



February 6, 2013, 10:00-12:00

Venue: CIGS Meeting Room 3

CIGS Seminar :
**"Post-Election Fiscal Drama in the United States:
A Real Cliffhanger"**

by Professor Jay Rosengard

< Discussion after His Speech >

Question 1:

Thank you very much for your excellent presentation on the historical and current situations in the United States. I would like to ask you a simple question. The market has reacted favorably to the situations in the US after the presidential election. Do you think that it is a right reaction? Do the measures taken by the US government at the moment rightly respond to the market expectation?

Professor Jay Rosengard

We have seen the US stock market significantly rallies now. Although the market easily gets nervous, it is satisfied at the moment with the certainty for the tax issues and a little certainty on the debt limit issue so that the credit rating will not be downgraded anytime soon.

The job figures also look good and many surveys show consumer and business confidence. The growth rate is fine and the job creation rates are good even though unemployment is stuck. There are a lot of favorable data for several months now and the job growth has been consistent for a few years. The market has responded to these situations favorably.

The problem is that we have not solved the issues on the spending side. The corporations are still sitting on trillions of dollars of their cash, but not investing. Until that the third element of the fiscal cliff is at least partially resolved, I do not think that they will make major investments in the real economy so that we can create jobs, create disposable income, make the growth rate higher and make the situation more sustainable. The good news is that the market is stable and it likes the certainty.

The other good news is that many big corporations have seen the damage caused by the uncertainty and by the Tea Party. In the Republican Party, the majority of the Republicans have lost control over the party. Some of the very rich donors of campaign financing are creating a fund to try to protect the moderate Republicans in the upcoming midterm elections and defend them against some of the extremists in their own party. I think that we will realize in the end that the uncertainty benefits nobody including the private sector, big corporations, small businesses and households.

In sum, we see a lot of good things but the big question is what we will do about the spending. I do not really know how the market reacts. But, it seems that people are relatively happy with Obama's new economic team, and that helps the market reaction.

Question 2:

Thank you very much for your nice presentation. I would also like to ask you a simple question. What do you see the Japan's recent development of the discussion on new monetary policy under the Abenomics? How do you advise the Japanese policymakers to make things right on the monetary side?

Professor Jay Rosengard

I do not believe that there are no really articulate economists in Japan. When I visited Japan several years ago as one of the team members to discuss the banking crisis in Japan, the Japanese economists knew exactly what the problem was and what the solution was. We found that we provided some support and credibility to the community who actually understood the problem, knew the solutions but was caught in the politics.

It seems to me that the same applies to the Japan's current situation. In a complicated issue, you always have tradeoffs – you have winners and losers. For example, if you have a weak yen, exporters like it but importers do not. How do you stop yen depreciation if it is needed? How do you intervene it without starting speculation because when people believe that currency is going in one direction all people will go that way and that will happen whether you want or not. If you have inflation targeting, it may work well, but how do you control inflation it becomes necessary? What is your exit strategy from that? You have the issue of autonomy of the Central Bank versus the executive branch. These are all controversial issues. It is not clear what to do because there is a combination of the short-term issues and the long-term issues.

In a technically complicated issue, it is not just the matter of what to do, but it matters the magnitude and the timing. Even if you agree on the strategy, questions also exist

how much is enough and how you control the timing and the sequence. You also have to deal with your short-term objectives and medium to long-term objectives. This is a challenge for the US FED. If the FED's balance sheet would roughly be tripled it is not sustainable. But, if you unwind too quickly it is counterproductive.

I think that it is actually a great question. There are no clear simple answers. Even if the strategy is straightforward its magnitude and timing may be the problem. I think that we will both watch the situations of the BOJ and the FED with great interest. I hope that the BOJ is successful in their strategy.

Question 3:

I would like to ask a little more specific question. In Japan there is a controversial discussion on an inflation target. It seems to me that the Bank of Japan tries to set the target which is not possible for it to achieve. The FED also set a kind of target or standard connected to the employment rate. Inviting a new governor from Canada the Bank of England also sets a similar kind of economic path. Why do the central bankers join the global trend to set a kind of target, for which they do not have full power to realize?

Professor Jay Rosengard

You have described the dilemma of the central banks very well. Targeting can be a very dangerous tool. The numbers have always tremendous influence over the economy. You can understand it when you see the credit ratings which are often frightening if you know who and how they are determined inside the organizations. But the central banks have to be transparent and accountable. But if they are in a clear box they lose some tools. If you want to change or adjust the target you are accused of inconsistent or not credible. If you stay with the target that turns out to be misguided you also have a problem. There are a lot of issues and the central banks know it. But they are under a lot of political pressure. So this is a political economy. Even on the economic side there are a lot of difficult issues and it is not just the issues within a country but affected by the global economy. The US is affected by Japan and both are affected by the euro zone. Chinese economy affects every country.

Central banks are independent and complement fiscal policy with monetary policy. The good news for the BOJ at the moment is both policies are consistently expansionary. The FED have often gone against the executive branch for last several decades when it thought that what they had to do was in the best interest of the economy. After the global crisis it is a tendency or a fashion to try to consolidate everything under one

regulator. The UK has gone this direction and has not gone very well. In addition to this global trend there is domestic political dynamics in individual countries that affect the central bank's policy.

One thing we have to be careful here is that in the UK and the US there are public statements in contrast to what actually goes on inside the institution because there are two constituencies. Sometimes you have to say things publically that might not be exactly what goes on technically. I think that the top leadership like in Japan is very sophisticated on the political economy and it has many constituencies. You look very carefully at the discrete policy components versus the general public statements because the statements for the general public have been very general but not been too specific. It is an uneasy answer to a very complicated question.

Question 4:

In relation to the fiscal cliff, I am a little concerned about the banking regulation recently adopted in the United States which may affect not only the US economy but also the global economy. What changes have been made and how will they affect the US and global economy?

Professor Jay Rosengard

We recently have passed a major piece of the banking regulation, which I would think is not perfect. Some parts of the regulation are very long and detailed while some areas are completely left out. For example, it does not say anything about Fannie Mae or Freddie Mac. But something has been done. The problem is that just passing a law does not mean that it will change things. The law has to be implemented by government regulations, ministerial decrees and operating guidelines. I think that the policy and its actual impact are dependent on how the law is implemented and interpreted.

Let me give you an example. We have new Consumer Financial Protection Bureau which I think is one of the most important parts of the act we passed. We have the problem in the past that the regulatory agency put more priority on financial institutions but not consumers. That is why this Bureau has been created. But the Congress, especially the Republicans in the House of Representatives, does not like it and wants to kill it. They will not approve a head of this agency. The person who is subordinated to the head was temporarily appointed – but not permanent – and he is not appropriate and competent for the position. The agency cannot deal with a lot of things without a permanent head. The Republicans wants to take away its independence by making it subject to the congressional budget. So it cannot be

financially independent like the FED. The Congress also wants to have veto or approval over a lot of the policies to be adopted by the agency, and in this way undercuts its independence. But if it does not have independence it is a waste of money.

So the idea of the Congress is to, through the implementing process, attack it from the budget, attach it by appointment and in all sorts of ways get something without actually changing the law. The Congress does not have the veto to override the law. But it can just beat it to death or bleed it to death slowly. So the big fear right now is again this regulatory capture by special interest through certain parts of the legislature.

Other than going on with Basel 3 which increased liquidity and capital requirements, there has been no fundamental change in banking regulations. I think that there still are vulnerabilities and a risk of concentrated systemic risk. We have institutions that I think are too big to manage or regulate because they are politically too powerful. In the US we have roughly over 8,000 banks but a handful control the majority of the assets like in many countries. Those institutions are politically powerful for systemic risk. Fundamentally, I would say that structural problems are still there despite the new legislation. It is discouraging but I cannot be optimistic in this area.

Question 5:

My question is about the Republican constituency. It seems to me that after the last presidential election the Republican constituency changed substantially. I do not think that the Tea Party group has any influence that it once had before. I would like you to explain a little about what the current Republican constituency is and what the important elements are in the Republican constituency.

Professor Jay Rosengard

I would like you to understand a little about US politics especially the difference between the primary elections and the final elections. What happens in the primaries or the first round where each party is trying to decide who will be in the runoff, we have a very low voter turnout. The only people who really vote are those who feel very strong about the issues. You tend to get the extremists both for the Republicans and the Democrats. The person who wins the primary elections often does not represent the core constituency but the fringe.

So, in the case of the Republicans, the person who gets the nomination might be a Tea Party person but not really representing the most Republicans. In the case of the Democrats, you might get a Democrat who is much more liberal than the most

Democrats. In fact, there are not many differences between the middle constituencies of both parties. Actually, one of the biggest voting blocks is what we call independents. For example, in Massachusetts the independents constitute a big group. They can sometimes vote the Republican and sometimes the Democrat because there is a lot of overlap. A lot of the political commentary exaggerates the differences between blue states (the Democrats) and red states (the Republicans).

If you look at Massachusetts it is overwhelmingly democratic on the registration and the legislature. But, Republican governors were elected several times including Mitt Romney. They were fiscally conservative, but a little more liberal than the average Republicans. It is a combination of fiscal conservatives and social liberals that are independent. Sometimes the Republican appeals to them and sometimes the Democrat appeals.

What happens in the Congress is that you often get some of the extreme members who do not represent general constituencies, and when they elect their caucuses, you often get extremists take control. In fact, over time the party leadership has gotten a little more polarized in the Congress. Again, they are not representing so much the majority of the Congress or the majority of Americans.

You also have to remember that if the presidential election is hotly contested like the last one we have a very good voter turnout. In the last presidential election it might have been about 60%. In the midterm elections, it is much lower. It is a complicated answer, but I would like you to understand the dynamics of the primaries and the dynamics of leadership selection where the parties often tend to get more of the extreme wings and then they get polarized.

Obama said that he could negotiate with anybody. That was his approach for the first 4 years, and he did not get very far. He was really hurt on the midterm elections during his first term. This time he has become much more aggressive. I would agree with your conclusion that many of the Tea Party candidates have been rejected because people saw them against the national interest when they held the government for ransom over the matters like the debt ceiling. When the budget is not approved, it hurts everybody. Obama has come out this time much more aggressively. On the tax issues, he was much tougher and came away with most. We say that in the standoff the Republican blinked. On the debt ceiling issue again, he was much tougher this time and he said that he would not negotiate. Again, the Republicans blinked because they do not have the support that they had 2 years ago. I think that the fact that Obama won by a

considerable margin in the election seems to have made him more aggressive and have made the Republicans and the Congress more careful.

You also see that the Congress is talking about the issues like the immigration reform. The Republicans lost almost all the Hispanic votes which are the largest growing constituency in the US. If the party is going to survive, they have to be able to get Hispanic votes. All of a sudden, the immigration reform has now become comprehensive but not piecemeal, which has been forwarded by bipartisan groups of both Republicans and Democrats.

I think that a lot of the dynamics you are talking about actually correct. Tea Party is weakened, which is the extreme wing of the Republicans. It strengthens the Obama's moderates. Republicans in general are weakened because of Obama's victory. When you are a second term president, you are in very strong position at least for the first year or two. Then, you become weaker and weaker as people start looking at the next round and you become more the lame duck. Obama has this window of probably for a year or for a year and a half where he can be aggressive on issues like gun control and immigration. In much of negotiations he will be very aggressive together with his team that he is currently forming. I would say that the Tea Party influence is definitely down, which changes the dynamics of the Republican Party. This is due largely to the results of the last election. I think it gives us more hope for some compromise on issues that make us worried.

Question 6:

I would like to ask you how the shale gas extraction in the US will affect the US economy.

Professor Jay Rosengard

The shale gas extraction and the shale fracking technology will have a big impact on the US. First of all, if the US becomes a net energy exporter it will change our foreign policy with the Middle East dramatically because it has been driven by oil. If you become less dependent on certain suppliers in unstable areas your diplomacy and foreign policy will change completely.

The second issue in the US is the tradeoff between using this resource and harming the environment. There are many unanswered questions about the potential long-term environmental effects of the technology in terms of polluting groundwater supplies in the areas. I think that it looks a sort of gold rush right now, but I believe that the

companies have not been properly supervised or regulated. I think that we may discover over time a long-term environmental damage due to weak or ineffective regulation of the sector that is greatly promising for the economy.

Lastly, but not the least, how it affects energy pricing in the US? The idea was to promote alternative sustainable energy that is more environmentally friendly and to promote conservation. I think that energy consumption depends largely on having energy being expensive. I hope that despite having plentiful cheap energy it does not change the strategy of increasing the price of energy for consumption so that you get alternative sustainable supplies in the long run. I am a little concerned that we might delay and undercut many of the very innovative research on alternative energy.

Question 7:

You are talking about the long-term fiscal health of a nation. For that purpose we must include various factors, and one of the important factors is demographic trend of a nation. As the baby boomers are now entering into retirement it will put big pressure on the mandatory spending in your budget especially for pension and healthcare. You also need to take a note that your per capita expenditure is twice as much as that of other industrialized countries. This is not only the issue of the US, but is common for the US, Europe, Japan and all the high income countries. How do you see the impact of this demographic transition on the long-term perspective of the fiscal health of the nation?

Professor Jay Rosengard

Thank you for your good point. I have prepared slide number 12 to explain this issue. In this slide, I want to say that cutting expenditure in mandatory spending is important. The fastest growing part of our budget by far is healthcare (Medicare and Medicaid). Unless we control that, it will be very difficult to manage the budget. This is one of the great aspects of Obamacare that tries to control costs as well as improve quality. So the issue concerns both costs and quality.

As you mentioned the US spends a lot in healthcare more than other high-income countries, but the results are not very good. If you look at the general statistics concerning life expectancy and general health, the US is worse than many poor countries. It is actually very bad if you look at the incidence or the quality. In the US, the special problem is that we do not get good value for our money in healthcare. We have created a lot of reverse incentive to increase costs. So, as a part of Obamacare, there is a board that is supposed to look at creative ways of changing incentives which reimburse doctors maybe based on results of treatments. Right now we often have

deeper service. We have a lot of tests that might not be necessary. We also have litigation, and in this practice we affect ourselves. There are all sorts of what I would call reverse incentives in the US healthcare system. We should create things so that we can get more value for the money. We have to contain costs and also to have better results. We need a healthier population and lower cost.

As far as quality of medical care is concerned Japan is in a good contrast. But, as you rightly pointed out, if you look at the issue of aging population Japan is facing sooner and more dramatic population change than the US. People who were born right after the WWII will reach a retirement age and live longer. In this area I am actually hoping that the United States can learn from Japan.

The US has the immigration and our fertility rate remains higher. It is still higher than replacement and affects the demographic change. In the country like Japan where the population is actually shrinking, the aging is more of a crisis. I have optimism in creativity and innovation of Japan. I hope that somehow through technology there will be some way to make healthcare more cost effective.

Another country facing the same problem is China. The issue in China is that more people get old before they get rich. Their population with the one child policy is actually aging very quickly. You also see the same issue in European countries, e.g. Spain where the population is shrinking. Comparing to Japan, the matter goes a little slower in the US because of the immigration, but it still has the same issue.

In some ways we have more challenges than Japan on the value for money in healthcare and fewer challenges in the short run on the demographics than Japan. But, I think that it is a great issue and it is the center. As I said the two centers of the problem in the US spending are healthcare and defense. In the healthcare side I think that we have a lot of similarities between Japan and the US. This is really challenging.