

A few challenges for the future of U.S. economic policy  
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Remarks to the Festschrift Conference Honoring Joe Stiglitz at Sixty  
October 25, 2003.

I am especially honored to be here today. I arrived at Yale too late to have been a student of Joe Stiglitz. I am not his coauthor, in neither the first nor the second degree of co-authorial consanguinity. We did not overlap in government.

On the other hand, I did blurb his book. And so, I was very pleased last week, on a visit to my father in Cambridge to celebrate his 95<sup>th</sup> birthday, to find a copy of the British edition of *Globalization and Its Discontents* on his bed. I turned it over to display my contribution, and found that the blurb had been shortened to something like, "This is a good book. Read it." More seriously, my name had also been shortened, to those two initials that for obvious reasons I never use: J.K. ... Galbraith.

My father's reaction was immediate: "That's just fine." And then he said something that I hesitate to repeat. But I think it is best viewed as something that a writer of a certain caliber would only say to a peer. "Tell Stiglitz," he said to me, "that he can look forward to the day, thirty-five years from now, when he will have achieved his mature style."

I have taken my brief today to comment on the future of all of American economic policy, and I have broken down my remarks into five categories.

I. Up from NAIRU.

When Joe Stiglitz was Chair of the Council of Economic Advisers, back in the last Golden Age, there were economists who believed that six percent unemployment or thereabouts was a magic threshold, below which inflation would accelerate without limit. Yet there were also dissenters, such as Bill Vickrey of this University, who won a Nobel Prize in the last days of his life, and Bob Eisner who should have.

Faced with the conflict between high theory and low reality, Joe struck an artful balance. *Yes*, he said, NAIRU was an important concept, deeply integrated into the models then used at the CEA. But *no*, he said, it would not be useful to reveal exactly what estimate -- six percent, or five and a half, perhaps lower -- those models were using. *And*, he said, NAIRU did not actually play an operational role; it was not a target rate for unemployment policy so far as he was concerned. Clearly I was up against an economist with political talent. I conceded that the main difference between Joe's position and my own was that I am not a church-going man.

The specter of inflation is today banished.-- at least, the specter of accelerating inflation induced by too much employment *per se*. So what should we do? Do we leave doctrine in place at the Federal Reserve, with priority on price stability? Do we content ourselves with a *de facto* standard of three percent jobless growth and a policy of doing nothing but predicting the best? Or do we recommit to full employment as ancient statutes require -- and set the challenge of how to achieve it?

## II. Getting Over Budget Balance

Late in the Golden Age, after Stiglitz had decamped to the Bank, there were economists in high positions who believed, or pretended to believe, that it would be possible for the federal government to run budget surpluses indefinitely, even eliminating the entire burden (so it was called) of the federal debt. “Fiscal drag” had been forgotten. When I mentioned the concept at a conference at the White House in April, 2000, the main reaction was a nervous titter.

Today we are (here I should perhaps say, “I am”) grateful for federal budget deficits near a half trillion dollars, just to keep the economy afloat. A new boom would probably require even larger deficits -- and with war at hand, who is to say we will not get them? “Stimulus” is a word spoken openly even by the Chair of a Republican Council of Economic Advisers, whose pet dog at one time was named Keynes. This is progress, I suppose.

Yet progress is threatened by the political habit of always looking at future fiscal decisions in terms of return toward budget balance, and not in terms of growth and progress toward full employment. In the budget process the economy is assumed; the goal of policy is to fit what needs to be done within the framework of falling deficits and eventual return to balance.. Needless to say, not very much in the public social sphere can ever be achieved this way. And particularly not, when one party has learned to game the system by reducing taxes on capital wealth year after year.

Fiscal federalism complicates these difficulties. Constitutional rules that state and localities balance their budgets have converted much public activity from counter- to pro-cyclical. And it is also possible for regressive federal tax cuts to force regressive state and local tax increases and cuts in public services directly, with the public scarcely aware of the connection. A new program of intergovernmental fiscal assistance, providing stabilizing federal funds for essential public services, should be high on the emergency list.

The broader solution? Surely it is for responsible political leaders and economists working with them to refocus policy around tangible objectives, of which full employment is only one. Others must relate to social goals, for public health, education, transportation and energy and in other fields. When these goals are set and the price of meeting them is determined, the question then becomes: what budget is compatible with achieving them at high levels of employment? People will pay taxes--and support deficits that finance investments--for a purpose. Or so let us hope.

## III. Facing Up to Private Debt.

The macroeconomists of the 1940s, 50s and 60s were fortunate in that depression and war had placed the American household sector on a strong financial basis, with liquid assets and little debt. The United States was also the world’s great creditor with an overpowering position in trade. From this starting point it was sensible to think of hydraulic models, of stimulus and restraint, working in an environment of occasional shocks to demand or supply. Fiscal policy drove consumer spending; monetary policy regulated business investment. Anyway that was good enough for a textbook approximation.

That world no longer exists. After the Keynesian Devolution, households now borrow and invest, and their effective demand is regulated as much by interest rates as by taxes. The power of monetary policy depends in part on the stock of household debt, and on the burden of personal interest payments in relation to income. Moreover, the United States is no longer a net creditor to the world, and runs a vast current account deficit at full employment.

How important are these factors? Is Wynne Godley right in emphasizing the mid-term reversion-to-normalcy of household acquisition of financial assets? Godley's analysis proved a useful guide to the recent recession. Its main implication now is that even more enormous federal budget deficits will be required to offset the public's financial preferences and leakages abroad. Without this, are we doomed to a sluggish expansion? Or will a new boom psychology sweep away the current mood of financial restraint? I do not know, and time will tell. Meanwhile, it would be good to have a few more economists working on this issue.

#### IV. New Economy, Oil Economy, War Economy.

To mention another unfashionable name, my friend the late Walt Rostow was a champion of sector economics – that middle ether of commodities, technology and energy, suspended between micro and macro, that most of us do not breathe. To most economists these are conceptualized as shocks. And a shock is unexamined, merely measured and classified as either positive or negative, supply or demand. But in a world governed by shocks, it would be useful to have economists who know something about how to control them.

We allowed ourselves to be hoodwinked during the technology boom, to convert in our imaginations a financial melee into a scientific marvel. The financial interpretation of this phenomenon would have been quite easy to understand – perhaps even to remedy by regulatory intervention, a point to which Joe called attention yesterday with his reference to margin requirements, which could have been raised by the Federal Reserve on its own authority under Regulation T. The other interpretation was to a large degree illusory and therefore impenetrable, and it is not surprising that it remains very poorly understood.

Now that we have been once again drawn into the vortex of oil, it would be good to have sorted out the geography and economics of energy supply, substitution, conservation, and the control of carbon emissions and climate change. Scientific work on these issues has advanced since I was in graduate school, at which time making fun of the Club of Rome was an indoor sport. Economists have not kept up; the facile architecture of emissions trading is not a sufficient contribution for our profession to have made to this field.

The challenge of reducing war and violence is central to economic development. Policy economists used to know a great deal about war – the costs of war, the effects of bombing, how best to avoid the use of nuclear weapons. Today, too few concern themselves seriously with these issues. More are welcome to do so. The first step is to join Economists Allied for Arms Reduction, at [www.eaar.org](http://www.eaar.org). You will notice that Joe Stiglitz is a Trustee and Director of this organization, along with Ken Arrow, Bob Solow, George Akerlof, and Inge Kaul, all present at this meeting.

## V. Inequality, Development, and the Financial Future

Finally, the United States needs stable economic development in the wider world. Rising inequality worldwide (yes, it is rising) and financial instability threaten our export markets, the stability of our population structure (because inequality promotes migration), and our health. Ultimately they will undermine the dollar-based financial system we have enjoyed as the world's consumer of last resort for the past thirty years. Beyond this, the problems of the wider world engage us on moral grounds, about which much more could be said but not in this space.

I mention this issue partly to call attention to a theme of my own, namely that global inequality is much easier to measure than most suppose. And when one does so, filling in gaps and fixing problems by statistical means, one finds that the pattern of change in global inequality is closely related to macroeconomic events, notably high interest rates and the debt crises of the 1980s and 1990s. In this way, one can begin to break down the barriers between macro- and microeconomics, by showing that macroeconomic and monetary events are not distributively neutral.<sup>1</sup>

Joe Stiglitz is a sharp critic of mis-governed globalization, beginning with striking insight into the Russian disaster of the 1990s. He has called for regional financial stabilization measures along the lines of Sakakibara's 1997 Asian Monetary Fund, vetoed by the U.S. Treasury at that time. The AMF and similar ideas to regulate capital flow remain a promising way forward, and the discussion around them should not die away. The next generation of international policy economists will inherit the job of putting it all together in practice. Once again, it would be a good if a few more of this generation turned their attention to how this might best be done.

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<sup>1</sup> Michael Rothschild yesterday described how Google functions as a new mechanism of peer review. Let me point out that if you type the ordinary word "inequality" into Google, then 1.3 million web-sites are returned. My research site, <http://utip.gov.utexas.edu> comes in, at the moment, fourth, and first among those dedicated to economic issues. Jean-Jacques Rousseau is a bit behind.