which the private deficit was growing was always accompanied by an economic boom—acclaimed, at least in the United Kingdom, as an economic miracle! But each boom was followed by a severe recession as the credit expansion unraveled.

In Chart 3 the path of the United States's private deficit is superimposed on the deficit paths shown in Chart 2. The solid line shows the actual path of the U.S. private deficit up to the first quarter of 2000; the dash line shows what must be held to happen in the future to validate the CBO's projections. It seems doubtful, to put it mildly, that things can actually turn out this way. As I argued above, the private deficit can go on rising only as long as net lending remains at least at its present level, so that private debt continues to rise rapidly relative to income. I reckon that to validate the story illustrated in the chart, private debt would have to rise to 230 percent of disposable income in five years' time and continue to rise further thereafter.

An increase in private debt relative to income can go on for a long time, but it cannot go on forever. It is true that the net worth of households rose from about 500 percent to more than 600 percent of disposable income in 1999 alone, and some people have argued that this rise completely outweighs any adverse effect from household debt, which has been inching up to a mere 100 percent of income. However, this argument suffers from two flaws. First, apart from the fact that asset prices may well fall substantially, the decisive constraint on borrowing may come not from the extent to which net worth is being mortgaged, but

CHART 3 PRIVATE NET SAVING IN THE UNITED STATES, ACTUAL AND PROJECTED, AND ABROAD, LAGGED ABOUT 10 YEARS, AS PERCENT OF GDP



SOURCE: IMF, NIPA, and author's projections.

from the extent to which payments of interest and repayments of principal (which must be settled in cash) can be met out of conventional income. It is income rather than net worth that is ultimately the criterion of creditworthiness, since in a crisis it may be impossible for everyone to realize assets simultaneously. Second, the argument that households' net worth has risen a lot does not touch the fact that half of the nonfinancial private debt is owed by businesses. Corporate debt has been rising rapidly relative to corporate GDP for the last two and a half years and now exceeds levels last seen in the 1980s, when the last debt crisis unraveled.

If private net saving were to recover over the next few years to the level that is normal in other countries and that was normal in the United States until fairly recently, the results would be horrendous. With private expenditure falling by 5 to 10 percent relative to income, there could be hardly any growth at all for some years. If the unraveling took place as quickly as it did in the United Kingdom, there could be a severe recession, with grave consequences for the rest of the world. The budget surplus would disappear. And it is easy to imagine that with a recession, or even a prolonged stagnation, there would be a large fall in the stock market, which would make matters infinitely worse.

A POLICY REORIENTATION TO CHANGE THE SCENARIO

It would be possible for the authorities to reorient policy so as to avoid the whole scenario I have just outlined. Any fall in private spending could, at least in theory, be offset by a relaxation of fiscal policy, which might have to take place even though the budget was already moving back into deficit. It is difficult to see how the growing external deficit can be stemmed, as it eventually must, without there being, at some stage, a substantial fall in the dollar. It is to be hoped that contingency planning along these lines is in hand, even though it runs slap contrary to conventional thinking at the moment.

While I believe continued prosperity in the United States to be at grave risk without a major change in fiscal and exchange rate policy at some stage, I would be a fool to try to put a date on the turning point. I simply do not know when it will come.

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