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War and famine. Peace and milk. — *Somali proverb*

The Sustainability Issue

"Between 1993 and 2008 (before the financial crisis really kicked in), the growth in average real household income was 1.3% per year... Growth in the bottom 99% — does this sound like Occupy Wall Street? — was 0.75%. The top 1% grew by 3.9%... [and] captured 52% of income gains."

Robert J. Gordon, page 4

Introduction

James K. Galbraith

This is a session designed around an overarching theme with many different dimensions: the concept of sustainability. It seemed to us to be fitting to hold a session on this topic at the moment when, in so many different ways, things are falling apart. Our conception here was to bring together the best talent we could, to address the problem of sustainability on a wide range of issues.

I'm very delighted to welcome the panel, to offer each speaker fifteen strictly-enforced minutes, beyond which their speeches will be considered totally unsustainable. On that note, I offer the floor to our first panelist, Robert Gordon.

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ABOUT THIS ISSUE

On January 6, 2012, EPS hosted "Sustainability," a panel session, as part of the American Economics Associations meetings in Chicago. This issue is comprised of edited transcripts from that session. The full audio recordings are available at http://epsusa.org/events/aea.htm.

Session panelists

Robert J. Gordon is Stanley G. Harris Professor in the Social Sciences and Professor of Economics at Northwestern University. He did his undergraduate work at Harvard and then attended Oxford University on a Marshall Scholarship. Gordon is author of *Macroeconomics*, eleventh edition, which has been translated into eight languages, and of *The Measurement of Durable Goods Prices*, and *The American Business Cycle*. He is an economic adviser to the Congressional Budget Office and the Bureau of Economic Analysis.

J. Barkley Rosser, Jr. is currently Professor of Economics and Kirby L. Cramer, Jr. Professor of Business Administration at James Madison University, where he has been on the faculty since 1977, having received his PhD in economics from the University of Wisconsin-Madison the previous year. He is author of over 150 books and articles in many fields of economics including environmental and ecological economics, and in 2011 he was named Outstanding Faculty Member by the State Council on Higher Education in Virginia.

Allen Sinai is Chief Global Economist/Strategist and President of Decision Economics, Inc. (DE), an economic and financial markets information and advisory firm with offices in New York, London, Boston and Chicago. Dr. Sinai is perhaps best-known as a forecaster and analyst, has been a frequent witness before the Congress on national issues and macroeconomic policies, and consulted with the Congress and the Executive branches of Government under both Republican and Democratic leaderships.

Richard Parker is Lecturer in Public Policy and Senior Fellow of the Shorenstein Center at Harvard's Kennedy School of Government. His academic articles appear in numerous academic anthologies and journals. His career before coming to the Kennedy School in 1993 included journalism, philanthropy, social entrepreneurship, and political consulting. From 2009 to 2011 he was an economic advisor to Greek Prime Minister George Papandreou. He received the Kennedy School's Carballo award for outstanding teaching in 2011.

James K. Galbraith, Panel Moderator, teaches at the LBJ School. He holds degrees from Harvard and Yale (PhD in economics, 1981). He studied as a Marshall Scholar at King's College, Cambridge in 1974 – 1975, and then served in several positions on the staff of the US Congress, including Executive Director of the Joint Economic Committee. Dr. Galbraith directs the University of Texas Inequality Project, an informal research group based at the LBJ School, and is Chair of the Board of Economists for Peace and Security,

Sustainable Growth

Robert J. Gordon

"Sustainable" growth implies that growth must be harnessed to the capability of natural resources to accommodate it, that it must protect the environment. For the US, however, the problem is how to spur growth, not how to harness or restrain it.

The US faces some fundamental problems. The first is that our historical record of growth in real GDP per capita of two percent a year (from 1929 to 2007) rode on the back of the great inventions of the late 19th Century. These were fully exploited by 1970 and many of them could only happen once. The second is that, even if innovation were to proceed apace, the US economy faces six headwinds

From 1900 to 1970 there was an accelerated wave of economic growth followed by a steady slow-down that I predict is going to continue or even worsen [see table, below]. The underpinnings of this process were caused by the three industrial revolutions. First, the industrial revolution of steam and railroads started around 1770. Then we had the Great Industrial Revolution, with all those inventions that were concentrated between 1870 and 1900. These innovations were more important for human welfare than those of the third industrial revolution: not the invention of the internet in 1995, but the transformation of human effort by computers that began in 1960.

Think of all the ways that the contributions of electronics to replace human labor had happened already, many of them over twenty, thirty, forty years ago. The 1960s brought us computerized bank statements and telephone bills, the first credit cards, and the introduction of industrial robots. In the '70s and '80s, we moved from memory typewriters to word processing on personal computers, introduced ATMs and barcode scanning. In the '90s, university and public libraries were completely transformed by replacing card catalogs with electronic information retrieval.

In my interpretation, the golden age after World War II, from 1948 to 1973, was the final set of applications of the great inventions of the late 19th Century — for instance, the interstate highway system. The reason that the growth has not continued at that same rate is that many of the inventions were one-time only. Only once could the horse be replaced with the motorcar and truck. The backbreaking labor of carrying water, coal and wood was replaced by running water and consumer appliances. We gradually transitioned from the open-hearth fireplace to 72-degree year-round temperatures thanks to central heating and air conditioning. The rate of transportation went from the speed of a horse to 550 miles per hour on a jet plane in 1958, and we're not flying any faster now than we did then.

That's a lot of progress, a lot of inventions. Now, let's imagine the rate of that invention and innovation is going to proceed at the same pace as it has over the last 20 years, which I obviously doubt. The US economy still faces six obstacles.

First, the demographic dividend is reversed. The reason our income per capita could grow as rapidly as it did between 1970 and 1995, despite dismally slow productivity growth, is that the entry of women and Baby Boomer teenagers into the labor force raised the number of people working compared to the total population. Now, of course, the Baby Boomers are going to be retiring over the next 20 years, and so hours per work will grow more slowly than the population. That's completely uncontroversial; it's incorporated in everybody's long-term growth forecast.

Second, we have reached a plateau of educational achievement in the United States, more than in other nations. At the college level, we have a

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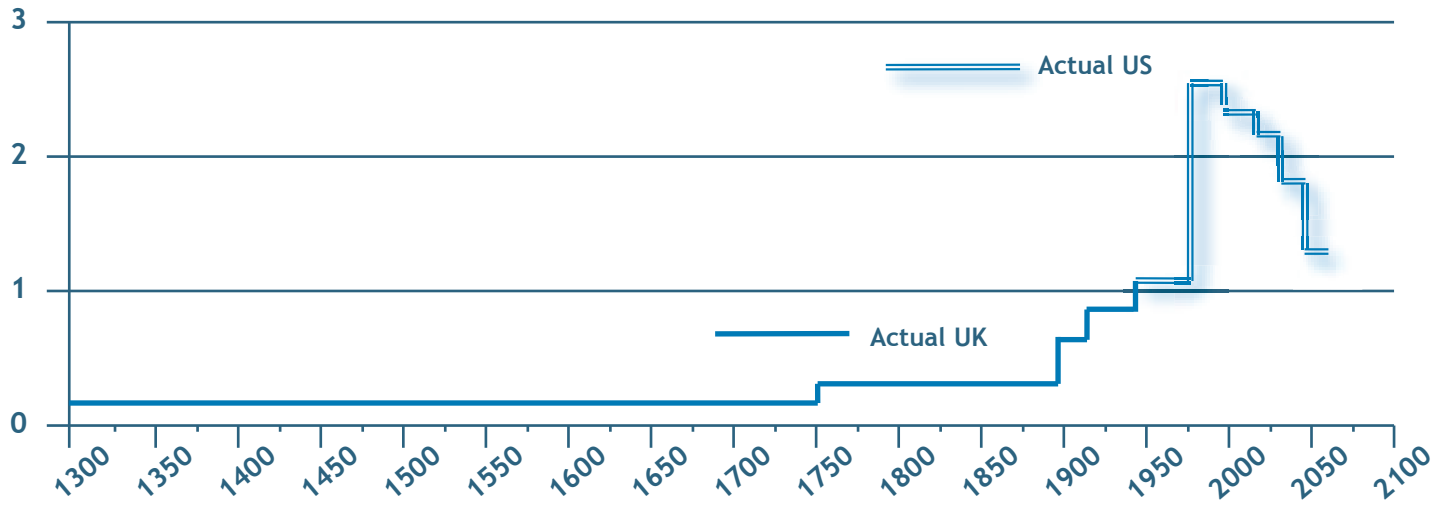
The Inexorable Decline of Growth in US Real GDP per Capita

GDP per capita growth, 1300 – 2100



Sustainable Growth (continued)

cost disease leading to mounting student debt. Able people are prevented from going to college because they don't want to saddle themselves with that much debt, and their life choices are distorted. At the secondary level, in tests of 37 countries, the US ranked twenty-first in reading, thirty-first in math, and thirty-third in science, with a continuing achievement gap of black and Hispanic students. That's just the beginning.

The third challenge is inequality. Growth in median income is much slower than growth in average income per capita. Between 1993 and 2008 (before the financial crisis really kicked in), growth in average real household income was 1.3% per year. Notice that's already a fairly slow number. Growth in the bottom 99% — does this sound like Occupy Wall Street? — was 0.75%. The top 1% grew by 3.9%. In other words, the top 1% captured 52% of income gains during that fifteen-year period.

Number four: globalization linked with IT hurts the leading nation more than others. It creates a convergence process where the availability of modern technology spreading around the world, outsourcing, and modern electronic appliances allow radiologists in India to read X-rays in the US. Indian and Chinese wages grow faster, and US wages grow more slowly.

The fifth one is the environment. To the extent that we deal with global warming by social measures such as increase in carbon taxes, this is partly a payback for past growth. Remember when all the pictures of American economic progress included huge black smoke coming out of industrial smokestacks? It's also a burden on the United States to have to partially pay for the global warming that's created by the rapid growth of the emerging nations, like China and India. The Chinese economy spews out more carbon than we do, and yet we're being asked to pay, I think, more than our fair share.

The last challenge does relate to the post-2007 period: an overhang of consumer and government debt. Any solution to which means that growth and consumption and disposable personal income is going to be slower in the future than actual personal income and GDP, because obviously we can only fix it by some combination of raising taxes and reducing transfers.

Now, I'm going to propose a few quick solutions. First of all, to deal with the reversal of the demographic dividend, we need to raise the ratio of working-age population to retired population. There's an easy way: completely eliminate any kind of limits on HB1 visas for high-skilled immigration. It's harder and more controversial to deal with low-skilled immigration. I'm all for eliminating the heartless deportation and terrorization of illegal immigrants. I want to open a road to citizenship, and I think the overriding principle here is they add to society. They create businesses and, properly administered, will not be a burden to society, partly because on average they're younger than our current population.

Education: at the higher education level, it's easy to think of ways of improving our student loan system. Get the private sector out of it, have the government directly in control, make many loans income-contingent. What to do about the higher education cost disease is a long discussion, and I don't have time for it here. For elementary and secondary schools, stop demonizing teachers and expand Head Start. We need to get inside the low-income families when children are six months or less to start offsetting the handicaps there. Elementary and secondary school: create more prizes to change the culture

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Sustainable Energy

J. Barkley Rosser

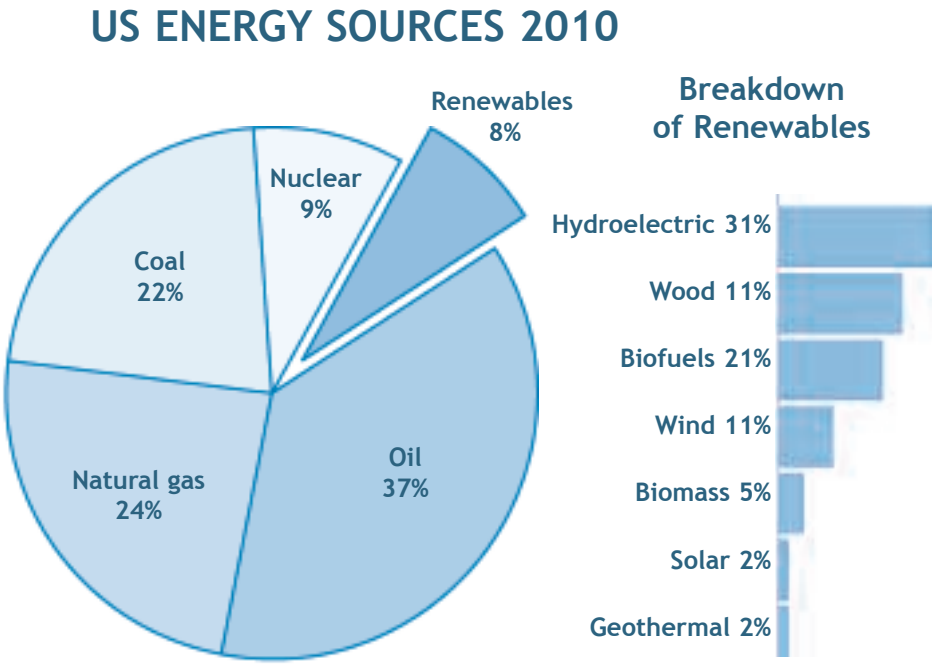
When thinking about sources of energy in terms of sustainability, it's very important to keep in mind that there are both inputs and outputs. On the input side, there's the problem that, if the nonrenewable, depletable resource is in limited supply, there will be a sustainability problem at some point. On the output side, it's a question of whether this energy source generates pollution, like greenhouse gasses (GHGs), or other damaging effects. With any given energy source, you have to look at both sides. In general, there ain't no such thing as a free lunch. There's no completely pure, clean, sustainable energy source. Pretty much all of them have either a problem on the input side, or a problem on the output side, or — in many cases — both. It's a balancing act of where we want to put our eggs, and which problems most need our attention.

Looking at US energy sources 2010 [see chart, right], oil — at 37 percent — is bad both on the input and on the output sides, and involves national security issues. Natural gas is next at 24 percent, and rising. Coal, at 22 percent — actually lower than I thought — is almost entirely utilized for electricity or steel refining.

Among renewables, hydroelectric is very clean and relatively cheap, but there are environmental problems. For ecological reasons, we're actually eliminating dams, so hydro is not going to grow any more. Wood is about 25 percent of renewable energy, used mostly for heating; although renewable, wood burning is in fact terribly polluting.

Biofuels are currently at about 21 percent of renewables. There may be some biofuels that haven't been thoroughly studied yet, grasses and so on. These may prove useful, especially in emerging countries, but I'm a little skeptical about biofuels doing too much.

Geothermal is two percent, and is not going to grow too much in the US. Countries like Iceland have really good geothermal sources, but most places don't. I'll talk more about solar in a minute. There are some other more exotic ones, like tidal power, that aren't really being used; the ones I mention are what's actually in place now.



Even though the US is a major coal producer and exporter, coal is 22 percent of energy sources in the US, compared to 30 percent globally. India and China are very heavy users of coal, because it's inexpensive. The rest of the world is actually using renewables at twice the US rate as well.

What is the status of nonrenewables? Oil is coming into somewhat shorter supply, in spite of some new fields being found and some expansion of new technologies. Coal is very abundant, but it's one of the worst in terms of both production and consumption. Production causes all sorts of ecological problems, and deaths from mining accidents. Its consumption is also very polluting, producing not just CO2, but probably the worst pollutant of all, sulfur oxide.

Natural gas use is really going up. It is a CO2 source, but much less so than either oil or coal. There does seem to be an increased availability, much of it due to the technological breakthrough of hydrofracking, a controversial technique that may damage water supplies and local roads. It is important to note that some of the more dramatically positive forecasts about natural gas have assumed there will be no problems with hydrofracking. In any case, it looks like for the near term natural gas is likely to be the main new source for electricity in the US.

Nuclear may be a way to go. The Fukushima situation was a terrible reminder of the dangers of conventional nuclear reactors. In addition to dangers from accidents, there is the problem of disposal: waste with thousands of years of half-life. Currently most waste is stored on-site at the nuclear reactors, which is disturbing. Uranium mining is also very polluting. I would note that most of the plants that have had major disasters — Chernobyl, Fukushima — have tended to be very old plants, with outdated technologies.

I'm a fan of thorium. There's a long list of potential advantages. There's more available input; it's much less polluting to mine the input; it generates less radioactive waste with a much shorter, 300-year half-life. The molten salt reactors are a passive technology that is much, much safer, with little room for human error. If there is an earthquake, or a volcano or tsunami, it just shuts down, so many of the problems of existing

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Sustainable Energy (continued)

reactors are just not there. It's scalable as well — you can build very small plants. Current technology requires great big plants, which leads to terrible problems when they shut down. India is actually pursuing this very seriously. The US didn't go with thorium earlier, because thorium processing does not produce plutonium. In the 1950s, probably the most important reason the US went for uranium was in order to produce plutonium for nuclear weapons. Now, we need to rethink these things.

A very long-term possibility of course is fusion. For decades, I've been hearing fusion is just around the corner. I've stopped waiting for it, but you never know. If it finally becomes available, that would really resolve problems.

The US Energy Department has data on various energy sources, with US average costs. Comparing average costs per megawatt hour, conventional coal is $94.80. Coal with carbon sequestration is $136.20, although recently it seems there have been numerous problems with the carbon sequestration. Natural gas, at $66.10, has an attractive cost advantage if externalities are not a concern. I've been a big fan of wind offshore, but I didn't quite realize it was so much more expensive at $243.20. Onshore wind, $97, is indeed competitive with some of the more conventional means. Solar photovoltaics, $210.70, is still pretty high, but coming down very rapidly. At $112.50, biomass is competitive if you want it. Hydro, $86.4, is less expensive, but as I mentioned, we're not going to get any more of that.

The most rapidly increasing renewables are wind and solar. Wind capacity actually increased 50 percent in 2008, but only grew 8 percent in 2011. Solar capacity has doubled between 2005 and 2011, and the growth there is continuing at about the same rate. One of the big reasons is that the price of the main input, polysilicon, has gone down 94 percent in three years, and that's about 25 percent of the cost of a photovoltaic cell.

Wind power has advantages and disadvantages. The main input is free, although of course some sites are much better than others — the Great Plains, mountaintops, offshore. Currently somewhat competitive in price with conventional sources and in terms of the output, there are no GHGs or other pollutants. However, there are problems with storage and transmission. There have been some large wind farms built in Texas and the Great Plains, but the electricity then has to be transported to the source of demand. One advantage of offshore wind is that it can be near some big city.

China is also now about half the global market for solar, not only because they have the rare earth, but also because of massive subsidies. This brings up US industrial policy.

Reliance on rare earth elements is also a serious problem. Neodymium and dysprosium are used in the magnets for wind turbines, and China controls nearly all of the production of these elements. There's lot of pollution from that production. Wind may be clean when you've got it, but it's not so clean in terms of producing the inputs to get it, and we may be running into some severe input limits, particularly with these rare earth elements.

Like wind, solar power has unlimited ongoing input sources, and no greenhouse gasses or other pollution on the output side. Although costs are dropping rapidly, it is still expensive compared to conventional competitors. The other big problem is that, like wind power, it requires rare earth elements, particularly tellurium and indium. These minerals are called rare earth because they *are* rare, so their scarcity becomes very serious if you're talking about replacing oil, coal, and nuclear power with solar and wind. Rare earths also present some policy challenges. In 1985 the US was producing about a third of the global rare earths, and China — zero. Because of pollution in the mining process, we shut down much of our production. Now, China produces around 90 percent of rare earths and the US about 5 percent. There is talk that maybe for national security reasons, we should reopen some of the US mines; but how will we deal with the pollution issue?

China is also now about half the global market for solar, not only because they have the rare earth, but also because of massive subsidies. This brings up US industrial policy. The Solyndra "scandal" was very damaging to efforts to subsidize the US solar industry, but as a matter of fact, there literally was no scandal. I read very carefully major reports on this. There was no bribery. What's so scandalous about the President visiting a plant that he hopes will do well? We lent them money and they went out of business. Chinese subsidization pushed down the prices so far that Solyndra couldn't keep up. This is not a scandal. If we really want to have green energy, we may have to engage very consciously in industrial policy.

The last issue that I want to talk about is policy for oil and automobiles. Mass transit would be nice, but it's really only useful in urban areas. There's also the fact that, boy, people just really like their cars; so, we need to move to cleaner, more efficient cars. In the longer term we may have hydrogen- or solar-powered cars, but the current push is for electric cars. Unfortunately, high costs and problems with the Chevy Volt show the limits of pushing the technology too hard. I think in the near term the most realistic approach is to encourage standard hybrids. Of course, there again is the rare earth problem: standard hybrids use eight of them. However, as far as I'm concerned, we need policies and subsidies to get more hybrids out there.

Another reason to reduce our reliance on oil is its national security implications. We've had wars over oil in the past, and we have a bad situation with Iran going on right now. Iran is threatening to shut off the Straits of Hormuz. We're threatening to embargo their oil. The more the US gets off oil, the less worry there will be about these threats to global peace, as well as the environmental and economic issues.

Sustainable Jobs

Allen Sinai

In December 2011, a labor market report confirmed light at the end of the joblessness tunnel: a higher pace of jobs creation and of people finding work — not anywhere near most historical upturns, but enough to be part of a self-sustaining and sustainable positive feedback loop in the macroeconomy. It's all taking place within a permanently lower US rate of growth trend. In my view of the future, two to 2.5 percent is about the best we can expect.

On this low-level uptrend, household financial conditions are improving , lifting consumption enough to provide a catalyst for better jobs that are now emerging, and a declining but still unacceptably high unemployment rate. I think that lower interest rates and debt reduction have created a source of spendable funds, increased retail sales, increased consumption, increased jobs, increased consumer sentiment, etc. The private sector is starting to do its job on jobs. This is the longest lag between easy money and a response in the economy that I can remember. The Friedman lags were six to 18 months long and variable, and this one is going on four years. That's not just long and variable; it's kind of like forever.

I want to look at four points: 1) How jobless and aberrant has this upturn been? 2) Why the jobless recoveries, with sticky-high unemployment and under-employment? 3) How do we get sustainable jobs at a high level and much lower unemployment? 4) My conclusion, which is basically, it just ain't gonna happen.

Number one: a better jobs picture. It's nowhere near the old days; the old days are gone. They are really old; they are really gone. The new world is a different world — better jobs, but not good. Initially, I'd said this episode was going to be the mother of all jobless recoveries, but that wasn't quite true. Indexed to the beginning of recovery, starting in June '09 when the recovery began, this is the second-worst thirty-months-out performance for nonfarm payroll employment in all of our economic upturns. The last three post-recession periods (November '01, March '91 and June '09) have—compared to history—given us very poor, anemic performance on the jobs front. I think it's due to a structural shift in the way companies hire, given their incentives and the mantra of "maximize shareholder value." Joblessness is defined as a number of months of declining non-farm payroll jobs after a recovery is begun, according to the National Bureau of Economic Research (NBER). I've defined it as 100,000 or less, and we're beyond that now. We're out of the joblessness, so this was not the mother of all jobless recoveries, unless there's a big relapse.

The second question: why have the last three post-recession episodes been jobless recoveries with sticky-high unemployment? The deepest, longest recession in modern history was 2007−09. On a real GDP basis, this has been the worst-performing recovery since World War II. Normally, in an economic upturn, pent-up demand leads to consumers buying a lot of cars and houses on low interest rates and availability of credit. One of the reasons for this aberrant business cycle is that there wasn't much life in these two big-ticket items until the last four or five months [see table, below]. For fully two years, it

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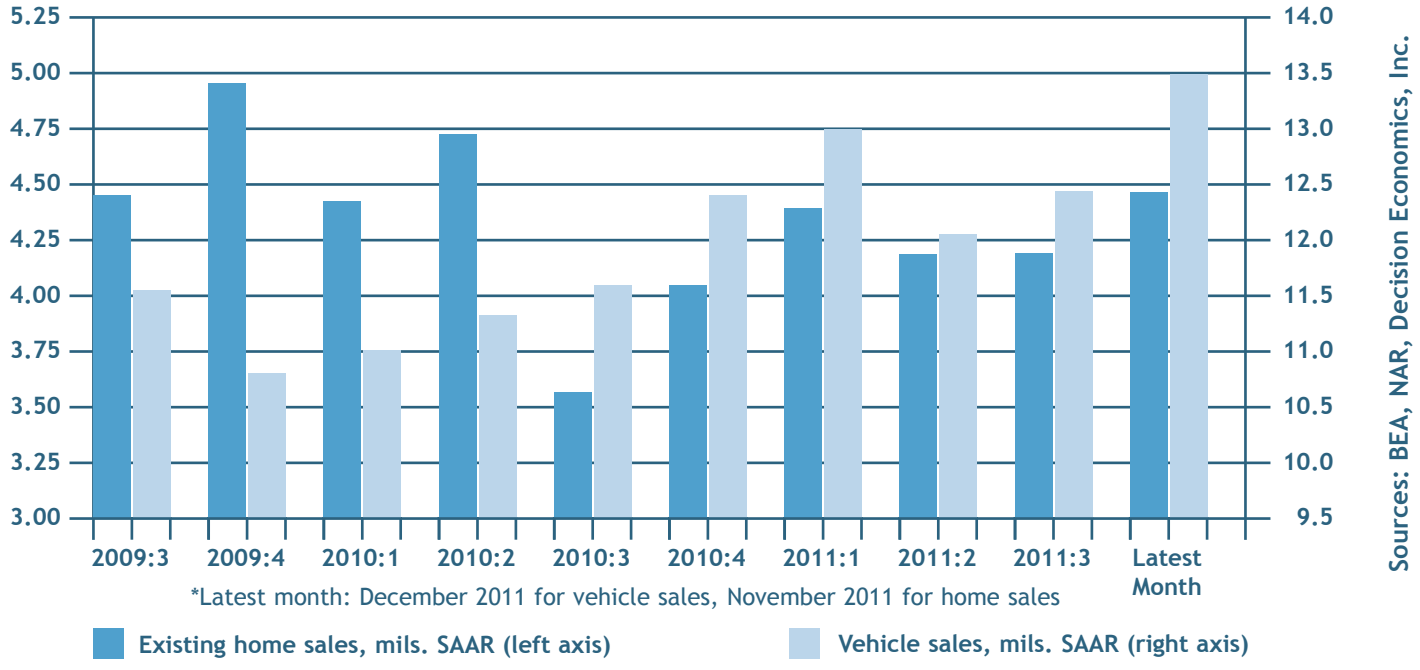
Evidence on Existing Home Sales and Light Vehicle Sales,Quarterly Averages*



Sustainable Jobs (continued)

just didn't happen. There has been improvement in household financial conditions with reduction in debt. Some of it's forced by bankruptcy and failures; some of it's voluntary; some of it is because consumers have not been buying cars and houses. This much-improved household balance sheet, which still is not normal, has freed up funds because the monthly payments on big-ticket items are way below what they were. This gives households some spendable money, lifting consumption, lowering the NIPA savings rate, allowing the economy to get a push up and, as a derived effect, better jobs. Decision Economics' analyses suggest that real GDP will be below average and below median — generally below par — well into 2014, at least.

So why this performance, high-unemployment and under-employment? According to the Decision Economics Consumer Financial Condititions Index, Q3 of 2009 was the worst position ever in history. We are now two-thirds of the way back to equilibrium because of tremendous reductions of debt, not because income is going up much. Debt to income, assets to income, monthly mortgage payments, monthly repayments to income and assets, interest charges relative to income are way, way down because the debt is down. We're not back to normal, and are not going to be financially whole any time soon, but the motion is positive.

Of course, money being pumped into the banking system by the Federal Reserve is going nowhere. The transmission mechanism is broken; banks are holding high levels of excess reserves and engaging in low levels of lending. The Fed eases, the banks are in between, and then households have to do something with it. They have to want to borrow, but when they're deleveraging and fixing their balance sheet, historically that doesn't happen until the balance sheet is in good enough shape.

Last year a number of external shocks interfered with the upturn: the Arab Spring with accompanying crude oil, energy and commodity price fluctuation; the tsunami and earthquake in Japan; China's disinflating; Washington's dysfunctionality; and regulatory uncertainty for business. The biggest one right now is the Eurozone crisis. That's a big-time macro external shock that potentially could hold down the US economy because of its effects on Asia, and Asia's subsequent effects on us.

I want to highlight the disconnect between Wall Street and Main Street. For EPS aficionados, I think this will resonate because it speaks to the rapacious nature of our corporate sector, which many of us in the markets call good old greed. It's simply what they're paid to do: "maximize shareholder value." I no longer think this mantra is a good thing. Everything is for the shareholders. Over time, patterns of shareholder compensation — such as restricted stocks and stock options — have changed. It seems to me that if the game is to "maximize shareholder value," which is not the same as maximizing expected profits — or profits — they're going to want to keep costs down and grow revenues. Why should an employer hire at all? It will raise costs and knock profits down, which will hurt shareholder value. Incented in this way, a rational executive would want to do the reverse, finding of ways not to hire.

Why should an employer hire at all? It will raise costs and knock profits down, which will hurt shareholder value.

If that's successful, earnings should do well, costs should be low, productivity should be high, the earnings do very well, and jobs growth should do very poorly. Lo and behold, this jobless recovery has returned the best post-recession operating earnings per share since measuring it began in 1991. I first started to notice this post-'90–91, when there was an odd decline in jobs after the recovery began. That wasn't supposed to happen; the question was, why? That's when the notion that maximizing shareholder value was causing different behavior took root in my research thinking.

Now, point number three: one of our most difficult macro policy dilemmas ever. How can macro policy be designed to grow the economy faster, create more jobs and lower unemployment, while reducing the federal budget deficit and public debt-to-GDP? Fiscal stimulus is at odds with reducing budget deficits and US sovereign debt. "Maximize shareholder value" is a mantra that is unlikely to change. Matching the growing demand (for labor from a highly technology- and information-based US and global economy) with supply (in the new global technocratic environment) is a challenge. If nothing is done, I think that we are in for a huge fiscal contraction after the elections and — given that it is an election year — resolution in uncertain.

Unfortunately, I don't have any solutions, but I can't resist closing with a bit of a story.

Lou Gerstner is one of those great executives who made a lot of money. I worked with him at American Express, and I can tell you, this guy knows about controlling expenses and finding ways to grow the company.

Lou became the CEO of IBM in 1993. If I'm Lou Gersten and I go to IBM, I'm going to fire my mother the minute I get in because the stock market the next day will reward me so well for firing my mother in terms of my options and my restricted stock. The stock price will go up, and I will be able to take care of my mother in the manner to which she should be accustomed.

I told this story the Hebrew Center in Martha's Vineyard to a crowd of retired people. Three days later I was in a place having a cappuccino, a guy walks in and says, "Aren't you the economist who spoke the other night?" I said, "Yeah, did I cheer you up?" and he said, "No, but you know, you were wrong." I started to shake, because what could be worse for a forecaster than to be wrong. He said, "It wasn't his mother he fired; it was his brother, Richard." It's a true story. Lou's a rich man now. I hope he's taking care of his brother in the manner that Lou should take care of his brother.

Sustainable European Union

Richard Parker

From late 2009 until two months ago, I worked as a consultant to the Greek government. The experience made me realize that the prevailing narrative about Greece and Europe is dangerously misleading. You all know the stereotypes about Greeks: they're lazy, they overspend, they've over-borrowed, they paid no taxes, they didn't work, they've maintained a socialist hostility to business in all forms. Greeks got what they deserved because they ignored the Greek Aesop's fable: the distinction between the Germanic/Anglo-Saxon ant and the Mediterranean grasshopper. However, I have some very interesting data collected from the OECD, EuroStat, the ECB, and IMF.

First, Greeks pay five percent more in taxes than Americans as a percentage of GDP. How could that be? Greeks collect their taxes in a distinctively different way, mainly through heavy Social Security taxation of wages, and a high VAT and excise tax system. Income taxation, both individual and corporate, is fraught with corruption and underpayment. In Greece income taxes amount to about four percent of GDP, whereas in Europe as a whole it's about nine percent. There's a significant gap in terms of collection of *income* tax, but that's not to say that the Greeks are not paying taxes: quite the contrary.

Second, everyone says that the Greek public sector is absolutely bloated, possibly the largest civil service in Europe: wrong. The Greek civil service is about one-fifth of the total workforce, which puts it right in the European average. It's about four percentage points higher than the United States. There are efficiency and organization questions that I could address, but it is not a question of a bloated civil service.

Greek government debt, we all know, was growing out of control. False. From the mid-1990s up until 2007, the Greek ratio of debt to GDP was about 100 percent — high to be sure, but quite stable over that more than decade-long period. Its climb up to 160 percent of GDP has come since the crisis that emerged in late 2008, principally as a consequence of all the public funding by the IMF, the ECB, and the European commission.

Greeks are lazy? Well, according to the OECD, Greeks work the longest hours of any population in Western Europe. Greeks are anti-business? They have more entrepreneurs per capita than any other country in Western Europe, and in fact, they're somewhat the Brandeisian ideal: a nation of small shopkeepers, of taverna owners, of micro firms. Fully a quarter of total Greek GDP is accounted for by micro firms with five or fewer employees. It's almost a perfect Marshallian world, at least in terms of price takers versus price makers, so: not anti-business.

What is the Greek crisis about, if not ...the ant versus the grasshopper? It is more accurately described as collateral damage of US deregulation of finance over the last 20 years, and its consequent blowup in 2008.

Measuring government, corporate, and household debt, Greeks didn't overborrow. In fact, household debt is below that of the European average, and corporate debt is substantially below that. Now that's of course a function of the enormous number of micro firms that aren't in a position to do extensive borrowing; but the aggregate of public, household, and corporate debt places it in the bottom quarter of European countries in terms of total debt to GDP.

What is the Greek crisis about, if not the Greeks' laziness, overspending and over-borrowing; the ant versus the grasshopper? It is more accurately described as collateral damage of US deregulation of finance over the last 20 years, and its consequent blowup in 2008.

Greek banks themselves didn't buy CDOs. They were not caught in the downdraft when the collateralized debt obligation market collapsed. They had followed their traditional pattern of lending heavily to Greek ship owners, to tourist complexes, and more recently, as the Greek economy has grown, to things like shopping centers. These are all deeply cyclically sensitive sectors. Global trade collapsed at a much steeper rate than overall declines in GDP because of the global meltdown. It idled huge numbers of Greek ships, and caused the prices ship owners can expect to fall by almost 80 percent in two years. This means one of the two largest sectors in the Greek economy saw its ability to earn income absolutely collapse, having nothing to do directly with the intrinsic qualities, performance or capacities of the Greek domestic economy. It was, rather, a direct consequence of the global economy and the global economic downturn.

The same goes for tourism, which is roughly a fifth of Greek GDP. There was a collapse of demand by German, British, and Scandinavian households, which again has nothing to with anything intrinsic in the Greek economy itself, but with a change in the situation of the European economy, which itself was related to the US deregulation of finance and the collapse of Wall Street.

In 2009, many hedge funds and bank trading floors realized that there was no future in playing the US housing market. Securitization and resale of US mortgages was not going to be a growth industry for the foreseeable future, but two other areas were. The first was commodities in the Third World, which contributed to the rapid run-up in many commodity prices in 2010. The other was the emerging realization that sovereign debt represented an investment opportunity. As the traders looked more closely at how much of Greece's government bonds were being held by the largest

Continued on page 10

Sustainable European Union (continued)

Greek banks, they saw that Greek banks were another opportunity to short in the market.

I mention this not to try to pretend that there wasn't something fundamentally, structurally challenging about the Greek economy. With the collapses in key sectors of the Greek economy, a lot of the loans that had been made by Greek banks to owners of ships, hotel complexes, and shopping centers were in fact effectively non-performing. Greek banks were reluctant to realize those non-performing loans, in part because they recognized the history of cyclicality in the shipping and tourism industries. They thought that if they could only wait it out, things would get better. In truth, over the medium- and long-term, that is often what happens. Traders in New York and London, however, saw emerging anxiety among the Greek people about their future, and the opportunity to play a panic option became highly attractive.

In May 2010 came a 110-billion Euro rescue package by the Europeans and the IMF, which had a number of positive effects. Pressure from outside sources allowed Papandreou to undertake reforms that he had wanted to make in the first place, and for which he had been elected. They were broadly popular reforms to reduce the cost of Greek government, lower exiguous wages and pensions in the public sector, etc. By the end of 2010, they had been able to reduce the government's deficit as a share of GDP by five entire percentage points — more than any other country over the same period. The US and the UK were running similar deficits and have come nowhere close to this level of reduction. In fact, the IMF is estimating that going forward in 2012, the residual deficit is composed entirely of debt servicing costs, interest and repayment. The Greek government has been able to maneuver itself into a position where it will run a primary balance that will either be even or start to go positive if some other conditions obtain.

It's inappropriate for economists to continue to concentrate on national macro economies as the relevant frame of reference. Greece is deeply integrated in the European economy, and the European economy in the global economy. We need to give attention to global finance, the lack of overall regulation of global finance, and the lack of even coordinative regulation among major actors in Europe and the United States. The creation of a World Finance Organization (WFO) would begin to improve national standards on a whole host of issues related to global finance.

By the summer of 2010, financial markets were probing Portugal, Spain, and Italy to test again the idea that a nervous market could be stampeded against other sovereign countries.

By the summer of 2010, financial markets were probing Portugal, Spain, and Italy to test again the idea that a nervous market could be stampeded against other sovereign countries. There were clear differences among the countries. Italy had a fairly high level of total debt-to-GDP ratio; but a very high proportion of that debt was owed to Italian nationals, which made it an entirely different situation from the one in Greece, where 80 percent of its outstanding debt was owed to non-nationals. Lost in the rising panic of 2010 was the idea that one could differentiate among these economies, or recognize that under "normal" conditions — that is, borrowing costs at something like the historical averages of the previous decade — all of these problems that the Mediterranean countries were facing were, by and large, manageable over a five-to-ten-year horizon.

Rogoff , Roubini, and Krugman have been unitary in the idea that the Euro crisis is the consequence of a fiscal misdesign and structural failure, due to the lack of any kind of coordinated fiscal integration to go along with the monetary integration of the Euro itself. There was nothing intrinsically wrong with the structure of the Euro, even without a common fiscal policy. European financial markets have grown increasingly integrated with the US financial markets over these last 20 years to a degree that's really quite extraordinary. We have enormous European banks, like Deutsche Bank and the big Swiss banks, operating in New York alongside the Goldman Sachs, Citi, and Bank of America trading floors. They themselves have been great initiators of the CDO phenomenon and securitization of the real estate market. The large financial institutions of Europe are players in this new deregulated Wall Street environment.

I want to draw attention to the problem with global financial market structures, and away from the idea that there's an intrinsic structural flaw — not to overshoot the case and say there is no reason for further federalization of Europe, or further integration of some kind of common fiscal policy, but to refocus economists' attention on the great fact that Dodd-Frank has not done the job yet, and may never do the job.

I think it is premature to say that Europe, or the Euro system, is on the verge of collapse. For example, just in the last few weeks [as of early January 2012], the ECB's willingness to provide $500 billion-worth of long-term refinancing has already begun to bring down long-term notes of European rates in a meaningful way and short-term notes in a dramatic way. The European Financial Stability Facility (EFSF) and the the European Monetary Fund (EMF) are on a fast track to being implemented and bulked up — if not to the steroidal levels of a billion-plus Euros that was being touted, certainly in ways that are meant to address specific problems from member economies that cannot find financing in the markets.

There has also been meaningful progress on fiscal limits. What hasn't happened is a confrontation with the terms of regulation of global capital markets.

This is ultimately the unanswered question to face if we are to reconceive

Sustainable European Union

the Greek and the Euro crises in a way that's useful to us as economists, and — more importantly — useful to citizens in Europe and the US going forward.

Europe needs better financial market regulatory institutions. In particular, it needs to back away from following the US and UK down the path of weak regulation or strong deregulation. It must reemphasize the role of banks versus securitization as a source of financing. There's a fatal reliance on US credit rating agencies. Europeans have talked about moving toward a public European credit rating agency.

There's still no significant limit on offshore hedge fund operations on the purchase of European securities and efforts to control tax fraud and money laundering are incomplete. European governments can no longer afford to lose revenue to Switzerland and Lichtenstein, and have increased pressure on these tax havens. There is opportunity for greater coordination among the countries of Europe to apply pressure not only to European centers of tax evasion, but to those offshore as well. Europeans do have the power to force the Americans to come to terms with the need for American oversight over American hedge funds.

Finally, derivatives need monitoring. Global GDP is around $60 trillion, and the notional value of global derivatives is around $600 trillion — ten times the sum of global GDP. These derivatives have very damaging effects on the ability of the ECB or of national governments to maintain their own fiscal and monetary policies. The initial argument, that derivatives were meant to make markets more efficient, has to answer in part for what happened over the last three years.

Sustainable Growth (continued)

about sports versus math and science. Deemphasize sports, and replace soccer moms with math moms and dads — I emphasize dads.

Inequality: most high incomes are rents. Take a lesson from Henry George in 1899: let's tax rents. Raise tax rates on capital gains and dividends to the top bracket income tax rate and cure the Warren Buffet problem. Tax reform is a long issue, but I think a simple solution is a progressive consumption tax with a top tier income tax on top of it, because rich people get a lot of power even if they don't consume. Eliminate many tax expenditures, but slowly, not suddenly, to avoid effects on asset markets.

The hard one to deal with is number four, because wages around the world are inexorably converging; there is no direct solution without protectionism, and that creates as much harm as good. I think we should try to make the US more like other countries to prevent the kind of distortions like when US auto makers couldn't compete with the Japanese because they were saddled with legacy costs. We need to reform the corporate tax system and have single-payer health insurance from the government, untying medical care from employment.

As for the environment, every "Econ-101" student learns that subsidies create deadweight losses. This may not apply when you can clearly identify an externality — for instance, when public transport eliminates or eases congestion, then public transport subsidies are indeed essential — but learn from Solyndra: stop subsidizing solar and wind power and ethanol and electric cars. Fortunately, the congressional subsidies on ethanol were allowed to expire through our political gridlock. Murphy's Law is perfectly exemplified by ethanol. It's raised the price of corn around the world and helped to lower the standard of living of poor people in less developed countries. Combat global warming by encouraging conversion from coal and oil to natural gas and nuclear. Introduce carbon taxes gradually, and let price incentives work; gas prices in Europe are higher, and they really do drive smaller cars.

[W]ages around the world are inexorably converging; there is no direct solution without protectionism, and that creates as much harm as good.

Regarding consumer debt overhang: although the Obama administration put a lot of money and thought into bailing out the big banks, equal thought didn't go into restructuring mortgages and rules to stop foreclosures, or forcing big financial institutions to take losses in repayment for being bailed out. For the government debt, let's listen to the balanced budget multiplier principle. Because the food stamps multiplier is four times greater than taxes on the rich, we can have more generous unemployment compensation or other redistributing activity without any effect on the budget. Social Security reform is easy with a mix of changing the indexation formula, gradually upping retirement ages to keep up with life expectancy, and some adjustment of benefits and the way wages are defined.

Forget ObamaCare, and start from scratch. Eliminate, through government incentives, fee-per-service individual practice. Medical coverage must become a right of citizenship, and end its tie to employment completely. When people become unemployed, it's bad enough; they shouldn't lose their medical care coverage as well. Eliminate private insurance overhead, and adopt a VA model. The last estimate I saw for private per-profit medical insurance was $380 billion per year — because of overhead, bureaucracy, and extra employees that doctors have to hire to fight the medical care bureaucracy.

I hope that's enough controversial material for fifteen minutes.

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UPCOMING EVENTS

•**June 25 — 27, 2012** The 12th Jan Tinbergen European Peace Science Conference, and annual meeting of NEPS (The Network of European Peace Scientists), will be held at the DIW Berlin, Department of Development and Security, Mohrenstr. 58, 10117 Berlin, Germany.

Details about the conference can be found at their website: http://www.europeanpeacescientists.org/jan.html.

•**June 29 — July 3, 2012** The 87th annual Western Economics Association International conference will be held in San Francisco, California at the Hilton San Francisco Union Square.

Find out more and/or register at http://weai.org/AnnualConf.

•**July 21 — August 18, 2012** The Hague Symposium on Post-Conflict Transitions & International Justice will be hosted by The International Peace and Security Institute in partnership with the Clingendael Institute of International Relations. It will be held in The Netherlands, bringing together 60—80 of the world's brightest young minds.

Visit http://ipsinstitute.org/the-hague-2012 to learn more or apply for the symposium.

•**September 18 — 20, 2012** The Conflict Research Society and the Centre for Peace and Reconciliation Studies will host an international interdisciplinary conference on Peace and Conflict at the University of Coventry, UK. The conference seeks to bring together developments in the 'real' world and developments in academic understanding. Moreover, it recognizes the existence of disagreement: concepts, theories and approaches can be contested.

For more information, email crs2012coventry@gmail.com or go to http://www.conflictresearchsociety.org.uk/2012%20CRS%20Annual%20Conference.html.

•**September 24 — 25, 2012** Workshop of the Economics of Security Initiative, to be held at the Johannes Kepler University of Linz, Austria. This workshop, managed by the Department of Development and Security, DIW, aims to bring together young and established researchers in security economics to present and discuss the latest work in this field.

For additional information on the workshop, contact Myroslava Purska, Tel.: +49 30 89789 277 or email mpurska@diw.de.

•**October 19 — 20, 2012** Conflict Studies Conference: The New Generation of Ideas, Ninth Biennial Graduate Student Conference organized by the UMass Boston Graduate Programs in Conflict Resolution, Conflict Studies. The New Generation of Ideas brings together graduate students from a variety of fields to present their work and share ideas.

Full details on the event are available here: http://www.umb.edu/academics/mgs/crhsgg/conflict_studies_conference/.