CARD 1

Defence spending in eastern Europe
Scars, scares and scarcity

East Europeans whinge (хныкать, выть) about security, but few want to pay for it

May 12th 2011 | from the print edition

ONCE they lobbied hard to join NATO. After Russia's war with Georgia, they begged for coherent plans to defend them. But now the alliance's eastern members are finding it hard to keep defence spending anywhere near 2% of GDP, the official NATO target they agreed to meet. Poland does best: Barack Obama will announce the stationing of a squadron of F-16s there when he visits Warsaw on May 27th. But others are at 1% or even less, or are unrepentantly heading in that direction (see chart).

Iveta Radicova, Slovakia's prime minister, says bluntly that defence is "not a priority". She wants to improve her country's competitiveness and reduce unemployment. Two-thirds of the population, she notes, live on less than €500 ($720) a month. If defence is cut further, Slovak troops will have to pull out of one of their overseas missions: Afghanistan, Cyprus, Kosovo or Bosnia.

Atlanticist sentiment is ebbing on both sides of the ocean. Once-eager support for American-led wars has faded, shown by the easterners' reluctance to play a role in Libya. Defence spending seems a waste of money on costly foreign-made kit. Many in Washington are cross: their defence planners face hard choices, too. Why spend money protecting ungrateful, stay-at-home skinflints?

Yet the easterners are not only NATO's weakest members, but also its most exposed. It should be in their interest to keep the alliance shipshape. Even scaremongers agree Russia is no immediate threat. Its military reforms are proceeding slowly, at best. Yet its defence spending this year will be around $63 billion, three times as much as that of the new NATO members combined. And even as their spending is falling, Russia's is rising, to 3.2% in 2013.

In exercises in 2009 the Russians practised the invasion and occupation of the Baltic states. That worried military advisers in the Pentagon, who plan big exercises next year in response. Estonia, the smallest of the three, is the only one that comes close to the 2% target: "a model alliance member," comments an American official. The line on low-spending Latvia and Lithuania is icy silence.

The weakest point is air policing. If budgets keep shrinking, few new members will be able to defend their airspace properly (Slovakia will have to junk plans to replace its ageing MiG-29s). The Baltic trio have no warplanes, relying instead on a rota of NATO visitors. That ends in 2014. And why should outsiders bother to protect countries that won't take their own defence seriously?

from the print edition | The Economist

CARD 2

Hunting the rich

The wealthy will have to pay more tax. But there are good and bad ways to make them do so

Sep 24th 2011 | from the print edition|The Economist

THE horns have sounded and the hounds are baying. Across the developed world the hunt for more taxes from the wealthy is on. Recent austerity budgets in France and Italy slapped 3% surcharges on those with incomes above €500,000 ($680,000) and €300,000 respectively. Britain's Tories are under attack for even considering getting rid of Labour's "temporary" 50% top rate of income tax on earnings of over £150,000 ($235,000). Now Barack Obama has produced a new deficit-reduction plan that aims its tax increases squarely at the rich, including a "Buffett rule" to ensure that no household making more than $1m a year pays a lower average tax rate than "middle-class" families do (Warren Buffett has pointed out that, despite being a billionaire, he pays a lower average tax rate than his secretary). Tapping the rich to close the deficit is "not class warfare", argues Mr Obama. "It's math."

Actually, it's not simply math (or indeed maths). The question of whether to tax the wealthy more depends on political judgments about the right size of the state and the appropriate role for redistribution. The maths says deficits could technically be tamed by spending cuts alone—as Mr Obama's Republican opponents advocate. Class warfare may be a loaded term, but it captures a fundamental debate in Western societies: who should suffer for righting public finances?

In general, this newspaper's instincts lie with small government and against ever higher taxation to pay for an unsustainable welfare state. We reject the notion, implicit in much of today's debate, that higher tax rates on the wealthy are justified because of the finance industry's role in the crunch: retribution is a poor rationale for taxation. Nor is the current pattern of contribution to the public purse obviously "unfair": the richest 1% of Americans pay more than a quarter of all federal taxes (and fully 40% of income taxes), while taking less than 20% of pre-tax income. And knee-jerk rich-bashing, like Labour's tax hike, seldom makes for good policy. High marginal tax rates discourage entrepreneurship, and no matter how much Mr Obama mentions "millionaires and billionaires", higher taxes on them alone cannot close America's deficit.

So the debate is poisonously skewed. But there are three good reasons why the wealthy should pay more tax—though not, by and large, in the ways that the rich world's governments currently propose.

First, the West's deficits should not be closed by spending cuts alone. Public spending should certainly take the brunt: there is plenty of scope to slim inefficient Leviathan, and studies of past deficit-cutting programmes suggest they work best when cuts predominate. Britain's four-to-one ratio is about right. But, as that ratio implies, experience also argues that higher taxes should be part of the mix. In America the tax take is historically low after years of rate reductions. There, and elsewhere, tax rises need to bear some of the burden.

Second, there is a political argument for raising this new revenue from the rich. Spending cuts fall disproportionately on the less well-off; and, even before the crunch, median incomes were stagnating. Meanwhile, globalisation has been rewarding winners ever more generously. Voters' support for ongoing austerity depends on a disproportionate share of any new revenue coming from the wealthy.

But how? So far most governments have focused on raising marginal income-tax rates, something most rich people respond to quickly (see article). Capitalists shift their income into less-taxed forms, such as capital gains; they move; they work less; they take fewer entrepreneurial risks. Even if it is hard to be sure how big these effects are, the size of the very top level seems to matter, so Britain's 50% rate is more dangerous than Mr Obama's proposal to raise America's top federal income-tax rate from 35% to 39.6%. Somebody earning $1m pays more tax in London than any other financial capital—madness for a place with so many mobile rich people. The excuse that it was worse in the 1970s hardly inspires confidence.

Simpler, bolder, better

Given the rich world's need for faster growth, governments should be wary of sharp tax increases—especially since they are unnecessary. Indeed, the third argument for raising more money from the rich is that it can be done not by increasing marginal tax rates, but by making the tax code more efficient. The scope for doing so is most obvious in America, which relies far more than other countries on income taxes and has a mass of deductions on everything from interest payments on mortgages to employer-provided health care, so taxes are levied on a very narrow base. Getting rid of the deductions would simplify the code and raise as much as $1 trillion a year. Since the main beneficiaries of the deductions are the wealthy, richer folk would pay most of that. And since marginal rates would be untouched (or reduced), such a reform would do less to discourage them from creating wealth.

In Europe, where tax systems are more efficient, one option would be to shift more of the burden from income to property, which would collect more from the rich but have less impact on their willingness to take risks. The "mansion tax" proposed by Britain's Liberal Democrats would thus do less damage than the 50% rate. And on both sides of the Atlantic there is room to narrow the gap between tax rates on salaries and bonuses and those on dividends and capital gains. That gap explains why Mr Buffett, most of whose income comes from capital gains and dividends, has a lower average tax rate than his secretary. It is also the one hedge funders and private-equity people have exploited to keep the billions they rake in.

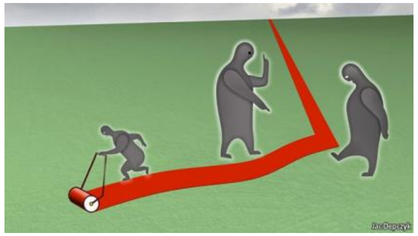
There is a basic bargain to be had. Imagine a tax system which made the top rates on wages and capital more equal, and which eliminated virtually all deductions. To avoid taxing investments twice, such a system would get rid of corporate taxes. It would also allow for a much lower top rate of income tax. The result? A larger overall tax take from the rich, without hurting the dynamism of the economy. Now that would be worth blowing your horn about.

CARD 3

Clause and effect

The business cycle matters when assessing the cost of new regulations

Oct 29th 2011 | from the print edition



AMERICAN policymakers are pulling every lever they can to revive the economy, from fiscal stimulus to quantitative easing. The big exception has been regulatory policy. From environmental protection to bank oversight, the rule book has steadily thickened in recent years. Republican critics of Barack Obama think this explains America's economic malaise. Scrap the rules, they claim, and the economy will spring to life. Nonsense, responds the Treasury. In a recent article, Jan Eberly, an assistant secretary for economic policy, scrutinised the behaviour of corporate-bond yields, corporate profits and other indicators. She found no evidence that regulatory uncertainty is holding businesses back from hiring or investment; weak demand is the big culprit.

Yet regulation, if not a prime suspect, could still be an accomplice. Rules raise costs by compelling businesses to do things differently. That is acceptable if the benefits—whether cleaner air or stabler banks—justify the costs. Ever since the administration of Ronald Reagan, presidents have required federal regulators to demonstrate precisely that. There is a growing view, however, that cost-benefit analysis should go further than just considering what a firm pays to comply with a rule or the premium a consumer pays as a result of new regulation. On this view, it should also incorporate the harm suffered by workers who lose their jobs.

Regulators in America do routinely estimate the impact of new rules on jobs, but such estimates do not enter the ledger when they calculate a rule's costs. This is not as odd as it sounds. In theory regulation rearranges the distribution of economic output, away from the newly regulated activity towards less regulated ones, but does not affect its overall volume. The calculations assume that, on average, workers who lose their jobs because of a new rule find other work at roughly the same pay.

In some circumstances, regulation can require more jobs. A 2002 study by Resources for the Future, a think-tank, found that mandated environmental spending by four heavily polluting industries—pulp and paper mills, plastics manufacturers, petroleum refiners, and iron and steel mills—resulted in slightly higher employment because displaced spending often went to more labour-intensive services than the activity curtailed by the rules.

But a study by Michael Greenstone of the Massachusetts Institute of Technology came to a more sobering conclusion. In the early 1970s the Clean Air Act divided the country into "attainment" counties that met federal standards for certain airborne pollutants and "non-attainment" counties in which polluters faced tougher regulatory oversight. After controlling for several factors, Mr Greenstone found that between 1972 and 1987 polluting industries in counties that were subject to heavier regulation lost 590,000 more jobs than the other counties.

The question of what becomes of such workers is the critical one. If they quickly find similar work in other counties or industries, then in aggregate the economy is no worse off. In reality job change is seldom so frictionless. A worker's pay is often tied to things like his specific knowledge and experience. Being forced to change occupations, employers or location destroys some of that human capital and thus lifetime earnings potential. A recent paper by Steven Davis of the University of Chicago and Till von Wachter of Columbia University estimates that being laid off costs a typical male worker 11% of his future earnings, in present-value dollars. During a recession, when longer spells of unemployment lead to more loss of human capital, that rises to 19%.

Would incorporating those effects into cost-benefit analysis change the equation for many new rules? Jonathan Masur and Eric Posner, both law professors at the University of Chicago, think so. In a recent paper they examine an Environmental Protection Agency (EPA) rule that limits pollution emissions from pulp and paper plants. The EPA estimated that the rule's benefits exceeded its costs by $27m. It also reckoned 900 workers, about 1% of the sector's total, would be displaced. After incorporating their lost lifetime earnings, the authors conclude the rule's costs surpassed its benefits by $63m.

Regulators do occasionally cite employment impacts as one of the reasons they sometimes turn down a rule. Mr Obama implicitly did so in September when he ordered the EPA not to proceed with a lower ozone-emissions standard. In the words of Cass Sunstein, Mr Obama's regulatory tsar, the rule came at an "economically challenging time". But Messrs Masur and Posner say that making decisions on the ground of employment without properly incorporating this into cost-benefit analysis results in "ad hoc and incoherent" rule-making. Abuses can run in both directions: good rules may be killed because of politically unpalatable job losses.

CARD 4

Taxation

by Joseph J. Minarik

http://www.econlib.org/library/Enc/Taxation.html

In recent years, taxation has been one of the most prominent and controversial topics in economic policy. Taxation has been a principal issue in every presidential election since 1980—with a large tax cut as a winning issue in 1980, a pledge of "Read my lips: no new taxes" in the 1988 campaign, and a statement that "It's your money" providing an enduring image of the 2000 campaign. Taxation was also the subject of major, and largely inconsistent, policy changes. It remains a source of ongoing debate.

Objectives

Economists specializing in public finance have long enumerated four objectives of tax policy: simplicity, **EFFICIENCY**, fairness, and revenue sufficiency. While these objectives are widely accepted, they often conflict, and different economists have different views of the appropriate balance among them.

Simplicity means that compliance by the taxpayer and enforcement by the revenue authorities should be as easy as possible. Further, the ultimate tax liability should be certain. A tax whose amount is easily manipulated through decisions in the private marketplace (by investing in "tax shelters," for example) can cause tremendous complexity for taxpayers, who attempt to reduce what they owe, and for revenue authorities, who attempt to maintain government receipts.

Efficiency means that taxation interferes as little as possible in the choices people make in the private marketplace. The tax law should not induce a businessman to invest in real estate instead of research and development—or vice versa. Further, tax policy should, as little as possible, discourage work or **INVESTMENT**, as opposed to leisure or consumption. Issues of efficiency arise from the fact that taxes always affect behavior. Taxing an activity (such as earning a living) is similar to a price increase. With the tax in place, people will typically buy less of a good—or partake in less of an activity—than they would in the absence of the tax.

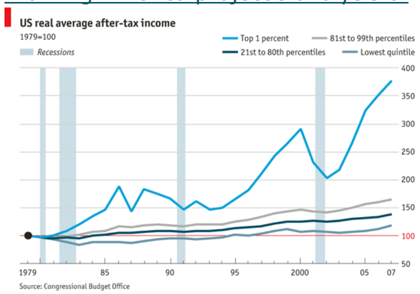
The most efficient tax system possible is one that few low-income people would want. That superefficient tax is a head tax, by which all individuals are taxed the same amount, regardless of income or any other individual characteristics. A head tax would not reduce the incentive to work, save, or invest. The problem with such a tax, however, is that it would take the same amount from a high-income person as from a low-income person. It could even take the entire income of low-income people. And even a head tax would distort people's choices somewhat, by giving them an incentive to have fewer children, to live and work in the underground economy, or even to emigrate.

CARD 5

Wages, income, and time for gardening

Oct 27th 2011, 16:34 by M.S. |The economist

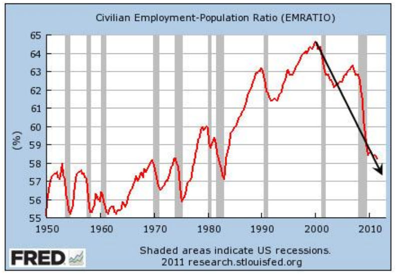
THE Congressional Budget Office has come out with its long-awaited study of rising inequality (see the CBO Blog for a summary), and it confirms what pretty much every such study says: the top 1% of households has made out like bandits over the past 30 years, the top quintile did reasonably well for themselves, and everybody else falls somewhere between "okay" and "treading water".
All this we know. The chart pretty much matches what the Center on Budget and Policy Priorities told us in 2010. But here's the part I hadn't really thought about: the line showing the change in household income for the middle three quintiles actually looks surprisingly steep, showing over 40% growth. After all, median wage growth in that period was pretty anaemic. According to the State of Working America project's analysis of



BLS figures, median compensation rose well under 20% from 1973 to 2009. Looking at hourly wages, at the 20th percentile they rose just 5%, while even at the 80th percentile they

only rose about 25%.

Clearly hourly wage growth was insufficient to account for the growth in income for most households, modest as such growth was in the lower quintiles. So what does account for that growth in income? Presumably, to poach a chart Kevin Drum used in a slightly different context yesterday, it was this:



From 1973 to 2007, the percentage of Americans who are employed rose to heights never before seen. This was largely a function of the mass entry of women into the labour force. Moreover, the average annual hours worked per employee also rose in that period. Household incomes rose, despite weak wage growth, because more people in the household were working and they were working longer hours. But that employment-to-population ratio has now plummeted back to the same levels it was at in the early 1970s. The result is massive unemployment and dead-in-the-water GDP growth.

Mr Drum posted this chart in the context of asking whether technological productivity increases might be destroying jobs that will never reappear. But one question we might want to ask is whether those ultra-high ratios of employment to population over the past 30 years were sustainable. Perhaps the period from 1973-2007 was an anomaly, and the ratio of workers to non-workers is regressing to a more realistic mean. And another question we might want to ask is *whether it's even a good thing* for that ratio to be so high.

Full disclosure: I am writing this under the influence of two rather trying days as a parent in a two-earner household. But it seems to me that in the decades since we started assuming that every adult was going to work a 40-hour week, a whole lot of things haven't been getting done as well. I mean, look at this living room—it's a mess! And who's supposed to drive our nation's daughters to piano lessons in the middle of the afternoon? What if that person has quarterly results to report on, or the results of a multi-year longitudinal study to write up for a peer-reviewed journal? Hypothetically speaking.

What was I saying? Right: it's neither desirable nor possible to push women back out of the workforce, particularly since apparently men are poorly suited to the modern economy. But maybe we should view the current reduction in the employment-to-population ratio as an opportunity to reintroduce some reasonable limits to the weekly work/leisure hours ratio, and get those back somewhere closer to what they looked like in the early 70s. And "leisure", of course, includes a lot of things that aren't really relaxation, but more like the important social activities that can't easily be outsourced to the cash economy, like attending parent-teacher conferences, planning holiday dinners, or raking those leaves in the backyard, which at the moment looks like it was hit by a hurricane. I'm pretty sure my dad would've had those raked by now, back in 1975.

CARD 6

Means testing is a marginal tax increase

Jul 25th 2011, 16:13 by M.S. |The Economist

There is, however, a difference, as Mr Krugman points out, and it's political, not economic. Basically, means-testing cracks apart political support for the programme. It slices away at support among the moderately wealthy, who are the most politically influential class in the country. As Mr Krugman puts it, means testing would create "class warfare—not between the rich and poor, but between the filthy rich and the merely affluent": where a rise in top marginal tax rates costs progressively more as you go up the scale, means-testing medicare costs millionaires just as much as billionaires. Billionaires won't notice the extra expense. Millionaires will, and they'll drop their support for the programme. One can rest assured that the people who launched the push to means-test Medicare while fanatically opposing a hike in marginal tax rates for rich people are entirely aware of these political effects.

If you think it's ridiculous for middle-class people's payroll taxes to be paying for David Koch's health care, a simple, elegant solution is available: lift the cap on the payroll tax. More generally, if you think the wealthy should be paying more for their share of public benefits, tax them more heavily. One might argue that average people's taxes shouldn't be paying for the highways Mr Koch drives on either, and again, the clear answer would be to raise his taxes, not force rich people to create or buy into some alternative private road system.

CARD 7

Welfare works

Nov 5th 2011, 14:45 by W.W. | IOWA CITY

I COMPLAINED about the Census Bureau's faulty methods for measuring poverty in September, so I'm very glad to report that something is being done about it. Revised numbers that take into account previously excluded forms of assistance, such as food stamps and tax credits, as well as regional variation in the cost of living, show that the number of Americans living in poverty has increased less than half as much as the September report indicated. Writing in the *New York Times*, Jason DeParle, Robert Gebeloff, and Sabrina Tavernise report:

One alternate census data set quietly published last week said the number of poor people has grown by 4.6 million since 2006, not by 9.7 million as the bureau reported in September. At least 39 states showed no statistically significant poverty growth despite surging unemployment, according to an analysis by The New York Times, including Michigan, New York, New Jersey, Ohio, Tennessee and Texas.

That's good news! It's better to measure things like this correctly rather than incorrectly, but sometimes stalwart supporters of generous anti-poverty programmes defend flawed measures that overstate the number of Americans living in poverty. My sense is that it is better to get as accurate a picture as possible, so that it is possible to show just how effective anti-poverty programmes really are. Who wants to throw more money at programmes that don't keep anyone out of poverty?

The *Times* nicely illustrates how the standard measures fail to reflect the success of the safety net in rescuing Americans from the cruel indignities of real poverty:

In Charlotte, Angelique Melton was among the beneficiaries. A divorced mother of two, Ms. Melton, 42, had worked her way up to a $39,000 a year position at a construction management firm. But as building halted in 2009, Ms. Melton lost her job.

Struggling to pay the rent and keep the family adequately fed, she took the only job she could find: a part-time position at Wal-Mart that paid less than half her former salary. With an annual income of about $7,500 — well below the poverty line of $17,400 for a family of three — Ms. Melton was officially poor.

Unofficially she was not.

After trying to stretch her shrunken income, Ms. Melton signed up for $3,600 a year in food stamps and received $1,800 in nutritional supplements from the Women, Infants and Children program. And her small salary qualified her for large tax credits, which arrive in the form of an annual check — in her case for about $4,000.

Along with housing aid, those subsidies gave her an annual income of nearly $18,800 — no one's idea of rich, but by the new count not poor.

"They help you, my God," Ms. Melton said. "I would not have made it otherwise."

Welfare works! In addition to showing that anti-poverty initiatives actually keep people out of poverty, improved measures give us a more accurate picture of the distribution of poverty and near-poverty, providing policymakers intent on intelligently shoring up the safety net a sound basis for doing so.

But what about all those poor people with Xboxes?!

While most scholars have called the fuller measure a step forward, Robert Rector, an analyst at the Heritage Foundation, argues that both census counts — old and new — sharply overstate the amount of deprivation in the United States. In a recent study, he cited government data showing many poor families had game systems like Xbox.

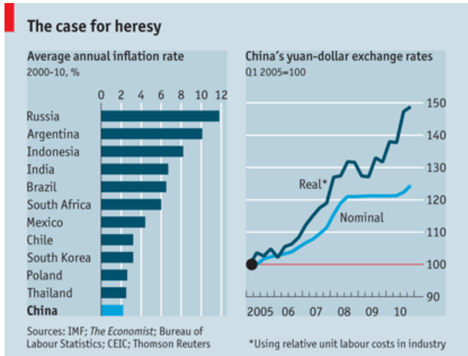
There is very little public support for programmes that would indefinitely provide assistance to households perfectly capable of economic self-sufficiency and full of modern conveniences. For my part, I favour fairly strict limits on the eligibility period for unemployment benefits, and fairly stiff job-seeking requirements for able-bodied, working-age recipients of public assistance. And I think this is the prevailing opinion. But recessions happen. Millions lose their jobs and can't easily find new ones. A lot of these people, like Ms Melton, really do need help, and they ought to get it. *Who cares* if the likes of Ms Melton bought her kids an Xbox a couple Christmases ago, before she lost her job? That doesn't mean she can now afford to feed her kids. It's hard to see what that has to do with anything.

CARD 8

China, an appreciation

Oct 16th 2011, 19:54 by R.A. | WASHINGTON

WITH a China currency bill making its way through Congress, the debate over whether America ought to get tough with China is firing up yet again. The case for an aggressive American approach continues to look very weak to me. Some writers are taking on the idea that Chinese inflation is having much of an effect on its export competitiveness—that is, contributing to a real adjustment much larger than what's observed in the nominal exchange rate. Kash Mansori makes an argument to that effect in this post, which has gotten a lot of attention. He compares CPI data in America and China and figures that Chinese prices have risen just 6.7% more than American prices since 2005—less of a contribution to adjustment, in other words, than one might have assumed.



That estimate seems unrealistically low to me. Looking at IMF figures on consumer prices and GDP deflators, the differential in inflation between 2005 and 2011 has been about 7 percentage points according to the former and 20 percentage points by the latter. *The Economist* put together an analysis of the real yuan-dollar rate and found that real appreciation has been significantly greater than nominal appreciation. From 2009 to early 2011, the analysis found, the yuan appreciated by just 4% in nominal terms, but by 17% in real terms, after accounting for inflation. The differential in wage growth has been more dramatic still. A Bureau of Labour Statistics report from earlier this year found that between 2002 and 2008, American manufacturing wages rose by just 20% while Chinese manufacturing wages doubled.

Meanwhile, other writers seem not to appreciate the trade-off that's actually on the table. Noah Smith seems to imply that critics of a "get tough" approach mainly think there would be no benefit to a yuan appreciation. I readily agree that there would be some benefit to both China and America of an appreciation in the yuan. It's difficult to demonstrate that there would be *substantial* benefit, however. Mr Smith cites economist Menzie Chinn in support of the point that a yuan appreciation would benefit both parties. Fair enough, but Mr Chinn has also written that a dearer yuan might not lead to a big increase in Chinese imports and might not have much of an effect in the absence of a broader Asian appreciation. He also cites Eswar Prasad's argument that a yuan appreciation would likely have little impact on American employment. There is a benefit there, but it's not at all sure to be a large one.

Meanwhile, the yuan is appreciating, by a meaningful amount in nominal terms and by even more in real terms. And there is some set of potentially serious risks to getting tough with China, including the possibility of a major trade dispute between the world's two largest economies at a time of significant global uncertainty and broadly declining industrial output.

So the question is what the expected value of a get-tough approach is likely to be. How much faster an appreciation is American pressure likely to induce? It's hard to see how China would tolerate *much* more appreciation. So we have a small increase in the rate of change of a policy with relatively small benefits, and against that we have the risk of a major trade dispute between the world's two biggest economies at the worst possible time.

The issue is not that there's no gain from appreciation. It's that an aggressive American approach seems unlikely to generate appreciation over and above the current rate at an acceptable cost. The onus is on supporters of a get-tough approach to show that the trade-off is worth the trouble, and so far they've done nothing of the sort.

CARD 9

In at last?

After 18 years Russia is on the verge of joining the World Trade Organisation

Nov 5th 2011 | MOSCOW | from the print edition

THERE was disbelief this week when Arkady Dvorkovich, adviser to President Dmitry Medvedev, told journalists that Russia was close to joining the World Trade Organisation (WTO). Russia has been “close” for ages, but the timing has always slipped. Yet after 18 years of talks, it seems that membership now beckons.

Both America and the European Union have long agreed, as have all the other 153 WTO members bar Georgia, a small former Soviet republic which fought a brief war with Russia in August 2008 and is still partly occupied. Georgia had insisted, quite reasonably, on placing international observers to monitor the movement of goods at its sovereign border, which includes the territories of Abkhazia and South Ossetia.

Russia, which has recognised the independence of Abkhazia and South Ossetia, said this compromised their status. Swiss mediators have found a deal that does not mention their status, refers to the border as a corridor and provides for monitoring not by a government agency but by a private foreign company accountable to the Swiss government. Now Georgia has said “yes”, clearing the way for Russia’s entry.

After a few days, Russia also accepted the deal. There is no doubt that Mr Medvedev would like to go down in history not just as somebody who tinkered with Russian time zones but as the man who took his country into the WTO. The final decision still lies with Vladimir Putin, Russia’s prime minister and likely future president, though he is unlikely to block it now.

As *Vedomosti*, Russia’s business daily, points out, Mr Putin has always been the real obstacle to Russia’s entry into the WTO. In 2009, when talks between Russia and America were going full steam, Mr Putin unexpectedly thwarted them by saying that Russia would join only with Belarus and Kazakhstan, with which it has a customs union. Mr Putin, initially eager for Russia to be in the big international clubs, has come to see some WTO demands as a politically motivated nuisance.

The benefits of WTO membership are debatable. Some estimate that Russia could gain at least $50 billion a year. Others argue that Russia would do better to stimulate exports before joining. As it is, two-thirds of exports are oil and gas, not covered by WTO rules. Apart from extractive industries and metal, few Russian goods are competitive. A World Bank report notes that Russian exporters have trouble not just entering foreign markets but surviving in them.

The real problem, however, is not trade barriers to Russia’s goods, but the country’s own inefficiency, institutionalised corruption and stifled competition. None of these problems can be solved by WTO membership. But Sergei Guriev, head of the New Economic School in Moscow, says that it would at least expose corruption and increase competition, deeply alien to Russia’s ruling bureaucracy. Indeed, the main benefit of WTO membership may be political. “It will be a sign that Russia is moving towards the civilised world,” says Mr Guriev, “not away from it.”

CARD 10

China to the rescue?

Oct 29th 2011, 12:34 by A.P. | LONDON

IT WAS only a matter of time before China was heralded as Europe's escape route from its debt crisis. News that Nicolas Sarkozy, the French president, called Hu Jintao, his opposite number in China, after the crisis summit on October 27th sparked speculation that China might put substantial amounts of money into the debt of troubled euro-zone borrowers. The chatter grew louder when Klaus Regling, the head of the European Financial Stability Facility (EFSF), the euro area's bail-out fund, visited Beijing a day later. And a poor post-summit Italian bond auction has made the need for a *deus ex machina* seem even greater. China certainly has lots of money to invest. its foreign-exchange reserves are reckoned at $3.2 trillion. It trades more with the EU than any other partner. It has exposure to the euro already. How much is not known, but currency analysts suspect that about a quarter of those reserves are already euro-denominated, giving it an incentive to keep the currency strong. It also suits China to play the part of a constructive economic actor.

Then again, we have been here many times before during the euro-zone saga. You can trace the growing seriousness of the crisis by the list of countries that have had talks with the Chinese about investments: first Greece, then Portugal, Spain and now countries at the very core of the euro zone. The pattern to date has always been the same: lots of encouraging rhetoric, perhaps even a little cash, but not enough to meet initial expectations.

There is at least something different on offer now. In the past, investment in euro-zone debt has meant taking on as much risk, and sometimes more risk, than the Europeans themselves have been willing to absorb. No one could ever explain why the Chinese would want to do that. Now China will be able to choose to invest in euro-zone debt that is ensured by the EFSF, or to buy senior tranches of the special-purpose vehicles (SPVs) that the EFSF will capitalise. China would explicitly be taking less risk than the Europeans.

That helps, but probably not enough to deliver a different outcome. The Europeans are taking more risk but that does not mean that they are offering lots of protection to other buyers. And it will take time for these structures to be set up: China will want lots more detail, and to see how the Greek bond swap with private creditors goes, before it commits cash.

Grand political bargains between China and Europe—money in return for more representation at the IMF, or market-economy status—seem wildly improbable. These prizes will eventually come anyway; and weak though parts of Europe are, the EU cannot be seen to trade them too nakedly. Bargaining of this sort would also require both parties to change their positions markedly. China is keen not to be seen as a source of "dumb money", but requiring big political concessions in return for cash is a pretty clear signal that this is not a commercially attractive investment. As for the euro zone, it can hardly claim that senior Spanish and Italian debt is now safe for institutional investors if it has to horse-trade too hard to get China on board.

That does not mean that Mr Regling's trip, which now takes him to Japan, is wasted. It is plausible that China will put some money into euro-zone debt alongside other non-European countries. How that money could be used depends a bit on whether it is channelled by the IMF or some other means. One option might be for other governments jointly to invest in a thick junior tranche of an SPV so that private investors would have an even greater cushion protecting them from any losses. A financial vehicle that saw the euro zone take most risk through equity, other governments a bit more through subordinated debt and private-sector investors the least through senior debt is still a long shot. But it is more realistic than expecting China to splash enough cash to save the euro.

A recovery, if you can keep it

Oct 12th 2011, 16:18 by R.A. | WASHINGTON

IT'S a fraught matter saying anything positive about the American economy, given the objective situation. GDP growth seems to be stuck below trend, and recent employment growth has been too slow to bring down the unemployment rate. For much of August and September, shocks threatened to knock the economy from a spluttering stall into an outright nosedive. No one thinks this economy is good. And yet, it's difficult to avoid noticing a hint of positive movement in the data.

For the last couple of weeks, a few key datapoints have surprised to the upside, including industrial production, consumer sentiment, and employment growth. Markets have staged a surprising turnaround. American equities are up over 10% since October 4th. Government bond yields are rising from record lows, indicating a bit more appetite for risk and greater expectations for growth.

One should be cautious in assigning too much weight to a fortnight's trend. But a positive spin on these figures might suggest that the American economy is shaking off recent hits to the growth outlook. The July debt-ceiling fight obviously shattered American confidence and was compounded by panic in Europe. It wasn't clear whether the Fed would react to the drop in expectations with new support. But Washington's games have become ever so slightly less nasty, Europe is once again actively kicking the can rather than allowing it to roll off a cliff, and the Fed did return to action in August and September. The American economy avoided a drop back into recession; indeed, private-sector job growth held up remarkably well during the summer swoon. Having survived the latest round of threats, a few salutary trends have been able to reassert themselves. Balance sheets are slowly being rebuilt. Petrol prices remain below their spring levels. And housing markets are showing increasing signs of tightening up. Inventories are falling, rents are rising, and construction employment is once again contributing positively to payroll reports.

These are not the makings of a V-shaped recovery, but the difference between 1% and 3% growth is qualitatively substantial. It implies a much better picture for labour markets, a much better picture for credit markets, and a much healthier fiscal picture. The latter is significant; a recovery in state and local tax revenues could help ease the continuing drag of government layoffs on the hiring picture. Despite a really brutal economic year, the American economic engine is still running, just waiting to be given a little gas.

Alas, there's a good chance it won't be given the opportunity to rev back up. American politicians could pour sand in the gears with another budget showdown or the failure to extend the payroll tax break and unemployment benefits. The Fed might get spooked by the contribution of rising rents to inflation, despite the absence of wage growth, and once again pull back before a real recovery is assured. And Europe remains a massive ticking timebomb. To me, that's the most dispiriting thing about good news in the American economy: the sense that it's all about to be blown up by a European collapse of one sort or another. And there's very little that Americans can do about it.

CARD 12

Work with me here

Oct 31st 2011, 20:46 by R.A. | WASHINGTON

AS A follow-up to this morning's post on Italy and the European Central Bank, I'd like to make a point about the use of communication by central banks. The Federal Reserve has been engaged in monetary easing for several years now, a process which has involved huge purchases of various kinds of assets. As I've noted before, the Fed's theory of these purchases seems to be primarily mechanical in nature—a certain number of purchases is expected to have such-and-such effect on interest rates, which will in turn influence spending and investment, thereby boosting the economy. Perhaps disappointed in the results and facing criticism, the Fed now appears to be experimenting with greater use of communications as a policy tool, that is, telling the market what the policy is designed to achieve.
The thought is that by directly setting expectations it can get more bang for its buck. Its a sensible strategy; when the Fed announces a purchase plan of $600 billion, markets can assume that it's unhappy with the present state of the economy, but they're left with a great deal of uncertainty concerning the path of future policy. If the economy is a smidge better at the end of the programme but still crummy, will the Fed act again? Who knows! The Fed, presumably, but it's not telling, or hasn't been so far. By connecting policy choices to specific macro variables, by contrast, markets can have a clear sense of the circumstances under which easing is likely to continue. Were the Fed to target nominal output, for instance, markets would be given to understand that easing would continue until the target was attained. Provided the target is credible, that would encourage markets to behave as though it will be attained, and that, in turn, leads to the attainment of the target. If markets are working with the central bank in this way, goals can be attained far more cheaply than through brute force purchases.

Why should markets work with a central bank? Well, if the goals that's being set is one that can be attained through money creation, then the central bank has an unlimited store of ammunition. You don't want to fight someone with an unlimited store of ammunition if they seem determined to do something. The credible promise to do a specific thing should allow a central bank to exert far less energy than the attempt to achieve that thing on the sly, through direct action.

Which brings us back to Europe. This morning I noted that the ECB is not behaving like a traditional central bank and acting as a reliable buyer of sovereign debt of last resort, in large part because that's not written into the ECB's DNA. The ECB *is*, however, buying sovereign debt. Whenever yields begin to rise in dangerous fashion, the ECB plunges in to markets to buy debt and hold them down. The ECB doesn't like doing this. But here's the thing: were the ECB to go whole hog and stand behind member-country debt, there would be no reason for markets to demand a liquidity premium for beleaguered economies. You wouldn't demand a panic premium for holding Italian debt out of concern that in a pinch no one would want to buy it from you; you'd *know* that the ECB would be there. And so that panic premium would disappear. The ECB would have to spend enough money to demonstrate the seriousness of its intention, but that amount would almost certainly be a pittance relative to the sums it may well shell out in coming months in an attempt to prevent a meltdown.

Now, the Fed and the ECB may both have their reasons, political and economic, for behaving as they have. All the same, it's worth noting that their reluctance to state publicly their intentions is likely to result in much more money being put on the line than would otherwise be the case.

CARD 13

Another day, another summit

Oct 21st 2011, 7:14 by Buttonwood

IF ONLY economic productivity were measured in summits, all Europe's problems would be solved. Earlier in the month, we were promised that a "final" deal would be reached on Sunday, October 23; now it seems that the October 23 meeting will just discuss options for the "final final" summit on Wednesday.
There are generally agreed to be three vital components of any deal. Greek debt must be written down; banks must be recapitalised; and the European Financial Stability Facility must be beefed up so that it has the firepower to stand behind Italy and Spain.

There are doubts on all three fronts. The writedown on Greek debt needs to be increased from 21% to perhaps 50% or 60%. But how to do that while involving private sector creditors and still keeping the "voluntary" nature of the deal? If the deal becomes "non-voluntary", the risk is that creditors of other euro zone countries will take fright.

Any writedown risks damaging the banks. So that's why they need capital. But will the deal raise enough capital to be convincing? And how will that capital be raised? From the private sector? Talking to an ex-banker friend of mine yesterday, he reminded me that many of his former colleagues had a lot of their wealth tied up in bank shares; raising more capital from the markets will dilute their stakes. They are fighting hard against the idea and, in any case, investors will not be keen. Raising the money from governments may be politically unpopular and is difficult when countries are trying to rein in spending. So banks would rather improve their capital ratios by shrinking their balance sheets. But that could reduce the credit supply to businesses and thus damage economic growth.

And then there is the EFSF. Many people think that the fund's size needs to be increased from €440 billion to €1 trillion or €2 trillion. But how to do it? The ECB could lend the EFSF the money but the bank regards this, not just as money creation, but as monetising the fiscal deficit. Trichet was dead against it; will Draghi change tack? If not the ECB, then what about governments? The previous limit has only just been passed by Parliaments; opening up the deal again risks rejection. And if the cost of the guarantee is added to the debt of other governments, will that damage their credit rating, particularly France's AAA status? The third option is some kind of insurance scheme but the details sound tricky. How would the premiums be set and the losses shared?

Given all this, it is not surprising that agreement has not been reached yet. What happens if they fail? The forecasts are apocalyptic with talk of another Great Depression (does it ever strike you that economists tend to be so certain in their predictions, even though their track record is so poor?).

Let's go back to first principles and accept that we have accumulated more claims on wealth (in the form of debt) than can currently be serviced. So four things can happen; we can grow real incomes to service the debt, inflate nominal incomes, default on the debts or stagnate, like Japan. The growth option would be the best but Europe's demography is so bad, it's hard to imagine this happening. (That's why Europe's debt problem is worse than that of the US.) Of course, it is possible to improve the growth record through reforms, but it will be a slow process. The inflation option seems, at the moment, to be opposed by the ECB so we don't need to discuss the drawbacks here. Japan has chugged along, but the markets have left it alone; not the case with Greece, Italy and Spain.

So we have moved to some element of default (for Greece, at least). Since much of Europe's debt is owned by Europeans, this just means doling out the pain. And politicians much prefer to hand out goodies to their voters. That is why they find it so hard to reach agreement, and why we have so many summits.

CARD 14

Don't forget the Chinese consumer

Oct 14th 2011, 18:51 by S.J. | LONDON

IN CHINESE karaoke bars, the drink of choice is a good Scotch Whisky mixed with iced tea. Don't accuse the Chinese of being weak; they prefer a 50/50 mix between the two. This might horrify Scots, but after two hours of "dice" (a Chinese drinking game) you appreciate the tea.

Chinese consumers are carefully following the currency politics in Washington this week. If the yuan is forced to rise, the Scotch gets cheaper. The ongoing debate surrounding the yuan’s appreciation focuses on the implicit subsidy of an undervalued yuan to Chinese manufacturing and exports, the resulting impact on jobs in China and America, the perceived influence of Chinese trade on the hollowing out of the American middle class. The effects on Chinese consumer are rarely considered.

For the Chinese consumer, a weak yuan increases the cost of imports. This decreases consumption of imports and protects domestic firms from international competition. Michael Pettis, of the Carnegie Endowment for International Peace, argues that the weak yuan is in fact just one of three implicit taxes on consumers in China. Mr Pettis believes there is a growing divergence between productivity growth and wage growth in China. In the time that it has taken for the productivity of the average Chinese worker to triple, wages have only doubled. As a result, firms are taking an ever larger share of the benefits of rising productivity. Firm often reinvest this return into their businesses, but there are doubts about the value of many such investments given the bubbly nature of some parts of the Chinese economy.

By maintaining very low interest rates on deposits, Beijing is able to provide cheap capital to firms, mostly state-owned enterprises, leading to higher growth. But the low interest rates come at the expense of returns to Chinese household investors. This is big deal in China, where households have one of the highest savings rates in the world; consumption as a share of GDP in 2009 was 35.1%, a remarkably low level. By providing an artificially low return on savings Beijing decreases consumption.

Subsiding and protecting Chinese firms increases their production. Decreasing the purchasing power of Chinese consumers decreases domestic consumption. The difference is phenomenal exports, which helps explains why the world is awash in Chinese goods. It is increasingly clear, however, that these policies aren't sustainable, either economically or in terms of international politics. Continued yuan appreciation, due either to American pressure or Beijing's self-interest, should ultimately facilitate a welcome rise in Chinese consumption.

CARD 15

Inflation versus relative price shifts

Oct 18th 2011, 21:28 by R.A. | WASHINGTON

BRITISH inflation remains above the Bank of England's target, generating uncomfortable headlines for those within the central bank advocating for greater monetary support for the weakening British economy. Annual inflation rose to 5.2% in September, powered forward by big jumps in housing costs and the price of clothing. Buttonwood comments on the report, writing:

I heard one economist on the radio say this morning that this was not real inflation at all. Many people like to focus on the data excluding food and energy. But if you look through the numbers, you will find that the second biggest contributor to the month-on-month rise was clothing, which was up 4.4% on the month. Meanwhile rents (which aren't measured directly in this data) are up 4.5% on the year. So this argument becomes a little like the Monty Python sketch about the Romans "Apart from the aqueducts, law and order etc, what have the Romans done for us?" Apart from housing, heating, clothing and food (all the basic necessities of life), prices aren't rising.*

What economists mean by real inflation is, of course, a wage-price spiral and that is not happening. However, that is of small comfort to normal people who have to pay a lot more for basic necessities but whose wages aren't rising to compensate. They may not regard this as a policy triumph. The Pensions Corporation notes that the elderly spend a lot more on basics than the rest of us; for them the effective inflation rate may be almost 8%.

I think it's worth thinking about what these price figures actually imply. Prices for some goods, especially housing and clothing but also things like furniture, restaurants, and hotels, are rising. That implies that demand for those goods is outstripping supply. As Buttonwood notes, wages are not following suit. And he is correct to point out that when prices rise and wages do not, that translates into a decline in real purchasing power or the real wages earned by workers. One might worry that this decline could undermine economic growth; perhaps it could, but if it did, we'd expect to see demand fall across the economy leading to a drop in upward price pressures. To the extent that price increases aren't subsiding, there's no reason to worry that falling real wages are undermining demand. Of course, the Bank of England is concerned that other factors, like austerity and a weakening European outlook, may hit demand, thereby leading to rising unemployment and falling prices in the absence of monetary intervention. Hence, the decision to move forward with QE2 despite a rate of inflation above target.

Now, if you're an employer in Britain you observe that you can sell a number of goods at ever rising prices. Further, you may note that the labour needed to produce those goods isn't getting more expensive. As such, the relative price shift we're observing in Britain is making British labour more affordable, which should in turn encourage British firms to hire more of it. That's an awfully convenient state of affairs, given that the government has begun sacking hundreds of thousands of public employees. If the Bank of England were not making it more attractive to hire British workers, one suspects that many more British workers would go unhired, leading to a much larger rise in the unemployment rate than has so far been observed.

Another way of looking at the situation is this: the Bank of England is facilitating a shift in relative prices necessary to maintain something like full employment. Were the Bank to rein in its monetary easing in order to constrain growth in the prices of some goods, that relative price shift could only be achieved through a decline in nominal wages. That would also make a lot of Britons very unhappy, and to the extent that wages are sticky, it would lead to a corresponding rise in unemployment.

By pumping money into the economy, the Bank of England has prevented an appreciation in sterling relative to its major trading partners; given euro-area panic, the pound would likely have shot up absent aggressive easing. That, in turn, facilitates an adjustment in the economy toward external demand, which also provides a cushion against public-sector contraction. The Bank of England is doing exactly what it ought to be doing, namely, sparing the economy the need to adjust through a painful drop in nominal wages, achieved through economic contraction and a gut-wrenching rise in unemployment, and which would in all likelihood undermine the government's fiscal-consolidation efforts.

Now, the distributional impacts of this policy aren't always pretty, but when are they? The distributional impacts of adjustment around the European periphery are far uglier by comparison. And if the British electorate isn't happy with the effect of an appropriate monetary policy on certain subgroups of the population, then it ought to complain to the government, which has the power to redistribute resources through taxation and the provision of public services. But it's unrealistic to think that tight Bank of England policy would make choices easier. One has only to look across the Channel to see that. At some point, the British economy may hit its capacity to produce more goods. We would then observe that more easing would have no real effect on output, and the wages of employed workers would rise with prices in an accelerating spiral. When that occurs, however high the unemployment rate, the central bank is unable to help. It falls to the government to enact the reforms necessary to bring unemployment down further.

CARD 16

Inflation expectations rise

Sep 16th 2011, 14:32 by Buttonwood

THE latest Michigan consumer sentiment survey shows a small rebound but also a rise in inflation expectations*. As Reuters reports

The survey's one-year inflation expectation rose to 3.7 percent from 3.5 percent, while the survey's five-to-10-year inflation outlook was at 3.0 percent from 2.9 percent.

Meanwhile in Britain, inflation expectations have risen to a three-year high, with those polled expecting 4.2% over the next year and 3.5% over the next five. Those figures are well above the Bank of England's target. The Fed, of course, doesn't have a formal target but is believed to want a core inflation rate of 2%. (The core rate has been below the headline rate for a while. But presumably one should expect the headline rate and the core rate to shadow each other over time, or why are you worried about the core rate?)

Perhaps this doesn't matter. If we want consumers to start spending; the expectation of future price rises should push them to spend now rather than later. But it will be interesting to see how the combination of higher-than-target inflation, plus rising inflation expectations, affects the balance betwen the hawks and the doves on the respective policy-setting committees.

*This contradicts the Cleveland Fed survey cited by Free Exchange which I hadn't heard of before. That is not based on a survey but, according to the website

The Cleveland Fed's estimate of inflation expectations is based on a model that combines information from a number of sources to address the shortcomings of other, commonly used measures, such as the "break-even" rate derived from Treasury inflation protected securities (TIPS) or survey-based estimates.

Not sure why this divergence should occur. It may be that there are better ways of measuring expectations that just by "asking people" but a lot of survey data are collected using the asking approach, so one would have to throw quite a lot of signals out of the window.

CARD 17

It's hard out there for a central banker

Feb 22nd 2010, 20:26 by A.S. | NEW YORK

THE job of a central banker seems fairly straightforward. Most have a dual mandate: price stability and tolerable, steady unemployment levels. Yet each of these objectives, at least in the short term, can be at odds with each other. According to the Philips curve, higher than *anticipated* inflation lowers the level of unemployment. So if you are a central banker who wants lower unemployment you must make markets expect one inflation level and then pursue a higher one. The problem is once you do that a couple times you destroy your credibility. Markets expect higher inflation than your announcement, you lose that element of surprise, and you're stuck with ineffective monetary policy, high inflation, and unemployment. Also this trick does not change the natural rate of unemployment, so after a while unemployment goes up again anyway. This and several other good reasons explain why inflation targeting became so popular in the last decade. It became accepted as the imperfect, but best, policy for central bankers because it entails setting and matching expectations.

Now, in the wake of the financial crisis, inflation targeting has fallen out of fashion. I am not ready to write it off, but I do wonder if we should redefine the scope of monetary policy. Up until recently it did seem successful; the Great Moderation appeared to prove that monetary policy could quell the business cycle. Keeping rates and inflation low contributed to decades of stability. I often wonder if central bankers became victims of their own success. Investors and individuals, complacent about risk because they forgot how painful a bad recession can be, took on too much debt. Our special report on risk last week mentions what has become known as the "Greenspan put", where investors counted on low interest rates from the Fed when markets tightened. Though often rates were lowered in an attempt to maintain price and output stability.

The recent IMF staff position paper, which my colleague previously discussed, wonders if inflation targets should be higher. That's a very hard question to answer. It could be that the inflation target should change over time, perhaps varying with the business cycle. But the even bigger and harder questions involve refining a central banker's tools and objectives. Many suggestions made by Olivier Blanchard, the Fund's chief economist, make good sense, such as explicitly considering asset prices in addition to consumer prices and taking on a more regulatory role. This will involve monetary policy relying on tools other than the interest rate, like adjusting regulatory capital ratios.

Central bankers might also be more mindful of the infuriatingly fuzzy concept of long-term stability. In retrospect, would it have been better policy to let recessions be a little more painful? Perhaps if they were, there would've been less risk taking. As it is, we may have to tolerate more frequent volatility in the future. That might sound reasonable now but in several years, when the American economy has recovered and experiences another recession, it may not be. Will people accept less aggressive monetary policy, and higher unemployment, because of the notion that doing so avoids something much worse 20 years from now?

Populists criticise the Fed for caring more about Wall Street than unemployment. But such thoughts are ignorant of the fact that the Fed requires a healthy financial sector to be effective. Maybe Ben Bernanke is a closet populist and his semi-regular assurances of low inflation are really a front to set expectations. Maybe he really plans to surprise markets with higher inflation. But I highly doubt it. The man built his career proving the virtues of transparency and inflation targeting.

The tension between what makes for good long-term and short-term policy highlights why central-bank independence (free from here-and-now populism) is so important. Alas, the case of central-bank independence is often best made by economists. An inherent conflict because it ensures an economist will always occupy some of the most powerful positions in the world.