

***RIGHTING THE UPSIDE-DOWN ECONOMY:  
CREATING A SUSTAINABLE RECOVERY***

**Transcript**

July 1, 2004

**Scott Lilly:**

My name is Scott Lilly. I'm the moderator of this panel. I'm going to try to move things along. This will last an hour and fifteen minutes. And we've got, I think, a good program in store.

It seems to be conventional wisdom in Washington and in some other parts of the country that this recovery is very much on track, that the strong GDP growth that we experienced last year is going to result in ever more jobs, those jobs are going to fatten the pocketbooks of ordinary households, the cash registers are going to start ringing more and more rapidly, and that will create even more employment.

That is the course of a normal recovery, and that is what has happened time and time again over the past 60 years. This is the ninth business cycle that we've had since World War II. But this cycle has been very different from the others. The others were largely induced by rising interest rates, which slowed down economic activity. But this business cycle, which began in March of 2001, started despite the fact that interest rates, and particularly long term interest rates, had been falling for more than a year. And so the origins of this cycle are very different.

And it has been very different in its shape. The other eight cycles had a distinct and similar pattern. Job loss lasted for a period of about 10-12 months. We lost about three percent of the employment in this country during that 10-12 month period. That was followed by a very sharp rebound, and within eight months, on average, all the jobs that had been lost were restored. Within an additional ten months, that is, 30 months from the beginning of the recession, we had about two to three percent more employment in this country than we had at the outset of the business cycle. This has not at all been the case with this recession.

A year after the beginning of the recession we were still losing jobs. A year after that, we were still losing jobs. And 30 months into this business cycle, when we had normally restored all the jobs and added two to three percent above pre recession employment levels, we were still losing jobs. It was only last August when we started to add jobs, and we added them very slowly. So the question is, have we finally begun to have a normal recovery, or are there some real impediments to growth that we need to understand in order to formulate more intelligent policies to counter it?

My judgment is that we are not on course for a healthy recovery. Job growth, while encouraging, has averaged only about 0.19 percent a month, that is less than 60 percent the rate of job growth is in a normal recovery. But more troubling is the fact that while jobs have been increasing, real wages have been falling. And real wages have fallen from

about \$15.73 last November to about \$15.64; they've fallen 19 cents, or about 1.2 percent since last November. So that means that wages are falling faster than employment is increasing. And ultimately that means that most households have less money, not more money, in the course of this recovery.

This is a topic that a member of our panel, Dr. Eileen Appelbaum will address. She is one of the nation's leading experts on wages and labor issues. She is a professor in the School of Management Relations at Rutgers and Director of the Center for Women and Work. She is going to be looking at this employment and wage issue and talking about what resources consumers have.

But beyond the weakness in employment growth and the decline in real wages, there is an additional problem facing the American consumer. That problem is that the level of consumption that we've had over the past several years has been artificially high because of the level of mortgage refinancing. Dr. Christian Weller, who's the chief economist at the Center [for American Progress] has done some calculations that indicate that refinancing of mortgages has probably put about \$20 billion in the pockets of consumers that wouldn't be there otherwise. But the great bonanza in home mortgage refinancing has come to an abrupt end – the Mortgage Bankers' Association reported last month that refinancing has dropped 86.5 percent compared to the same period a year ago.

So this enormous flow of cash that has been going into households from increasing borrowing against home equity has been suddenly shut off. And yet for the economy to grow, consumers will have to not only spend the same amount they spent last year, but they'll have to spend probably about six percent more just to maintain a normal rate of growth.

To look at that issue is Dr. Robert Manning. He comes to us from Rochester, New York. He is a professor at Rochester Institute of Technology and a special assistant to the provost. He is also the author of Credit Card Nation, which is one of the well known and most often-cited books on the question of consumer debt.

And finally, we have someone that I've only known recently. We worked together first in 1971, in the McGovern campaign, and then he was just down the hall from me in the Rayburn House Office Building when he worked for a Wisconsin congressman named Henry Royce and I worked for another Wisconsin congressman, Dave Obey. He preceded me as executive director of the Joint Economic Committee and he is now the Lloyd Bentsen chair at the LBJ School at the University of Texas. He has written a number of books. And he's going to talk about all of these trends from a macro standpoint. He will give U.S. an overview of how these problems with wages and debt fit together and what they spell for the future course of this recovery.

So I'd like to first call on Dr. Appelbaum. Thank you.

Eileen Appelbaum:

Thank you, Scott. I'm very happy to be here, and happy to see all of you this morning. My topic is job quality in the upside down economy.

I want to talk about the kinds of jobs that the U.S. economy has been creating, and what we can expect for the future. We're going to hear a lot more in a few minutes from Jamie about the macroeconomic situation. I think that most of you are well aware that we've had very expansionary macroeconomic policy. The interest rate – the Federal Funds rate – went up a little bit yesterday. But interest rates have been at historic lows for three years. In addition, the federal budget has gone from a position of surplus to a position of deficit.

Despite all of this, we have not created enough jobs to keep up with the growth in the working age population. Indeed, the U.S. has had a decline in the share of Americans of working age who are employed. This is sometimes attributed in the popular press to women and mothers who have decided that they want to stay home with their kids. But as you can see if you look at the top line of the first chart, it's true of men also. So it's a labor market issue, unless we also want to think that fathers have decided that they should be staying home full time with their children. So we definitely have a jobs problem here.

The next several slides that I am going to show you will run through what is happening to job quality. We'll look first at the establishment data, and see where employers say the jobs have actually been created. Then we'll take a look at the household data. When we get to that slide, you will see that, in the past year, part-time employment increased by more than half of the number of all jobs that were created. You'll also see that real wages are declining. And finally, I will show you some slides that illustrate the really important point I want to make – namely that we're dealing with a long term trend. The creation of poor quality jobs is not just something that is due to the current business cycle, and if we don't address this development through economic policy, we're going to see a continuing shrinking of the middle class.

This slide shows private sector job growth, and what I've done here is select out the service industries that are producing lots of jobs. You can see that they are retail trade, temporary services, janitorial, home health aides and nursing home facilities, child day care, and restaurants and food service. These industries account for some 56 percent of the jobs that have been created since last May. So we're definitely creating jobs again, as you can see: 1.35 million jobs have been created in the last twelve months, most of them more recently than that. But more than half of them are in these low wage service industries employing lots of women. Not surprisingly, if we look at total employment from the household data, we see in the next slide that many, many of the jobs that have been created are part-time jobs. We know that in retail, in foodservice, in janitorial, nursing aides and so on, these are frequently part-time jobs. So the economy is now creating jobs again, but these are lots of low-wage jobs, and lots of part-time jobs.

If we take a look in the next slide at what has happened to real average hourly earnings, and Scott has already talked about this, you can see that the tremendous spurt in productivity growth since the mid-90s was translated into an increase in wages, although

wages never, never kept up with the increase in productivity. Workers never got their share of the growing economic pie. But we do see that real wages were increasing in the 1990s. Then, as we move into the 2000s, we see the rate of increase slowing. And in the last year, while the jobs were finally being created, we see the real wage going down. And I think it's not a mystery why this has happened – if you create a lot of jobs in low-wage industries, you will see the real wage, on average, going down.

I think the next slide is really telling. I think this graph makes it really clear what has happened in the last few years. On the right hand side you can see the tremendous increase in jobs that pay very, very low wages. If you look at the lower middle class and the middle class jobs, you can see that those were shrinking. And on the left hand side of the slide, you can see the increase in higher paying jobs. So it's not that the U.S. economy doesn't create any good jobs, we certainly do create good jobs. But the middle-class jobs that have supported a middle-class standard of living are shrinking, while the jobs that pay rotten wages have been increasing.

If we look in the next slide at the top ten occupations in terms of employment growth between 2002 and 2012 – the occupations that will create the largest numbers of jobs, then we see that this expansion of low wage jobs is a long-term structural problem. We're not dealing here with something that will go away if we can only come out of the business cycle. We're dealing here with something that needs to be addressed through public policy. It's a long term structural problem.

Looking out to 2012, you can see that for the ten occupations that will create the most employment, in seven of them the wages are low, and in five of those jobs the wages are very low. That is to say, they are below the poverty line basically for a family of four. If I had shown you the top twenty (they wouldn't fit on this slide) you would see that the story is even worse. If you look at the top twenty occupations, 15 of the top 20 occupations in terms of the number of jobs they're going to create pay low wages, nine of these pay very low wages, only two require a bachelor's degree or higher, and 14 of them require only short-term, on-the-job training. And these 20 occupations account for 35 percent of the job growth between now and 2012. So we need to do something about this.

Here you can see the same thing graphically. What are the occupations in which we have the job growth? You can see the low wage jobs growing rapidly and the middle income jobs growing much more slowly. So this is really the nature of the problem.

Now I want to say a few words about why this is happening. We are creating jobs; it's not that the economy is not creating jobs. Our problem is that the jobs employers are creating don't pay middle-class wages, and the question is, why not? If you look at the jobs the economy is creating, you would see that these are jobs that are not footloose. These are jobs that are not going to be exported. You cannot blame competition with low wage countries for the low wages that we pay nursing assistants, or that we pay people that work in childcare centers and take care of our kids, or take care of our elderly parents, or our sick and frail relatives. The real problem is that there is no countervailing force to the blind and mistaken pursuit of profit that we so often see.

For one thing, unions lack membership density. In your packet you'll see an advertisement for a book that I co-edited called *Low Wage America: How Employers Are Reshaping Opportunity in the Workplace*, which is a study of a large number of industries. We looked at companies and we asked the question, "How come they're creating so many low-wage jobs? And what makes a difference?"

What we found is that housekeeping jobs, jobs for certified nursing assistants, these jobs pay decent wages – they pay middle-class wages – in cities where union density in those occupations is high. So, certified nursing assistants in New York City, for example, get much more training, they get much more training than nursing assistants ordinarily receive. Those nursing assistants taking care of your sick parents generally receive two weeks of training. In New York City, they receive much more extensive training. As a result, they can take over some of the lower level, more routine functions that nurses otherwise would have to carry out, and it becomes cost effective to pay the more skilled nursing assistants higher wages. And that's exactly what we see in New York City.

In San Francisco and in Las Vegas, where union density is high among hotel workers, we see that the housekeeping staff starts at about \$14 an hour. So it is possible for these jobs to be middle-class jobs. But of course union density is rather low in this country, and we can't rely on that.

The second problem is that government has abdicated responsibility for setting minimum acceptable standards in the labor market.

You know, I was in Germany when the Italians imposed speed limits on the Autostrada, These are the Italian highways, and the Italian government a few years ago imposed speed limits there. And the Germans were outraged, absolutely outraged, because of course the Autobahn has no speed limits. It used to be possible to go from Hamburg to Milan as fast as your car could take you. And that's why everybody in Germany has those BMWs and Mercedes, so they can go racing down those highways on their vacations from Hamburg to Milan as fast as they want. But the result of the new traffic regulation is that deaths from traffic accidents in Italy have been greatly reduced. Meanwhile, Germany has the highest accident fatality rate of any industrialized country. Sometimes, you know, speed limits – standards – make a real difference. And I think that the same is true here in the U.S. labor market. Standards would make a difference.

What we find in *Low Wage America* is that low wage policies and the low wage model are not necessarily good for companies. But if your company is competing in a competitive market, it's really difficult for you as an employer to resist the downward pressure on your workers' wages and benefits if your competitors are paying low wages, or if your competitors are not providing health care. We have the example of southern California, where there was a major supermarket strike. It was brought about because supermarkets in southern California do pay middle-class wages, they do pay health benefits for their workers, and now Wal-Mart was coming into their markets. And, as we all know, Wal-Mart does not pay middle-class wages and very few Wal-Mart workers

have access to health benefits through the company. The supermarkets in southern California felt that if they were going to remain competitive with Wal-Mart in their market, they would have to emulate Wal-Mart's low wage policies.

But in fact, we have a lot of research on management practices – I am a professor in the School of Management and Labor Relations at Rutgers University – that tells us that investing in your workers, raising their capacity to do their jobs increases a company's productivity. It increases job satisfaction, it increases customer satisfaction, it allows companies to retain their customers, and it allows them to be profitable.

The next slide shows a side by side comparison between Costco, which prides itself on paying decent wages, prides itself on giving employees health benefits, prides itself on its pension plan, which believes that having satisfied employees will lead to customer retention, and which in fact on every measure important to shareholders is doing better than Sam's Club, which is owned by Wal-Mart.

Let me conclude by talking about what government can do. Companies often find themselves caught between a rock and a hard place. They would like to do better for their workers, but they are afraid that they will be undermined in the short run by less scrupulous competitors who pay poverty-level wages and don't provide benefits. So we need government to set standards in the labor market, just like we need government to set speed limits on our highways.

We need government to help companies be good employers by reestablishing standards in the labor market. Three really important things that government could do would be first, to raise the minimum wage and peg it to half the average wage. That's where it was when it was first established, that's where it was in the 1960s when the U.S. had a growing middle class, and that's where it is in most countries that have a minimum wage. The minimum wage should be pegged to one-half the average wage. It shouldn't take an act of Congress for a low-wage worker to get a raise.

The second thing we need government to do is to guarantee workers a minimum number of paid sick days. I think it's pretty obvious. Most kids have a mom who works. And working parents need to be able to take off for their own illnesses and for their children's illnesses a couple of days a year. Companies can afford it. And the third thing we need in this country is California-style paid family medical leave. That is, workers need an insurance system like the unemployment insurance system, a parallel system, to provide for paid family medical leave.

In addition, the U.S. needs to bring healthcare costs under control. Companies are really struggling with health care costs. And they are shifting a larger and larger share of the burden to employees.

We need to think about innovative training programs for incumbent workers. We have very little in the way of training for workers without a college degree who are already employed, and we need to do more about that.

Finally, the most important insight I think to come out of Low Wage America is that where companies in a region and in an industry have organized themselves into an employer network, they are able as a result to access resources that they cannot access individually. We have three examples in the book of industries, occupations and regions where this has happened. And those employer networks provide employers with access to customized training and to other training resources. It allows them to benchmark technology and management practices. It allows them to maintain quality standards. And it allows them to, as a group, employ people who are able to help them seek out new market niches, new export markets for their products. We have found that this enables companies to both be better employers in terms of how they treat their workforce, and more successful in terms of their own productivity, profitability, and long-term survival.

Reestablishing standards in the labor market is the key to restoring the growth of the middle class.

Thank you very much.

Robert Manning:

It is a pleasure to participate with such a distinguished group of panelists in this critical examination of the U.S. economy. The Center for American Progress is to be commended for organizing such an impressive program. Today's symposium will no doubt raise numerous provocative questions and policy issues as we explore the prospects for a sustained economic expansion that offers good jobs with good wages to hard working American families.

One of the most notable features of the U.S. economy over the last 25 years is the increasingly prominent role of the American consumer (accounting for nearly 70 percent of Gross Domestic Product) which has been facilitated by the concurrent "revolution" in consumer lending under the auspices of banking deregulation. Indeed, instant access to consumer credit is a distinguishing feature of the "new economy," one that we all enjoy through an enhanced material standard of living. What is striking – a key question for U.S. today – is how the shift in consumer power based on present versus future earning power will impact the future vigor of the American economy. In the spirit of the upcoming summer Olympics, I would like to present an analogy that epitomizes our shared concern over the current debt-driven growth of the U.S. economy. That is, whether U.S. households are healthy, well-conditioned athletes (balanced assets and financial obligations) or precariously dependent on muscle enhancing steroids (soaring debt levels). The answer will shed light on the long-term vitality of the U.S. economic expansion and its public policy implications.

In my brief remarks, I would like to address four major issues regarding the importance of consumer debt to the U.S. economy. First, its recent growth and current burden on American households. Second, its cost and future impact on household consumption. Third, the role of household "sentiment" in sustaining domestic consumption and expenditures. And fourth, how globalization will impinge upon the ability of debt-

dependent households to continue to propel the American economy and, in the process, assume a less important role in the international “Neoliberal” trade regime.

Most of us here today are familiar with the ongoing trends in U.S. consumer debt levels. Over the last decade, total consumer debt (mortgage, installment, revolving) has more than doubled: from about \$4.4 trillion in 1994 to over \$9.1 trillion today. During this period, mortgage debt has climbed from \$3.5 to \$7.2 trillion while other forms of consumer debt have jumped from \$905 billion to over \$2 trillion. Overall, U.S. per capita consumer debt (including mortgages) exceeds \$33,000. Like America’s national dependence on cheap energy (U.S. petroleum consumption is over four times greater than the next largest international consumer), the U.S. reliance on cheap credit dwarfs the household debt levels of our peer nations throughout the world. Therefore, in assessing the long-term vitality of the U.S. economic expansion, two key questions demand our attention. First, how much consumer debt can American households effectively manage and, second, how long can we expect the rest of the world to be willing to finance our elevated standard of living?

Since the 1981-82 recession, when the current phase of globalization ushered in the dramatic restructuring of U.S. goods production industries, American households – especially those experiencing stagnant incomes and unanticipated job loss – have become increasingly dependent on consumer credit to balance their family budgets. Between 1984 and 1994, during the most aggressive marketing of bank credit cards to new middle- and working-class clients, net “revolving” debt jumped from \$73.7 billion to \$279.8 billion. Today, outstanding net revolving debt is nearly \$640 billion and the “real” cost of credit card borrowing (finance charges and fees) has nearly tripled since its low in 1982. This is not insignificant since finance costs are not included in the Consumer Price Index (CPI) which statistically attenuates the official measurement of inflation.

Not surprisingly, the focus of bank credit card marketing and other lending practices shifted in the 1980s from “convenience” users to more profitable “revolving” debtors – even those between jobs. As a result, household demand and related consumer debt accumulation patterns have changed dramatically since the early 1980s when households sought to reduce their debt loads during recessions and other periods of financial distress. That is, consumer demand has traditionally risen and fallen in accordance with the macro-economic business cycle. For example, between early 1981 and early 1983, U.S. non-mortgage consumer debt increased modestly (9.3 percent) while personal bankruptcy remained relatively stable at about 300,000 per year (declining in 1983); installment debt increased from \$295.8 billion to \$322.4 billion while net revolving debt rose from \$52.6 to \$57.5 billion. During the more prosperous 1980s, consumer debt climbed sharply (increasing effective household demand) which heralded a new era in consumer debt capacity and subsequent household financial distress: personal bankruptcies doubled to over 600,000 in 1989. This countercyclical trend – the rise in personal bankruptcies during a period of economic prosperity – augured the increasingly central role of consumer credit to the expansion of the U.S. economy.



During the 1989-91 recession, installment debt for durable goods (autos, furniture, appliances) actually declined by 10 percent (from \$584.7 billion in November 1989 to \$525.2 in July 1992) whereas more costly revolving debt jumped by 28 percent in the same period (from net \$179.2 billion to \$230.2 billion). The major durable goods industries quickly realized from this experience that “easy” financing terms are more effective in stimulating “big ticket” purchases during economic downturns than price-sensitive sales campaigns. Hence, the genesis of “0 percent financing” and “cash back” purchase programs from the auto industry. Not surprisingly, the 1989-91 recession produced an unprecedented number of personal bankruptcies, climbing nearly 50 percent to over 900,000 in 1992. This was due to the inability of financially overextended households to cope with wage stagnation, job loss, rising medical expenses, and family crises (such as divorce, parental care, support of dependent children). Indeed, during the 2001 recession, both consumer installment and revolving debt steadily increased. For example, between February 2001 and February 2003, non-revolving debt increased 15.4 percent (from 1.04 trillion to 1.20 trillion) while net revolving debt jumped 6.7 percent – from \$576.7 billion to \$615.3 billion. Consequently, consumer credit rather than the judicious use of household savings has emerged as the financial rudder of the American middle-class as it steered through the treacherous shoals of a volatile labor market, more costly medical care, higher education expenses, and rising debt-service obligations.

The 1990s was truly an extraordinary decade for American households since the U.S. achieved the ignominiously distinction of possessing the greatest economic inequality of the Western industrialized countries. Indeed, while Americans witnessed the longest economic expansion in U.S. history, it featured a new and unexpected trend: personal bankruptcies soared while unemployment plummeted. In 1992, unemployment (over 7.5 percent) and personal bankruptcies (over 900,000) peaked; two years later, 1994, bankruptcies had fallen to less than 800,000. Although U.S. unemployment steadily declined through the end of the decade (4.0 percent in 2000), personal bankruptcies jumped above 1.4 million in 1998, temporarily dipping to 1.2 million in 2002, before climbing to its historic high of 1.6 million in 2003. Clearly, with over 12 million personal bankruptcy filings over the last ten years, American households are finding it increasingly difficult to manage their new fiscal realities. Over the last six years, for example, the average household credit card debt (among the three out of five households with outstanding balances) has jumped from about \$10,000 in 1998 to nearly \$13,000 in mid-2004. This raises important questions regarding the ability of American households to sustain long-term economic growth in the context of stagnant wages, modest job growth (especially low-wage occupations), and a sharply rising cost of living. The situation is even more difficult for distressed households as public social services are cut-back or eliminated while cash-strapped local governments raise taxes and seek new sources of revenues through private-public partnerships and new cost-sharing arrangements.

Another striking feature of the last decade is the widening wealth gap between the most affluent households and the U.S. middle class. For those who have not glanced at their 401(k) statements since late 2000, asset formation has become an increasingly difficult challenge for households struggling to pay their monthly bills. Indeed, the data are

unambiguous. For most members of the American middle and working classes, the “wealth effect” is largely a rhetorical mirage. The top ten percent of all U.S. households were the primary beneficiaries of the booming ‘90s – especially the top one percent. For instance, the net worth of the top one percent households climbed from \$9.1 million in 1989 to over \$10.5 million in 2001 while the net worth of the next nine percent households rose from \$898,000 to over \$1,000,000 in 2001. And what about the middle-class? If we look at the third income decile--the 20 percent of American families in the middle of the U.S. income distribution--what is striking is the illusion of wealth and prosperity among this group. Between 1989 and 2001, average household debt from grew 37 percent (from \$34,000 to \$46,600), more than double the rate of household asset formation at about 17 percent (from \$89,100 to \$104,400). Overall, the net worth of middle income families rose an average of \$2,700 over this 12-year period to \$57,800. This represents an annual increase in net household wealth of only 0.4 percent. These trends are consistent with a key household financial health indicator. That is, the extraordinary decline in personal savings, from over seven percent in 1993 to nearly zero in 2000. Hence, the revolution in consumer lending has meant not so much that people are more adept at managing their household finances. Rather, easier access to consumer credit has provided opportunities for household consumption that were not possible two decades ago or, at a minimum, would have been deferred.

So, the central question is how much more debt can American consumers effectively manage. Looking at the most recent statistics, we see that the financial squeeze on the American middle-class is exacerbated by the soaring cost of housing. Since 1989, the debt service obligation for housing (as a percentage of discretionary household income) has jumped sharply – from 57 to 85 percent. Other consumer debt has risen from 20 to 24 percent while home equity loans have jumped from about seven to 12 percent. This suggests that Americans are compensating for higher cost housing and other sharply rising expenses by reducing their family savings, tapping into their household assets such as home equity loans, and relying on costly installment and revolving loans. Of course, the number one asset of most Americans is their homes. Even so, record Chapter Seven bankruptcies and spiking home foreclosure rates suggest that increasing numbers of American homeowners have cashed out most of their housing related equity. Moreover, a potential housing “asset bubble” could swiftly erase tens of billions of dollars of household wealth as 30-year mortgages begin to march past the seven percent threshold.

Obviously, some sectors of the American middle and working classes have reached their household debt capacity in terms of their access to bank loans. They have exhausted their traditional lending sources including off-book, informal loans. This raises the related question of the national dependence on cheap credit. One of the assumptions about the de-regulation of the financial services industry was that the cost of consumer credit would fall significantly for the middle-class. True, those with excellent credit ratings and low debt/income ratios have seen their borrowing costs fall over the last few years, including zero percent credit card offers and 2.9 percent home equity loans. For the heavily indebted middle- and working classes, however, the reality is that the cost of credit has increased significantly in “real” terms after adjusting for inflation. And, for millions of middle-class households, lower interest rates have been primarily due to

reductions in the Federal Reserve lending rates to its member banks rather than less onerous government regulation, greater competition, or synergy enhancing corporate mergers. Remember, only four years ago the U.S. Federal Reserve's Fund rate was six and a half percent compared to one and a quarter percent today. Consequently, with inevitably higher borrowing rates on the horizon, U.S. households are less prepared for the financial strain of increasing interest rates and finance charges than previous generations. And, of course, they are less able to increase their savings for retirement.

In terms of residential mortgages, the frenzy in refinancings and home purchases has enhanced household cash flow with the lowest interest rates in 46 years. But, as the U.S. economy confronts the limits of consumer and public sector debt-financed stimuli, American households are responding to higher borrowing costs through interest rate hedging such as adjustable rate mortgages [ARMs], interest-deferred installment loans, and short-term, low-rate balance transfers on their credit cards. For instance, the percentage of homes purchased with adjustable rate mortgages over the last twelve months has jumped from 12 percent to 34 percent. If the average American family moves every 5-7 years, the income boost of low-interest mortgages could become the bane of the U.S. economy in only a few years as 5 percent mortgages are replaced with 7 percent-8 percent loans. Furthermore, nearly all credit card contracts today feature amendments that specify adjustable interest rates. In fact, as the Fed Fund rate steadily declined, banks actually established interest rate "floors" so that the finance charges for consumers would not fall in accordance with lower bank borrowing costs. In other words, banks have not been passing on their lower costs to consumers in the form of revolving and installment loans for over a year.

The picture of the U.S. economy that is emerging is a fragile patchwork of "Two Americas" where social inequality is tempering job expansion, wage growth, asset formation, and the benefits of lower borrowing expenses. For example, the cost of borrowing on credit cards if you can pay off the balance each month ("convenience use") is literally free and, if you have access to home equity loans, the cost is less than 5 percent while the finance charges are tax deductible. But, if you are among the increasing number of financially squeezed households, then you must accept loans at 12, 15, 19, and even 24 percent interest rates. And if you are "maxed out" without the option of additional bank loans, then you have no choice but to accept legal "loan shark" rates such as pawnshop loans at 10 percent-25 percent per month, rent-to-own contracts at 15 percent to 30 percent per month, and "payday" loans at 20 percent to 70 percent per month.

If current U.S. economic policy is dependent on the rapacious appetite of American households, then our national dependence on cheap credit may become even more important than the reliance on inexpensive petroleum supplies. For example, over the last twenty years, the "real" cost of borrowing on credit cards has nearly tripled, led by rising penalty and transaction fees (from \$1.7 billion in 1996 to about \$11 billion in 2003) and the widening "spread" between the banks' cost of funds and the interest rate charged to consumers. This explains why the finance subsidiaries of many corporations are much more profitable than their manufacturing and retail divisions. GE Finance, for example,

has grown so much faster than its “core” divisions that it was spun off into an independent company whereas Circuit City lost money on its core retail operations in the early 2000s and its profitability was largely attributed to its finance operations. Consequently, a key to the past growth of the U.S. economy has been easy access to relatively low-cost consumer credit – a condition that will invariably change to the detriment of middle- and working class households.

How much longer can American households continue to consume at their current standard of living? This is an especially important issue because the first legislative initiative of the current administration was consumer bankruptcy reform – largely pushed by the major money-center banks and their credit card subsidiaries. One way that the American consumer-driven economy has retained its resiliency – even during economic downturns – is by allowing people to file for bankruptcy when they can no longer pay their bills. The U.S. Congress offers this option to corporations and individuals-- regardless of the factors underlying their financial insolvency – so that they can swiftly return to their role of contributing to economic growth. It is noteworthy that banks have not previously opposed this statutory provision because of their ability to levy increasingly higher finance charges and fees which more than compensates for larger default rates. If many financially distressed households are denied this historic right, then the bankruptcy reform legislation will negatively impact the U.S. economic expansion. That is, millions of American families would be forced to sharply curb their consumption activities and accept a long-term form of debt peonage that primarily benefits the banking industry and its record profits.

A third issue concerns the role of consumer sentiment in the expansion of the U.S. economy. The June 2004 release of the Consumer Board survey of consumer attitudes reports a modest improvement in Americans’ attitudes towards their economic future. Job growth has improved but anxiety over wage stagnation, inflation, and costs of the Iraq invasion are tempering Americans’ optimism in the short-term. This is significant because household consumption, especially costly purchases, tend to be influenced by consumers’ perception of their future economic situation – regardless of present financial circumstances – even unemployment. It is for this reason that politicians emphasize optimistic economic forecasts in the hope that Americans will positively respond to their exhortations to consume and realize their rosy prognostications. Unfortunately, the reality is that the U.S. economy recently has been propelled by refinancing of home mortgages (past consumption) and the use of consumer credit (future earnings) with the expectation of a resurgence of national economic prosperity. However, with the stimuli of personal tax refunds and public sector expenditures winding down together with rising interest rates, we are already witnessing a slowdown in “big ticket” purchases such as new homes and mortgage refinancing. As U.S. households confront these ominous economic realities, they are also facing more stringent credit standards which will increase the cost and availability of consumer loans. Indeed, it is not just the rising cost of credit but access to credit that will impinge on domestic consumption growth and the vitality of the current economic expansion. Furthermore, it is not just consumers but also small business people that are affected by a “credit crunch.” This adverse impact on the credit needs of the small-business sector – the backbone of job growth in America – directly affects

employment. In the process, it can reduce consumer optimism and thus indirectly temper household discretionary consumption.

A final issue concerns the future prospects of American debt-financed consumption within the larger global political economy. Can the U.S. sustain its dominance in the international economy and continue to successfully pressure other countries to continue to lend U.S. money at relatively low rates?" For instance, the accumulation of hundreds of billions of dollars of currency reserves in China, Japan and other national banks is essentially a free loan to the United States. But, with the Euro appreciating about 25 percent against the dollar, more and more countries and hedge fund managers are buying Euros to reduce the cost of international transactions and thus speculating against the value of the dollar and low U.S. interest rates.

More significantly, at the structural level of international trade, is the inevitably diminished importance of the U.S. as the leading global consumer. Between 1990 and 2000, the total volume of international merchandise trade nearly doubled (87 percent), climbing from \$3.45 trillion to \$6.45 trillion. Although U.S. merchandise trade volume doubled (from \$394 to \$781 billion) during the decade, the U.S. share of global trade increased only modestly (from 11.2 percent to 12.1 percent). During this period, the U.S. share of global imports rose from 15.3 percent to 19.7 percent. Furthermore, our appetite for international goods and services was increasingly financed with borrowed money from foreign lenders as the balance-of-trade deficit soared from \$111 billion in 1990 to \$452 billion in 2000. Clearly, the U.S. cannot maintain this share of global imports following the next surge in international trade. In fact, U.S. consumption of total global merchandise imports has already fallen to 18.9 percent in 2002 while U.S. exports have fallen to only 10.7 percent of global merchandise trade. The result is a widening of the balance-of-trade deficit to \$484 billion in 2002. Together with a projected federal deficit of over one-half trillion dollars over the next two years and an abysmally low savings rate of about two percent, the U.S. pressure on international capital markets will assume staggering levels.

The current dominance of the Neoliberal trade regime (emphasizing low wages, taxes, labor standards, public sector growth, and government regulation) ensures continued downward pressures on household income in the U.S. and throughout the world. As U.S. trade partners necessarily seek non-U.S. markets for expanded levels of production, including the expansion of their own domestic markets, it means that the future ability of the global economy to absorb higher levels of trade will become increasingly dependent on national and regional access to consumer credit. Indeed, U.S., British, and Japanese banks have taken the lead in initiating the global deregulation of consumer financial services through the General Agreement on Trade in Services (GATS) under the auspices of the World Trade Organization (WTO); over 90 countries are signatories to the GATS.

Clearly, the future growth of domestic and regional markets will depend upon greater access to consumer credit which will intensify competition for capital in international markets. The strategy of increasing national employment levels by encouraging domestic consumption will impinge on international capital markets in two ways. First, currency-

rich countries like China and Japan will allocate more of their dollar reserves to domestic consumer loans such as credit cards. Second, countries with aggressive programs to increase their domestic consumer economies will be forced to sell asset-backed securities (credit card debt) in the international secondary markets that will compete with U.S. bank issues. The ill-fated attempt of Korea to accelerate the growth of its domestic consumer economy through the indiscriminate allocation of consumer credit cards in the early 2000s highlights the risks of this policy as well as the local-national-international linkages of credit card financed consumption. Furthermore, global banks such as Citigroup (branches in 103 countries) and HSBC are rapidly expanding their consumer lending operations throughout the world. This has already contributed to sharp increases in consumer debt levels and plummeting savings rates in European countries like Great Britain, Latin American countries such as Mexico, and Asian countries such as Korea.

Ultimately, the promotion of regressive corporate/personal tax rates and downward pressure on wages ensures that the U.S. cannot increase its current market share of international trade (imports). If other countries must resort to cultivating new export markets as well as their own internal consumer economies, one of the major foreign policy challenges of the next presidential administration will be to secure adequate levels of borrowing at relatively low finance rates. This, of course, will intensify pressure on financially distressed middle- and working class households to propel the U.S. economic expansion. In the absence of widespread job and wage-growth, the heavily indebted consumer will remain the key problematic and challenge to a sustained U.S. economic recovery.

James Galbraith:

Let me say first that it is a privilege and pleasure to be here as the guest of Center for American Progress, one of the most important new forces on the American scene.

Our general economic condition is presently one of moderate expansion, following a long stagnation, propelled in part by provisional factors and endangered by hidden obstacles. Recovery is far from complete. It would take four years of job growth at the March-April rates to return us to the full employment prosperity of 1999-2000. And one of the most important factors which has been supporting growth of spending so far, that is to say low interest rates on new debt, is in the process of being attenuated as we speak. For this and other reasons, some of which I will touch on in the next few minutes, the prospect of going all the way with current policies is very low.

It is important; it seems to me, in thinking about this issue, not to be mesmerized by a metaphor – or at least to use metaphorical language properly. In this case, we have a plethora of potential metaphors. But the most common one is a medical metaphor, that of illness, followed by recovery, and return to health.

Now, doctors and hospitals like the start of recoveries because it means that their job is mostly done. The patient is not getting worse and organic recuperative powers can usually be relied upon to kick in. Patients, on the other hand, count the days until they are actually out of the hospital and fully back to normal. If the convalescence is prolonged

and the continuing treatment is lousy, the patient is unhappy and rightly so. What we see in most discussions of the economy is the perspective of the doctor and the hospital and not the perspective of the patient.

Moreover the economy is not actually a biological process and recovery mechanisms are not automatic. Sustaining the Reagan expansion of the nineteen eighties required complex fiscal and monetary maneuvers, including large take backs of the original tax reductions in 1982 and 1984, interest rate reductions, and a major devaluation of the dollar beginning in 1985. Sustaining the Clinton expansion in the 1990s required fiscal adjustment in the beginning, low and stable interest rates thereafter, and the careful cultivation of the eventual technology boom that brought us to full employment at the end. Sustaining the present expansion will also require major policy adjustments -- some of them similar to the ones I've just described, some of them quite different -- of which there is absolutely no sign so far.

This expansion is different from past expansions, partly in that job creation has been very delayed and compensation growth has been slow, while corporate profits have soared, particularly in recent months. I am however, not inclined to blame corporations for their rising profits. Total profits are up, but from very low levels a couple of years ago. And a 40 percent profit growth has therefore only returned total corporate profits to the share of total income that they had back in 1996, which was a pretty good year.

What has been rising steadily over time in this process is the share of proprietors' income in total income. It was 7.1 percent in 1994 up to eight percent in 2000, 8.6 percent now. Proprietors are basically those who report themselves as self-employed -- neither corporations earning profits nor compensated employees. Is this a good or a bad thing? I think the answer to that is: it depends.

To have more prosperous professionals, more merchants, more entrepreneurs, would be fine. More-down-at-the-heels housekeepers, gardeners, out-of-work academics posing as consultants is not such a good thing. So it depends on the numbers and the income. And what you find when you look at the numbers is that the rising share of proprietors' income in the late nineties was in fact mainly rising income. But in recent years, it is mainly rising numbers. This is not a good sign, and I would judge that it is mainly due to the unavailability and poor quality of regular jobs, which Eileen Appelbaum has already described. And this is not surprising, considering the total number hours of compensated employment are still less than they were in 2000. Real compensation per hour is up only a little more than four percent over that entire time compared to a 15 percent gain in total productivity.

Is this situation sustainable? I think Bob Manning has raised some important questions about the sustainability of the debt process, a process that has been fueling consumer spending for a long period of time. And I have been raising those questions myself for quite a few years. There is the old Herbert Stein adage, that when a trend cannot continue it will stop. The only question is exactly when -- and that of course you don't know.

The phenomenon of rising proprietors' income may well go on for a long time. The problem is that it isn't a symptom of real recovery. The patient won't die, but he will go on feeling miserable for quite a few years into the future. And this is not something that we should be happy with.

What is to be done? Some of the strategies have already been mentioned by the previous speakers and I don't see a need to elaborate on them in depth. We need a comprehensive set of policies to improve the wages and the benefits of those who are employed; to move health care costs away from private business so that they don't have that major barrier to adding employment; to support public employment, particularly in states and localities. I have long been an advocate of a revenue sharing initiative, so that states and localities can keep up the level of vital public services and don't continue to add a downward drag on the economy by cutting spending and raising middle class taxes at a time when the full growth of the economy is not assured. I saw this morning the particularly deplorable story of the downward spiral of the Washington Metro – raising prices and cutting services to the point that people will go back to clogging the streets with cars. This is exactly what you do not want to happen as a result of deteriorating economic conditions.

We need also to shift the tax burden more generally away from the working poor and away from middle class families, that is to say to take the pressure off of states and localities to raise those taxes, to take control and put some of the burden back on to what the New York Times reporter, David Cay Johnston in his book *Perfectly Legal*, calls the political contributor class. But my brief has been the macro level and let me close with just a few remarks about what we should be about at that level.

We should, it seems to me, clearly be driving to make labor scarce again. Work should be well paid and profitable. But we can't get there if the Federal Reserve continues to commit medical malpractice and if the administration simply doesn't care about the issue. If there is no national leadership on the pressing issues – for example, of energy security – very closely tied to the whole question of national economic security and national security generally speaking – then we'll be in trouble. Global economic management will also have to be improved if we are to open up vistas for private profitability in a fashion similar, but not the same as, we were able to do in the late 1990s.

We should be aiming for full recovery, for a return to a situation where the private economy is producing good jobs, at good wages, and in great numbers. For that, though, we may well need both new doctors and new ideas about medical best practice.

Thank you very much.

Scott Lilly:

We are going to have about a ten minute discussion between the panel on points that were raised, and then we are going to open it up for questions from the floor, but I would like to start off by asking each of the panelists, a question. In the late nineties, we had very substantial improvement in wages across the board, and that improvement actually continued into 2002. Since then we've had flat, and now in the last six months, falling



wages. But what are the prospects that that is only a short-term phenomenon, and what are the prospects that wages, we will continue to see wages fall over the months ahead? Eileen would you start out on this?

Eileen Appelbaum:

Sure. Well, of course what happened in the late 1990s is that we had very tight labor markets, and that this extended all the way down into the jobs that I was describing in my book. My own research was on workers with a high school degree or less working in hospitals, food service workers, nursing assistants and so on. And for the first time, hospitals had to worry about high turnover in these occupations because hospitals in general pay about \$7.50 or \$8.00 an hour for these workers. In tight labor markets, McDonald's was paying \$7.50 or \$8.00 an hour and you didn't have to handle bodily waste. So, the hospitals were having a hard time holding on to these workers. And our research shows, which would not be a surprise to anyone in this room, but, that higher wages reduces turnover, that better staffing ratios reduces turnover, and modern managing practices, giving workers more autonomy, greater patient contact and more skills, reduces turnover. But the higher wages turns out to be really important in terms of retaining workers, in terms of attracting workers, even in these jobs that typically did not pay high wages. So I think that the really tight labor markets made a difference. So as Jamie is talking, as Jamie has indicated, a number of policies that could lead to a tightening of labor markets. I have also indicated that I think that there are policies that we could use, or that that we should have, that would provide a floor in labor markets so that, in fact, we don't see the growth of really low wage jobs. No one should work full time and still living below the poverty line. And yet, we have about a quarter of the workforce in that situation today. So I think the macro policies to tighten the labor market, and the labor market policies to provide a floor under wages and to enable, to provide a level playing field for good employers who do want to pay decent wages are the things we need to do to move forward.

Scott Lilly:

But the tightening of the labor market really is dependent upon consumers having purchasing power, to buy the things that create jobs. What is the prospect of that?

James Galbraith:

Well, there are a couple of considerations in the late 1990s. One was that consumers did, in fact, go deeply into debt. They spent well ahead of their incomes, and they are likely to try to avoid that in the future. And that has really been Bob's point; I think it's a correct one. There other is that we had an enormous amount of investment spending in the information and technology sectors, which itself, directly created a fair number of high paid jobs, but also contributed significantly to tightening up the labor markets for everybody else. So you actually had, while you had enormous increases in the inequality of wealth in that period, you actually had decreases in the inequality of pay and wages and in the inequality of consumption expenditures. All in all, it was a very successful period. And one other thing about it is that under the pressure of tight labor markets, firms found ways to economize on costs. And I believe that that is not given enough credit for the rise in productivity growth that we observed in the late 1990s. We tend to

treat the rise in productivity growth as being a gift from the technologists, but in fact, to a very substantial extent, it was because private businesses, facing the scarcity of labor, found ways to adjust to it, and they made themselves more productive. Now we are, we continue to see rising productivity growth, but it comes from a different set of pressures: namely, a desire to first of all get your profits up as much as possible, and to keep your labor costs down because of essentially a cut-throat environment. I think that one can reasonably hope that if the strategy were to succeed, you would have, you would return to in some sense, healthier high productivity growth, and you would not have the inflation problem, which seems to be motivating the Federal Reserve's decision to start raising interest rates. Whether we are going to get there or not, well, the answer is, if we change policies, I am sure there are ways to get there. But under current policies, no.

Robert Manning:

One of the points that I would want to make, is that in the last 20 years in this period of globalization, it is far more profitable to finance things than it is to make things. And this of course has huge implications to unionization of goods production sectors, which have traditionally had higher levels of wages and compensation. At the same time, in this era of free trade, we have also seen the free movement of labor. And it is extraordinary that the President made the point that he felt that every Mexican really deserves the right to have a job, and that free trade should provide that whether it is here in the United States or in Mexico. So I think it is very clear that as we seen the social contract being redefined, that is, productivity increases don't necessarily lead to higher wages, higher corporate profits do not necessarily mean full-time employment, and that these changes in the labor markets are going mean that lower paid workers are going to face an even more difficult employment market. And certainly with outsourcing and the nature of globalization, which is really changing the subsidiary structures of multinational investment strategies today, increasingly now we are going to see higher skilled jobs being performed outside of the United States and the focus of selling those jobs through consumer debt in those countries rather than exporting them from the United States, to say the Europe and the EU nations. I think what we are going to see is that, we are going to have highly skilled and highly paid labor that is going to do well, we are going see low wage manual labor that is going to continue to do worse, and we are going to see the middle class confronting a volatile labor market with part-time and contingent work, which means that they're going to be dependent on consumer credit to make up for the social services that are being withdrawn in this period of fiscal crisis. So not a very sanguine look in terms of future wage growth.

Scott Lilly:

There is a rule of thumb that, you get a response from the economy from changes in interest rates about six months after the interest rate change takes place. We had a fairly dramatic change in long-term rates that took place the first of April. When would you expect to see a response to that and how significant do you think the response is going to be?

James Galbraith:

Well, it's in my area, and I am going to duck it. I believe that we still do not know to what extent the Federal Reserve is going to continue to raise rates. My earnest wish is that they should see the wisdom of stopping. A quarter point is only a quarter point. A hundred, a hundred fifty basis points and you would begin to get significant effects. The rise in the long-term rates may be rather slow in having major effects on households, because to a large extent, they've already conducted their refinancing exercises so their balance sheets are not in such bad shape. But what we should be worried about is not, well there maybe some precipitous reactions in financial markets because of institutions which are carrying securities that are vulnerable to rising rates, but what we should be worried about for the larger economy is how these effects play out over time, and what takes the place of debt-fueled consumer spending to keep the economy growing if we do not have a program that is going to motivate, or an environment that is going to motivate, a strong revival of business investment and if state and local governments, whose spending amounts to a fairly substantial fraction of GDP are continuing to have to cut back. That's the problem that we are basically facing.

Robert Manning:

I think we have to recognize in the long bond market, as we look at home mortgages, that's already priced in a substantial increase in the last six months. Just as we saw estimates of \$20 billion going back to the consumers' pockets for refinancing, the average consumer is holding on to their home for five years. If we're talking a third of new mortgages now are adjustable rate, what we are going to be seeing then is money going out of consumers' pockets as they buy new houses. But I think also there is a potential domino effect: as interest rates rise, home appreciation is going to stagnate, and maybe decline, people aren't going to be able to rely on appreciation from home equity loans to balance their household budgets and there's going to be a real concern about the "two Americas:" those people who are already maxed out, banks aren't going to loan them money, regardless of what interest rates they're willing to accept, and the other America, that can conveniently accept a higher level of debt, but probably has bought about everything they need. And that is really going to be the key question: if we had a bankruptcy reform where it is going to be more draconian in terms of the middle class having to pay off debts: medical, job loss related expenses that they can't afford, then we're talking about a huge slowdown in a core part of the consumer portion of the economy. Keep in mind almost nine percent of American households have declared bankruptcy in the last ten years during a period of enormous economic expansion. This I think really plays to the question about how strong the recovery is, if we're talking about Middle Americans with two incomes that can not pay their bills at the end of the month.

Eileen Appelbaum:

I just would emphasize the last point and that is: one of the ways that we have kept middle class families afloat is that women have entered the labor market in larger numbers; that mothers of young children have entered the labor market; that the hours of work of women have increased; and that they are pretty much maxed out at this point as well. So, that as a source of keeping middle class families afloat is also drying up.

Scott Lilly:

Okay, I am going to take questions from the audience now. I want to start out with our senior economist here who I asked to take careful notes and try to bring the discussion to as fine a focus as possible.

Christian Weller:

Well thank you very much to all the panelists, this has been very illuminating. I have two questions. One is whether the panelists could talk a little more about the dark cloud for the economy that I see coming in the trade deficit, especially now that we have rising interest rates in the U.S. The other piece that you did not talk much about is investment, business investment in particular. We are behind the curve on the labor market but I think even more so we may be behind the curve in business investment.

Eileen Appelbaum:

I think you are right about that. Jamie talked about the profit rising and only getting up to, I forget what you said it was, but if you take a look at what has happened to after-tax profits, it has now reached levels that have not been seen in the post-war period. And I think more alarming than that is if you look at the share of after-tax profits that is devoted to domestic investment this has fallen to very low levels in terms of where it has been in the post-war period. So high profitability doesn't seem to translate into high levels of domestic investment and I think that is a serious problem going forward in terms of employment and wage growth.

Your other question was about the trade deficit and one of the things that I think is a problem is the fact that we have had a lack of attention to manufacturing. We've acted as if we could be a country that only emphasizes services and doesn't have to emphasize manufacturing. I have no illusions that we are going to create enormous numbers of jobs in manufacturing, but that is very different than losing our capacity to manufacture goods. As we all know, agricultural employment is a tiny fraction of total employment in this country, but we are capable of feeding ourselves if we have to. We are able to produce enough agricultural products that we run a trade surplus in agricultural products. This is not the case in manufacturing. I think that the ability to get out of the hole that we are in with respect to the trade deficit really requires a new focus on building manufacturing capacity. We do have a trade surplus in services, but this is so small relative to the trade deficit in goods. In addition, the trends in outsourcing, while they are still relatively small in terms of employment impacts, we are now importing services that we used to produce domestically, and I think that that is going to make getting out of the hole of the trade deficit even more difficult.

Robert Manning:

I think that as we look at these trade numbers, one of the bright spots in the balance of trade is financial services in particular, and what we are seeing is a very aggressive effort under the General Agreement in Trade and Services in the World Trade Organization is to create a kind of global framework of managing foreign investment and the way in which US-based global banks are going to be investing. And what I am seeing here is the use of consumer credit as kind of a macroeconomic tool for specific countries. For example, Korea tried and did a disastrous job of stimulating its service-based economy

through consumer credit, has led to the fault of its largest bank with unpaid credit card debts. But at the same time, what we're seeing is increasingly corporations that are cutting deals with countries so that their products are going to be produced and consumed there rather than being exported from the United States, and this is clearly being driven by access to consumer credit where we are talking about populations that have barely cut the surface in terms of their ability to absorb more debt. So, what we're seeing here is a replication of the American experience in other parts of the world, but not where we're exporting those goods and services except for key financial-type services that will rebound back to the benefit of the U.S. middle class.

James Galbraith:

One of the most difficult and important things, I think, to do in this area is to think in terms of practical steps and objectives that might be pursued. It seems to me that we face an enormous challenge over the next 20-30 years in rebalancing our energy budget. That we are uniquely vulnerable amongst the wealthy economies of the world in that we do not have a diversified portfolio of energy sources and uses, we do not have a diversified, particularly, transportation network, and the price that we pay for that is visible, in our external military commitments, in part. If we want to reduce that price, one of the things that we need to do is to build up the alternatives to oil-fueled transportation. We need to build-up our commuter alternatives, our urban transportation alternatives, our inter-city transportation alternatives. We need to invest in conservation and in renewable energy sources. We need to seriously think about this problem in an organized way, which we have really not done since we made an effort to try to do it in the first oil crisis in the 1970s. But then we were not committing 150,000 young men and women to a place like Iraq, and we are now- and it seems to me that this ought to be concentrating on our minds.

As we do that it seems to me there is a large body of manufacturing activity, which could be directed, since this a public and a national security issue, to domestic production. If we were to procure the steel for example that we require for this effort mainly from domestic suppliers, not necessarily prohibiting other users of steel from buying on the international markets, which was the problem of the tariffs that were recently imposed and then removed, then we might be able to make progress on this and at the same time help our manufacturing trade balance and get to some more sustainable international financial position. This is not an easy thing to design, it is going to require a lot of effort and a lot of thought, but the problem here is at the moment we haven't even begun. We have not even started to think about these issues in a coherent and focused way, at least not at the level of national policy makers yet.

Beyond that it seems to me that we are clearly, I think anyway, that we are coming to the end of the 30 year run of the dollar as the world's sole reserve currency. The creation of the Euro, which has already been mentioned, is a fundamental fact, we're now back in a situation which somewhat resembles the world when you had the choice between the dollar and the pound sterling. The Europeans are not doing a good job of taking advantage of their opportunities, but if they suddenly became a little bit smarter about that, we could be in very serious difficulties, in which people really would choose to hold

their reserves in euros rather than in dollars and we would be faced with a precipitous fall in our international purchasing power, if that were allowed to go unchecked. The way to deal with that is to rebuild an international financial system somewhat along the lines but perhaps with a more of a regional basis, somewhat along the lines of the Bretton Woods system of the early post-war period. Something which requires us, incidentally, to treat international economic policy as a collective enterprise that requires the cooperation not only of ourselves, it can't be done unilaterally; it requires the cooperation of our allies in the industrial world and our friends in the developing world. Again, a large project and one which may well require new conceptions of medical practice and perhaps some new practitioners.

Question:

I am going to ask a somewhat self-serving question; I work for a Federal employee union, and this administration, the current administration, came into office saying they wanted to contract out some 850,000 federal jobs, and that's about half of the federal workforce. And this sort of just emulates a trend that has been afoot in government for a long time and at all different levels of government. And yet there is scant if any evidence of any great savings from this, but you do get people earning lower wages once they are employed by contractors and not the government. I'm just wondering if indeed what's going on in the public sector, we talk a lot about the private sector, but what's going on in the public sector is having any significant impact.

Eileen Appelbaum:

The short answer is yes, in fact, that the notion that you can have cost savings by contracting out has taken hold in the private sector as well. It is one of the important reasons in my view for setting standards in labor markets. What we have seen, what I have seen, in the private sector is that there are many employers who think of themselves as good employers: they pay \$2.00 above the minimum wage so therefore they must be good employers that would put you at \$7.15 an hour, well below the \$8.70 an hour you would need to just be at the poverty line. So they think of themselves as good employers, and then, however, they are not willing to pay the minimum wage but you see them subcontracting functions to other companies that have no such scruples. So for example: hospitals pride themselves on paying what they consider to be reasonable wages because they have a vulnerable population in the hospital – sick people – and they want to be sure that they have some control over who is in the hospital as employees. But they then subcontract laundry, which used to be done in hospitals is now subcontracted to someone who has no scruples whatsoever about paying \$5.15 an hour, no benefits and so on. So, we do see quite a lot of that.

In addition, we see pressure coming from large companies which do have high profit margins on their suppliers. The large companies now set the price at which they will accept whatever the supplier is producing and then it is up to the supplier to see how they're going to produce whatever it is at that price. We see this even in the apparel manufacturing for example where you may sub-contract out parts of the production process because the retailers have said: "this is what we will pay." And that then leads to another kind of subcontracting. So absolutely, this idea, that low wages are the way to go,

that the low-wage model is the way to go and that subcontracting is an important way to get it, I think you are absolutely right about that. Whether it in fact it delivers cost savings is another question altogether.

Question:

I would like to take issue with the idea that this recession and weak recovery is really something completely new, a break with the past. Instead I would like to put to the panel that it is in fact really a continuation of trends that have been in place for about 25 years. Eileen talked about job developments, while you were at EPI, the Economic Policy Institute, Eileen's "State of Working America" documented all these things and we are seeing just more of the same as it were. The credit developments, they've been in place for 25 years essentially, when you look at the trends: rising borrowing in both the private and the public sector. And Jamie, the business cycle is the same, you know, with the Reagan recession was the first time since before World War II that we had wage reductions, 1991 we saw a jobless recovery, it was shorter than this current one but still the same. So I think what we're talking about is an economic policy model that is fatally flawed, and my metaphor, Jamie, is in terms of the Wile E. Coyote economy: heaven help us if we look below us, there's nothing there, we're just running furiously to keep the thing going.

So I would like to suggest that what we really need is a major policy U-turn, and that must be the way in which the public policy debate must be framed. This administration deserves particular criticism because it has actually amplified and accelerated all the sorts of things that have been going wrong in the past, but you know there's fault on the other side too. The last Democratic administration pushed many of the same policies albeit milder. So Eileen the sort of labor market policies that you've talked about are not new. We need a new Federal Reserve Chairman; Alan Greenspan has been supported by both parties, he is a man who opposes the minimum wage, out to privatize social security, against labor standards in the international arena, will not use margin requirements when it comes to taming an asset policy boom, will not speak to sort of doing things on the dollar. Is that the right way we should frame this debate rather than keeping it in the moment? Rather let us make it a debate about a policy model that has not been serving American families well.

Eileen Appelbaum:

Well, I certainly agree with you, that there is an important role for the government sector in many ways: in terms of employment as Jamie pointed out earlier, in terms of setting standards in the labor market, in terms of giving guidance to monetary and fiscal policy, and this is something that needs to be done. We can not just go back to the policies of the 1990s and think that we are going to come out of this better than we are now. I think you're absolutely right about that.

I do also think, however, that some things are different. I think this is a different kind of recession because I think it's the first time since the Second World War that we have had a business-led recession and not a consumer-led recession. That is, this recession did not happen because consumers were at a party having too much fun and the Fed took away

the punch bowl. This was a classic, in terms of pre-World War II recessions, a classic recession in terms of over-investment, and we will need help recovering from that and there is no attention being given to that. So some things are a little bit different. The acceleration of the trends that, as you rightly pointed out were there already. What we see is that the jobs that provided the bottom 25 percent of the wage distribution in the past, in the future are like to provide about a third of the jobs. Instead of our having policies in place that reduce the number of low-wage jobs and increase the number of middle-class jobs, we see an acceleration in the creation of low-wage jobs encroaching into what were middle-class jobs.

Robert Manning:

I would say that there has been a marked shift in terms of the impact of the deregulation of financial services. What you really saw was banks got what they wanted in the early 1980s and suddenly the corporate sector was not delivering the kind of profits it needed and they could go straight to Wall Street and float a bond. Keep in mind it is only 1989 that Citibank was technically insolvent in terms of its reserves and they were talking about merging it and what would be an appropriate suitor. So there was a real issue here of actually looking at consumer credit as a temporary way of stabilizing American banks and it became so successful for example with marketing consumer credit cards that who would have thought that people, even before they could get a job, college students, would be getting \$15,000, \$20,000 in debt before they get their first job. So that as entrants into the job market and future consumers, clearly the level of debt has changed in the last 15 years and we are only now beginning to understand what those consequences might be.

James Galbraith:

I have never been a new-paradigm type, and I have always believed that if economists know anything at all it is because they have studied history and they have some precedent and parallels to draw upon. I think Eileen drew upon one which is relevant to the current situation, and that is the late 1920s and the early 1930s. Not over the whole sphere of the industrial economy but certainly in those sectors, the technology sectors which were driven to an enormous height by a speculative boom and which then collapsed. The message from that is that it takes those sectors that are affected a long time to recover and new policy measures are required if you want to bring the economy out of its doldrums in the meanwhile.

The other historical precedent that I would point to is the 1970s and this is particularly relevant to the current discussion of monetary policy. Where we seem to be having an instinctive reaction amongst observers and commentators that because the inflation rate is rising, which it undoubtedly is, although it is still very low, that the appropriate reaction of the Federal Reserve is to raise interest rates. The Washington Post today said: "Fed raises interest rates to fight inflation."

There are two problems. One is that this inflation has nothing to do with tight labor markets. The entire theory which drives you to use a restrictive policy to fight inflation is based upon the idea that the unemployment rate has somehow got too low. That clearly has not happened. The unemployment rate remains far above levels that we proved were



non-inflationary just four years ago. That is a clear fact of the Fed's own models, and the next governor, Laurence Meyer, made that point in the Financial Times a couple of days ago.

So what are we seeing? We are seeing a cost-driven inflation which is partly due to the insecurity of the world's oil supplies, partly due to health care and other factors, and you can go down the list. It is a supply inflation, not dissimilar from what we experienced in the 1970s. React to it with higher interest rates- you don't accomplish very much, you do add to cost pressures and at the end of the day, you keep on going in that process until you have slowed the economy down enough that unemployment starts to rise from its present levels. So you basically have only one instrument, which is to short-circuit the expansion. The question we have to ask is: "Is this the appropriate way to deal with this particular problem?" My answer on the basis of that historical precedent is that it is not and that we badly need to rethink what we are doing as we look to the actions that the Federal Reserve may continue to take over the months ahead. It is worth discussing in any event.

Scott Lilly:

Thank you. I think we have had a terrific panel this morning. If there is one last question we could respond very quickly to it.

Question:

A question for Eileen. I'm not an economist, I'm not sure that I really understand a lot of the technical discourse that has taken place this morning. But I found very eloquent the comparison you put up between the Costco figures and Sam's Club figures. I'm wondering, maybe it is a naive question, why, if that is indeed the case, we need any intervention at all, and why we can't rely on the hidden hand to take care of the interests that I guess we all share.

Eileen Appelbaum:

That's right; that is an excellent question. I thought for a while that it was that not enough people knew that these more modern management practices were effective in terms of raising productivity, raising profitability. I worked really, really hard with a couple of colleagues; we produced a book called Manufacturing Advantage where we demonstrated with hard data and econometrics the payoffs from companies from these practices. We just assumed that the invisible hand would do its job and the practices would just spread. We do have that; I need to say that there is a part of the U.S. economy where in fact we do see modern management practices and we do see competition on the basis of producing higher quality products and so on. And where worker's wages, driving up wages is not seen as a good thing, where retention of employees or training of employees, where investing in your employees is important.

But in too large a part of the economy a low-wage model has taken place. The interesting thing about the example of Sam's Club and Costco is that Sam's Club is what Wall Street holds up as its model and prior to the publication of the article that I took that table from, what people on Wall Street would say about Costco is: "Well, it's good for workers, it's

good for customers, therefore it can't possibly be good for shareholders." There is a prejudice on Wall Street that if you are spending money investing in employees, that in fact this is bad for business. If you have a very short time horizon that might be the case because of course initially you have to make the investment in employee skills, in new technology, in work reorganization; it's not easy to implement teamwork, sharing of information, evolution of the responsibility and decision making down to the front-line workers. These things are not easy to implement and in fact that is why I think that there is a role for government in all of this.

It would take us too far a field, but these are not costless, quality is not free, but ultimately, after the initial investment period, as in any investment, it pays off in higher productivity, higher long-term profits. It is getting from here to there that is the problem, especially if you have companies that are already trying to implement a low-wage model it becomes that much more difficult for an individual employer to implement a different kind of model, which is also the reason that our most successful examples of low-wage America are where employers have been organized, or have organized themselves, into a network which then allows them to access resources, allows them to set mutual standards, allows them to find common export markets and so on.

My favorite story is that those Danish socks that are made especially to be worn with Danish clogs and if you don't look at the label really carefully you will have thought come from Denmark, in fact come from North Carolina, where the sock manufacturers are a group that have organized themselves this way, have sought out export markets, have set quality standards. Any company anywhere in the world buying socks from this consortium of companies in North Carolina knows the quality they will receive. These companies compete with each other in terms of style, in terms of many things, but not by reducing quality in order to make a few pennies.

So it can be done, it is not easy to do, and I think that many companies would appreciate a helping hand to get from here to there.

Scott Lilly:

Okay, thank you very much. We finished exactly on time so if you will stay in place we shall resume the program in about 15 minutes. Thank you.

Lunch Service

Cassandra Butts:

My name is Cassandra Butts and on behalf of the Center for American Progress, I'm very pleased to welcome you here today. As the new progressive think tank on the block, it's wonderful to be able to put on a program like this and to be able to have such high caliber panelists and participants, and to have such a significant level of support and attendance at our events. I thank you on behalf of the Center for American Progress for coming out today.

It's not an exaggeration to say that, since 2001, many of us have watched the economic policy making process, here in Washington, with a mixture of dread and dismay. But we've also found sustenance and hope in the writings and the ideas of our next speaker. And there's a reason for that: it's because Paul Krugman, on his very worst day, still makes ten times more sense than most conservative economists do on their very best days.

I think most of us know that he is a professor of economics and international affairs at Princeton, and we all know that since 2000, Professor Krugman has been a columnist for the New York Times. His columns have become required reading for those seeking a strong and bold voice against conservative policies and a coherent and engaging explanation of economic theory. By honing the skill of writing serious economics in non-technical language, Professor Krugman has managed the difficult task of making economics accessible.

Professor Krugman has been recognized for his professional accomplishment with numerous awards including the John Bates Clark medal from the American Economic Association for his work in international trade and finance. It's an award The Economist magazine describes as slightly harder to get than a Nobel Prize.

Professor Krugman is also the author of more than 200 academic papers and several academic and popular books. His latest book is the bestselling *The Great Unraveling: Losing Our Way in the New Century*. It's a searing critique of how America has lost its course under our current leadership. In the words of Professor Krugman: "It is not a happy book. It's mainly about economic disappointment, bad leadership, and the lives of the powerful." But take heart, because as Professor Krugman reminds us: "nothing has gone wrong in America that can't be repaired."

Please join me in welcoming a gifted scholar, an immensely talented writer, and one of America's strongest voices for sound, sensible, and progressive economic policy: Professor Paul Krugman.

Paul Krugman:

Thanks. I guess I have to make the usual disclaimer: because of the Times I'm not allowed to do political endorsements; my political preferences are as well hidden and obscure as those of Bill Safire's. And I just want to say the Center for American Progress, I was a little skeptical, does Washington need another think tank? But it is spectacular work, I just find it an incredible resource and I'm honored to be asked to speak to a CAP gathering.

Okay, well I'm going to talk about, I'm going to devote about half of this to talking about where we really are in the economy and in that I'm going to be covering ground that was probably covered in the panel, which unfortunately I wasn't able to make it to. But I have the feeling you're going to be hearing some of the same messages so let's just hope that my take is just a little bit different in presentation, though I suspect we have all arrived at the same conclusions. And then I'll talk about what this says about the prospects for

recovery. So, let's hope that our technology works here. I'm not usually a PowerPoint person, but as you'll see in a bit, pictures are actually terrifically important for trying to make sense of what's happening here.

The first thing to say is that we are in a period of economic recovery and if you read the papers, certainly if you watch the cable news, you'd have the impression that it's really spectacular and there's this almost whinny note from a number of commentators about "why isn't the public feeling more enthusiastic? Why isn't this leading to a huge surge for Bush?" But, just in general, "why isn't the public saying things are great," with fairly often the implications that people are stupid. Or they just haven't caught on yet, and just you wait.

It's important to have some perspective. So the first thing to say really is "how good are the numbers?" And the answer is "they're good, but they're not something that we've never seen before." And the reference point which drives certain people wild is to look at the Clinton era, at the eight year stretch from January 1993 to January 2001. These last five months have been much better than what went before, which means that the average so far this year is just about exactly the rate of job growth that we had under Bill Clinton for eight years.

We are eagerly awaiting tomorrow's numbers, but for what it's worth, straws in the wind, new claims for unemployment insurance, suggests an improving but not great labor market. If anything, the last few numbers suggest that we might be seeing job growth at roughly the rate of population growth. Real GDP first quarter was good but not great. Again, it was just barely faster than the average over the whole of the Clinton years, and just average for Clinton's second term. So again it is not a spectacular number.

Again, for what it's worth, the straws in the wind suggest that second quarter, if you look at a little piece in this morning's Wall Street Journal, saying that it's probably a number that begins with a three and possibly a number that begins with a two. Again, it's probably not, it doesn't look spectacular, we'll find out. But what you're seeing is good growth, and after all, we do think of the Clinton years, correctly, as a time of enormous prosperity, but there's nothing in recent experience that's better than that.

One question you might ask is "where is the sense that we're having some extraordinary boom come from," and a lot of it comes from the third quarter of 2003, which was in fact more than eight percent growth. But that's getting a little old you know, you can only live off that one spectacular quarter for so long, so it's not really as big a thing as it seems.

But to really have a perspective, of course, you have to have a sense that these pretty good numbers are coming after a long stretch of really pretty bad stuff. And here's my favorite picture. The blue line that goes all the way, there is the actual non-farm payroll employment. And as you see, in early 2001 it turned down, continued to slide down after the recovery formally began, and in the last nine months has finally turned up. And if you just take the last few months, it's a pretty good pace.

How are we? We might end up just with employment in October, which would be the last number that we have, being higher than it was when Bush took office, which will remove a big debating point for the Democrats. But that's really silly – what we really should be asking is how we are doing compared to what we should be doing. And there's a pretty nice simple gage of how we should be doing which is the purple line there. That's actually the forecast from the 2002 Economic Report of the President, which was released in February 2002.

For those who want to know the technicalities, what it actually forecasts is year average employment, which I've assigned to July of each year. It's actually based – the last date that's baked into it is from October of the proceeding year, just for technical stuff. The important thing about that is that this is a report that is post-9/11, it's post-NASDAQ collapse, it's post the recession. So, this is what the White House, or actually the Treasury, OMB, and the Council of Economic Advisors thought was a reasonable projection of what was going to happen over their term. What they were really projecting was that by 2004, the economy would be back on the track of the Clinton years – the slump in employment would be over, that we would have had a recovery, a period of above normal job growth. And, as you see, unless we create about seven million jobs between now and July, we're not there. We're really a long way down.

Another way to look at it is to use the – again technical stuff. There are two surveys. This is a survey that asks employers: "How many people do you have working for you?" The other survey asks people: "Are you working?" And that one has the virtue of telling us what fraction of the adult population is actually employed. So we can look at the employment-population ratio. Actually, last year, when the numbers from that looked a little bit better than the payroll numbers, we heard a lot about it but now we hear a lot less about it because now it's looking a little worse. Basically, that little wiggle at the end is the Bush boom I guess.

The point is that jobs are still very scarce compared to population. People here probably know that the measured unemployment rate fell quite a lot over the last year. But that as you can see, is entirely because of a reduction of the number of people who say they are looking for work, not because of an increase in the employed share of the population. Again, the picture is, compared with the first two and a half years of the Bush administration, recent numbers have been very good and they are a huge relief to people who thought that we were really sliding into the abyss. But compared with previous growth, they are not spectacular and they don't come anywhere close to making up for the long period of very poor job performance.

A word here about "why doesn't the public feel more enthusiastic." It's an interesting thing. What the people who say that the public should be feeling enthusiastic about the economy are really urging – what they believe is right, just – is not that the public should be smart, but that the public should be medium-stupid. That is, if the public is really stupid and has no idea that the job picture has improved, well, that's the story they are telling, and maybe that's the case. But if the public was really smart, they would say, "Well, you give me five months of okay numbers after all of that – I'm still a whole lot

worse off than I was when you took office,” and the public would be feeling pretty disgruntled despite the recent numbers.

So when the people say what the public ought to be feeling is really good, what they are saying is that the public should be smart enough to notice that the numbers have improved lately, but not have enough storage in their memory to remember what things were like a few years ago. So it’s a funny kind of proposition. For what it’s worth, it is also the proposition that econometric models of voting tend to suggest – that people really only look at the rate of change in the last few quarters. But I’m less and less convinced that those models are actually right.

The thing that you can’t capture by looking at these job numbers is the question of who is getting the benefits from the growth. And here the story is really quite spectacular because we’ve had, one way or another, a fair bit of growth these last few years, but almost none of it going to the working population.

Here’s one picture I’ve chosen from the last Clinton quarter, which is the most recent one that we have data - you can play with other time periods, it doesn’t really make a difference, you come up with a similar story. The economy has growth of more than eight percent since the fourth quarter of 2000. The wage and salary income deflated – adjusted for inflation – has risen only a little over one percent over that period. So basically there has been very, very little shared with the work force.

And then you ask the question: “Things have to add up, where did the growth go?” And the answer, of course, is: This is real GDP growth over that same period and the growth in after-tax corporate profits, adjusted for inflation, but it doesn’t really make a difference. Since the fourth quarter of 2000, after-tax corporate profits have risen 96 percent, after inflation, in a period when the GDP only grew eight percent. So it’s an extraordinary redistribution – basically all of the growth has gone to profits, none of it to wages. It’s pretty spectacular.

Now you might say: “Isn’t that what always happens during economic recoveries?” And the answer is: “Yes and no.” I don’t want to be too extreme here. So here’s the picture of after-tax profits as a share of GDP. Now if you do look, the first Clinton term was also a period in which the share of after-tax profits rose. So you don’t want to say that this is completely off the tracks. Something like this has happened before. But, the pace at which it has risen, given the fairly modest pace of the economic growth, is very rapid and it has now reached a level, after-tax profits as a share of GDP are at their highest level since quarterly data began being collected in 1947. So this is really dramatic.

Now, it turns out – actually, John Irons at OMB Watch is the one who pointed this out – sending me to the BEA website to do some downloading. And it turns out that it’s not quite right to say that we don’t have data on this before, we only have quarterly data back to 1947. We do have annual data, God knows how reliable it is, but there is annual data reaching back further than that. It turns out that this share of after-tax profits in national

income has been matched before, but only in one year in which we have data, which is 1929. Which raises the question: “How are we doing in terms of sustainability?”

Before I get there, I just wanted to say two things. This is the hourly wage of non-supervisory workers in 1982 dollars. Just to make the point, as you expect, big wage gains, although, in Clinton’s second term, not in the first term. Again, you don’t want to overstate the differences too much. And stagnation in this administration, with a fall in recent months. One more thing, I just picked this up from an article in this morning’s Wall Street Journal. It was an afterthought. I have not gotten back to it.

This really is a lopsided recovery, in which those who have, are getting better off, or think they’re getting better off, than those who don’t, are not sharing and actually see a deteriorating situation. Which you can see also – straws in the wind, Wal-Mart, Target are issuing warnings that sales are falling short of anticipations. We are seeing something happening.

Okay. So let’s talk about what it all means. We’re all a little bit at sea here because this is not a typical economic recovery, not a typical post-war economic recovery, anyway. What I have been trying to tell people for some time- this is not your father’s business cycle. It’s your grandfather’s business cycle. For reasons that we do not fully understand, we had a very long boom without inflation. And it’s a boom that, unlike previous booms, died a natural death; it was not brought to an end because the Fed slammed on the brakes by raising interest rates because of fear of inflation, rightly or wrongly. It’s a boom that came to an end because at a certain point, businesses which had been investing like crazy suddenly discovered that there really wasn’t a market for all that they were able to produce. It was an over-investment slump, at least that is my understanding. It is a 1920s or previous style of economic slump. It’s like the panic of 1873, when they built more railroads than they actually had traffic for. It came to an end basically because as long as everybody is investing like crazy, it’s kind of self-sustaining, but at some point it just can’t go on. It was a Wile E. Coyote moment, you run off the edge of the cliff about five steps, then look down, realize there’s nothing and “tshhhhn.” And that was the recession.

The recovery, if you go back, the problem is now we’re going back to the mists of history. If you go back and ask: “How did the economy recover from recessions of that kind in the past?” And the answer is, “actually, it was sort of time eventually created healing.” That as enough time went by between a growing population, technological progress, and just plain depreciation; there came a point where even though the economy was weak, businesses said: “Well, we really need to start replacing some stuff.” When the big businesses jockey to do that, enough businesses do it; you get a self sustaining recovery, as investment leads to a growing economy, which leads to more investment and so on. By those historical standards, the recovery we are having now is premature, which doesn’t mean that it is a bad idea. I would be doing a lot more to be promoting recovery. But the point is that we have had a recovery that is not the result of businesses saying: “Our stuff is so out of date we really need to replace it and we invest.” There is some of that – that is part of the reason why this year is better than last year.

But by and large, the recovery is driven by aggressive, expansionary policies. By aggressive monetary policy which has driven down interest rates that has led to a housing boom, which is very unusual for a housing boom to continue through a recession. But that's how it's happened. And it's the result of an expansionary fiscal policy, which is, I'm sure almost everybody in this room knows is something that any college sophomore could devise a fiscal policy that would have delivered much more stimulus with much less debt increase but none the less, as somebody said, "There's not much bang for the buck, but it's a heck of a lot of buck." So it is at least something to push the economy up.

The question that we now ask is: Okay we've got a recovery, which is certainly gratifying, but falls well short of a full recovery. And it's one that does not seem to be accelerating. At this point, if you had to make a rough guess, a rough judgment from all the scraps of information we have, it's probably getting a little slower – I'm not saying it's about to end, but it's probably getting a little bit slower rather than faster. Meanwhile, the fiscal and monetary policy has pretty much done all that it's going to do. The tax cuts have happened. We're not going to have another wave for a while anyway, and the long term budget concerns are going to crimp any future tax cuts. The war, well, it's not over, but the big surge of military spending is behind us. You go down the list, things are pretty much, policy has shot its wad. The monetary policy, I have to say I am a little baffled at why there is such a strong consensus that interest rates need to go up. Again, you see how the inflation numbers are a bit higher, but every measure that I can think of, of labor force utilization, capacity, suggests that the economy is still way down there. But in any case, the Fed is not going to cut rates any further and the market believes that they are going to go up. So you kind of have an exhaustion of the stimulus.

Does that mean that this is unsustainable? I'm not sure. You have to be a little careful of confusing value judgments with economic analysis. I'd say that the form of this recovery is grossly unfair, is grossly unjust. The workers are not sharing in this thing. But economics is not a morality play. What's fair and right isn't necessarily what works. And there's no reason in principle why you can't have an economy in which jobs are created producing luxury goods even while sales languish at Target and Wal-Mart. So there's no reason in principle.

Although we often talk about the Great Depression and the huge inequities of income that the economy had in 1929 – inequalities that we have now fully replicated today and say that the inequality of income must have been a reason why the economy was structurally weak and had to have a collapse, that's – we're not sure of that. It's a good story, it might be true, but we're not sure of that. The main source of weakness here I think that's pretty obvious, is that wages and salaries of all kinds, including salaries of highly paid people are lagging far behind economic growth. So if you ask me where is the extra income generated by this extra growth showing up, the answer is that it is showing up in corporate profits. And in a world of perfect rationality, everybody would say: "Well look, I own a piece of that corporation so those profits are really part of my income." In the real world, people don't necessarily see through the veil that way. And so disposal incomes is not rising nearly as fast as the economy, which makes you wonder whether consumer demand will keep on growing fast enough to sustain this rate of growth. I think



the answer has to be, (I know the background paper that CAP has produced says this) consumer demand is not going to keep on growing at recent rates. It might even turn down because there is a lot of build up of consumer debt because the home refinance boom is not going to keep delivering cash into people's hands.

Will corporate investment come along and save the day? And the answer is maybe, but it seems kind of weak to count on. As I said, the huge backlog of unexploited technologies, unexploited investment opportunities that traditionally led the economy into a recovery from a pre-WWII style recession has not happened yet. We have moved into a recovery before all the machines had time to wear out, which again is not a bad thing. We are saying that that kind of recovery probably needs more "umph" behind it then we seem to be getting.

Short-term forecasting is a black art. I think everyone has been surprised again and again. But I have to say that the consensus that everybody has had – that this is going to be a banner year for growth – that we've got a firing of all cylinders recovery that is going to be four to five percent growth for years to come, seems to be based pretty much on thin air. The consumer demand is not going to drive it. Businesses are not saying that they're going to invest at rates that would sustain that. So this is all about in effect, patting the heads of CEO's saying, "Yes, yes, we know you're saying that you're cautious, but we don't really believe it." I'm not sure that you want to base your economic forecast on that.

In a different world, we would want to sit down with the leaders of economic policy and talk about: "Let's have some sensible back up plans for economic stimulus that would keep this recovery going if it falters in ways that won't actually lead to massive build up of long-term liabilities for the federal government." In a different world, you could lose weight without dieting and lots of other things.

The point is that this is a recovery that is more fragile than people have been saying. It's not as good as people have been saying. And we may have some unpleasant surprises in the quarters ahead.

Thanks.

Cassandra Butts:

We are going to take a few questions. We have about 15 minutes for questions.

Question:

How influenced economically has the Bush administration been to the Washington think tanks that have helped staff the administration and supplied ideas to it?

Paul Krugman:

The thrust of policy comes from those think tanks. The general picture is coming from it. If you look at policies that have not happened but have been advanced – social security privatization and the social security reform initiative is the CATO institute. They just

moved the staff over to form the staff of the panel and it all comes from the social security privatization project at CATO, which they went back and scrubbed the old documents on the website to rename them social security reform. Heritage is probably the source of the underlying ideas. But by and large, I have the feeling that if you look at details of policy they seem to be coming from Karl Rove's office – it's the Mayberry Machiavelli's – and I don't see much sign of economic intelligence behind them.

Question:

I was wondering what impact the bursting of the housing bubble would have being as it seems to be centered not nationally but rather on about 10 metropolitan areas?

Paul Krugman:

Housing bubble. I think there is a bubble. You have to be a little careful because there are some issues. It is not quite as slam-dunk as I would like it to be. There are some structural reasons why house prices are getting more expensive. The house prices to rents ratio has been raising, which is usually an indicator of a bubble, but it is also at a time of relatively low interests rates so it is a little confusing. But it is probable that there is a housing bubble in major metropolitan areas in the United States.

The main thing to say is most people live – I should know off-hand what fraction of the population lives in the 10 biggest metropolitan areas – but it is not a small thing. Of course, the effects are very indirect. If housing prices plunge, it is not just going to affect the people in the areas where the houses are. It is going to affect the construction industry much of which is materials that are sourced in from elsewhere. It is going to effect consumer demand because of the wealth effect. So, it is a pretty broadly sprung thing.

I have not really gotten into that because it is a sufficiently ambiguous thing. I would not make it a core of my case for worrying about this recovery. One of my favorite business sector columnists, Paul McCully of Pimco said right at the beginning of this business cycle that Greenspan's task is to create a housing bubble to replace the NASDAQ bubble. Basically, I think he did that. Now the question is, "Now what?"

Question:

Can you talk a little bit about what you think the outcomes will be of proposals to allow corporations who have moved offshore to bring back money into the states at lower tax rates?

Paul Krugman:

No. It is one of the things that is sitting on the stack that I have to think through. I have not done the homework, so I am actually just blank on it. It is something where I really should not say. I do more homework than you would imagine on these things and I really have not done it on that one.

Question:

Can you talk a little bit about ways of changing the attitudes of consumers – we had a whole panel talking about consumer debt. Are there other ways that you think that there can be a soft landing to that problem?

Paul Krugman:

I have been strongly influenced by Elizabeth Warren's book, *The Two Income Trap*, and I have not done any independent work. I am really a believer, for the most part, in her view that we are not really talking about spend thrift consumers who are overextending themselves because they do not know how to manage their finances. We are talking about middle-class families who are desperately trying to buy houses in good school districts and overextending themselves because our public education system is so spotty. That is the reason why people are so vulnerable. The structural answer to that is not economic education – it is a better education system. In general, I am disinclined to believe the stories that place the onus on the irresponsible average American. We really want to look at other explanations and this is not, for the most part, about people going wild with their credit cards.

Question:

You have not given us hope, but a good realistic perspective. I was wondering what you see the most promising short-term policies to make this a more sustainable recovery for the next few years.

Paul Krugman:

This is the same stuff that some of us have been pleading for all along. Aid to state and local governments, which are still operating on very much on reduced...In an economy that is still short of demand, where we are worrying where the expansion is going to come from, we should not have the Governor of California proposing to kill the dogs in the shelters as a way to save a few dollars. Of course there is more serious stuff than that. So that is one source to provide demand.

If this looks like it is going to be a sustained problem, which it might turn out it is going to be then we can actually be talking about some fresh infrastructure projects that would provide demand. There is at least half a percent of GDP of homeland security stuff that should be done which would generate economic stimulus. If we need another boost, how about rebates that do go to people who are likely to be liquidly constrained and spend the money? All along we have been saying we have a pretty good idea of what kinds of stimulus proposals have a lot of bang-for-the-buck and we have not done any of them. All of that discussion faded away because we have job growth. If we start getting a string of 300,000 job-a-month-plus months, then that discussion will stay off the table. But if the numbers start to slip to 200, 150, 100, then we are going to be back in that position.

Question:

What we are reading now is that Japan might be coming back on board, that China might be in for a bust. I am wondering about your feeling about the international picture and how that might impact on our recovery or so-called recovery.

Paul Krugman:

First of all, I am not sure where these things are going. I used to be obsessed with Japan. But lately, it seems to me that the dangers of economics are here so I have not really been very focused on it. If you do the numbers, international linkages are not nearly as strong as people would say. If you do the multiplier effects, “What would an extra three percent of Japanese GDP do to the U.S. economy?” It is a remarkably small number. The main spillovers are more financial and psychological. It is not clear to me why the stories that we are seeing now should matter a whole lot there.

The one thing that bears some thinking about is how economic changes in Asia might affect the value of the dollar and through that, interest rates. The U.S. current account deficit is largely financed now not by foreign investors but by the Bank of Japan and the Reserve Bank of China – try to think about the economic scenarios there. But I do not have a real answer about how that is likely to play out – it can go in all kinds of ways.

Question:

Conservatives always say that raising the minimum wage hurts the small business owner and costs jobs. I was wondering if you could talk about that.

Paul Krugman:

What we know is demand curves usually slope downwards. I do not think anybody doubts that if you raise the minimum wage to \$15.00 it would cost jobs. We also know that the most careful economic studies that have been done by people like my colleague, Alan Krueger, suggests that in the range where minimum wages are now there does not seem to be a job loss effect. If anything, maybe positive. You don’t have to believe that to say but it does not seem that it is in there. We can come up with stories about that. There is probably some market power on the side of the employers, which means that we are in a range where an increase in the minimum wage can actually increase employment -- it is a little bit of a stretch but it is possible. We are certainly in a range where it does not seem to do a lot of harm.

If we were talking about raising the minimum wage from \$10.00 to \$15.00, then I would probably end up being a good, orthodox economist and saying, “Raising the minimum range is a bad thing for employment, although maybe good for incomes.” But we are not in that range. I can also say one of those things: “Really, there are better ways to raise the income of low paid workers – what we need is a five times bigger EITC program.” But in the world as it is, I am not wildly in favor of an increase in minimum wage but it does not seem like a bad thing.

We do not have a full employment economy so in this case we are talking about losing some jobs in a situation in which it is not clear that they are going to be made up. We also have an economy that has very poor social and income protections. So the workers who are in the path of outsourcing are hurt and those of us who talk about the broader gains are correctly abashed to say, “Gee, they are not outsourcing university professors or newspaper columnists yet.” There is actually a very funny parody. I will deny that I told it. There is a very funny parody – Tom Friedman column written by his replacement in

Bangalore. They actually found a South Asian guy who kind of looks like Tom. The point is that on the whole we want growing international trade. On the whole, over the long-term we want a world in which outsourcing expands, but right now in the United States, we have to say, “Look, we probably do not want to burble on about this. We might even try to create some speed bumps until things get better.”

What I am hoping is that we are going to have, sooner or later, under somebody or other, we are going to have another Clinton-like boom in which all these issues will become a lot less acute and we can talk about helping workers in general because outsourcing is probably, on the list of things that happen that cause workers to lose their jobs, outsourcing is probably way down the list, probably five or six. It just catches more attention than other things. There are a lot more workers who are getting crushed under the Wal-Mart bulldozers than are under the outsourcing – although there is some relationship between those. And that we will be able to have a more or less free trade policy. But it is all a discussion that is really hard to have rationally until we get a real economic recovery. If we do not, then it does not matter what defenders of free trade have to say, we are going to go protectionist anyway.

Cassandra Butts:

Thank you. We are going to close our program with a few remarks by Gene Sperling. But before Gene speaks, I would like to thank our staff for putting this together. Our communications staff is ever on the job in putting these events together: Anna, Antoine, Sarah, and Maya did a wonderful job and made this happen. And also on the econ policy staff, I would like to Jenna Churchman – who got all our panelists here on time. It is that type of work – we get the glory, we get a chance to speak, and C-SPAN covers us – but it the work of everyone else that makes the place run and makes these events real. And also the Mayflower staff for making us feel at like we are at home here. Closing remarks by Gene Sperling.

Gene Sperling:

Well thank you, and I probably should extend my thanks to Cassandra, Christian Weller, and Scott Lilly and our great panelists Eileen Appelbaum, Robert Manning, James Galbraith and of course Paul Krugman.

I have to tell you that there are some of us who feel that little bit of the mix of the public interest and the personal interest with Paul Krugman, being a columnist for the New York Times. From the public interest point of view, this is an unambiguously good thing. What an amazing thing that one of the nation's, truly one of the top, top economists of his generation, of our generation, is writing in the Times twice a week telling the truth - it is a fantastic thing. Now, if you ever aspire to actually publish an op-ed on economics in the New York Times, it is challenging because usually if you have a pretty good idea, when you're about half way through your submission, it's already in the New York Times, written with better analysis and better writing than you would have done. So, I spend a lot of time trying to think of, “Okay, what is Paul maybe not writing?”

I have a common experience, which is that I start to write something and about half way through it – when we read it with my fiancé, she says, “Ah! This is the best article ever by Paul Krugman!” In fact, she is such a huge Paul Krugman fan that I had to get him to sign something for her as I came in. So I would say thanks to Paul Krugman, even though I was the President of the United State’s national economic advisor and I do write a monthly column, if you were to ask my fiancé, “Was I her favorite economic columnist?” she would have to respond diplomatically that I had made her shortlist. Paul’s response to me was that it is a target-rich environment and there are lots of things that I should find to still write on.

Let me just say a couple of notes in closing. I think one of the most quoted lines is John F. Kennedy’s “a rising tide lifts all boats.” Republicans, conservatives, often have you believe that he was talking about supply side tax cuts – he was actually talking about public investment when he made that remark. But the key thing is that the notion of a rising tide lifting all boats really is not an automatic, factual assumption. What is significant about that line is it is the aspiration for growth, for people of progressive values. That there is both growth, but that it lifts all boats – and that one without the other does not lead to the type of expansive and inclusive economy we want. I do think that when we look at policies “the rising tide lifting all boats” should not be an assumption, as we have seen with the discussion of the upside-down economy, but it should be, for those of U.S. who consider ourselves pro-growth progressives, our aspiration, what we aim for and look at in all policies.

The 1990’s, although not perfect by any means, were significant in that we did see, to a significant degree, a rising tide lifting all boats. If you look at the Census from 1993 to 2000, every single quintile, every 20 percent group, saw their income go up. The most significant, 23.7 percent was the bottom 20 percent. Every group was over 16 percent, between 16 and 23 percent and it was the bottom 20 percent that saw the largest income gains. The largest group to gain income-wise during that period was African-Americans who saw their income go up 33 percent. This was at a time when poverty went down across the board. Poverty went down for black children, from a shameful 46 percent to a slightly less shameful 31 percent. This is not always a cause for celebration but it is to show that it has not been an uninterrupted period of income inequality. We have seen that our economy is capable under some circumstances of seeing growth that is not upside-down and even does raise all boats.

You have heard a lot about what is weak in this economy and I think a fair comment someone could make is, “Well, look, Presidents don’t deserve all the blame or all the credit. Federal policy does not deserve all the blame, or all the credit, for what goes on in the economy.” That is unambiguously true. I do not think that you can give President Clinton credit for everything great that happened or President Bush blame for everything negative that has happened. But that caveat does not go to the other extreme, which is to say that policy does not matter. Clearly, we see over and over and around the world that policy merit matters dramatically in the soundness, in the distribution of economic growth. Sometimes federal policy, public policy may simply be pushing in the right direction. At its best, it can lead to a tipping point that can get the economy in a better

position. It can help to ensure that more people are contributing to the growth and sharing in the growth's benefits. Or it can have the opposite effect.

Now when you consider fiscal policy, for those who would consider themselves pro-growth progressives, when you are seeking to have fiscal discipline, when you feel that the economy needs to have greater savings, long-term savings, to bring the deficit down, a progressive should aim to do so in the most progressive way possible – not to soak the rich, not out of class warfare, but of the notion that those who are most well off will be most able to bear a marginal burden and if the economic strategy works, will be the ones most likely to reap the benefits. That's exactly what did happen in the nineties. Those at the top were asked to pay higher marginal rates on their highest amounts of income, but they were the ones who gained the most by far from the prosperity of the nineties. At the same time, that plan included, in that period, an increase in the minimum wage, the earned income tax credit, a tripling of dislocated worker training, and at least an effort – though not successful – to give all Americans health care. That is a fundamentally different approach. It is an approach that tries to do fiscal discipline in the most progressive way.

When you are doing stimulus, you even have a better argument for doing progressive policies, because as professor Krugman says, when you are putting money in the hands of the people who have the least, are more liquidity constrained, then you are not only meeting progressive values, you actually have the best strategy to get more money into the economy and stimulate economic growth. In that light, when you look at the policies we have seen over the last few years, it is not just an upside-down economy, we have seen upside-down policies. The upside-down policies may not be to blame for everything but they certainly have not helped and they have probably hurt.

If one looks at the economy, looking back at what we needed in 2001, one could have argued that what one really needed was a strong dosage of stimulus that should have gone to states so that they were not raising tuition and taxes and to lower the modest income people who would have spent the money and helped stimulate the economy and at the same time, maintaining long term fiscal discipline.

As Paul said, there is certain amount of giving credit for walking and chewing gum. If you did anything to put money out into the economy during 2001 to 2003 it is a successful strategy, but the right analysis is bang-for-your-buck. You can stimulate the economy by building pyramids as well, but you would not necessarily think that it was a good economic growth strategy. If you look at what we needed, one can imagine, a strategy that would have put into the economy \$150 billion a year in high bang-for-your-buck stimulus and still maintained fiscal discipline, and then think of that that this was completely upside-down – that you had the worst bang-for-your-buck policies, that had the worst impact on long term fiscal discipline. I think that if one could, and since I'm a closer I will not go through, but it is worth looking back at what was done.

In 2001, while there were projections, supposedly a recession, there wasn't a penny supposed to go into the economy in 2001 in the initial plan of the administration. It was

only at the end that they decided to do an advance of \$300 to \$600 and leaving out the 34 million lowest income workers who would have done the most to stimulate the economy. After 2002, the Congressional Budget Office looked at the things being proposed and found that they had their very worst bang-for-their-buck. In 2003, the dividend and capital gains passed were among, according to Goldman Sachs, I could bore you with all the sites but from numerous independent sites would see as having had the worst bang-for-your-buck. What we have had is the least progressive bang-for-your-buck, with the worst impact on the deficit.

I think that this is not to say is that the best thing always for a rising tide that lifts all boats should be policies that go directly just to people who are lower-modest income. There are investments; there are private sector incentives that one needs to do for strong growth. But as pro-growth progressives, one should go by the basis that when funds are being distributed to the very top and when they are in particularly hurting the deficit, they should bear the highest burden of proof that there is solid and strong and irrefutable evidence that even though one is increasing the deficit and helping off the most fortunate, that there is such good evidence that it will not only raise the tide but lift all boats.

There is nothing approaching that evidence. When the administration, the supply-siders finally got their dynamic scoring, their impact, all they came back was to show that the impact increase in the deficits would wipe out any of the benefits, the supply-side benefits from the tax cuts. With very little evidence, and very little effect, these upside-down policies have gone into effect. One of the important things about having the debate about the upside-down economy is to at least make clear that we do not validate the idea that these upside-down policies have been successful.

It is hard to add any statistics when you are following Paul Krugman. But the last 12 months are the 20th to 31st month of the recovery. We went back and looked at labor growth during the 20th to the 31st month of the recovery – over this 12 months, it is the worst 20th to 31st month of a recovery in job growth ever. So let's think about this. You have never had a recovery go 20 months with job loss. And then it is followed up by 12 months- that when you put the average of all twelve months together, not just focus on the last three or four - is still the weakest period of job growth for that part of the recovery. And then, people have seen their wages lower, dealing with higher health, energy costs and as Paul said, the notion is that the media runs, "Isn't it a mystery? Why aren't people feeling well? What's wrong with them? Aren't they watching their cable economic news enough? Don't they know how they are really feeling?" I think people are responding to what the facts suggest.

I want to really thank everybody for coming here. I have been part of the think tank world and part of an administration world and I agree that ideas don't just spring from nowhere. Analysis does not just spring from just anywhere. It develops because so many people here work hard, and the fact there are people who are now spending their time developing policies and agenda for right-side up policies that will lead to hopefully economic outcomes that not only lift the tide but raise all boats should be encouragement to everyone. Thank you for coming and have a good day.