Mitchell's Musings

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Mitchell's Musings 7-4-16: Downgrading the Graders

Daniel J.B. Mitchell

The decision of British voters on June 23rd to select the "Brexit" option was, shall we say, not carefully thought out, as noted in prior musings on this blog. It was followed –as I indicated in last week's musing - by silly statements by various continental politicians in the EU that, given the vote, Britain should exit quickly. Now the foolishness has spread to the rating agencies:

> *The UK has lost its top AAA credit rating from ratings agency S&P following the country's Brexit vote. S&P said that the referendum result could lead to "a deterioration of the UK's economic performance, including its large financial services sector." Rival agency Fitch lowered its rating from AA+ to AA, forecasting an "abrupt slowdown" in growth in the short-term.*
>
> *S&P had been the only major agency to maintain a* (sic) *AAA rating for the UK. It has now cut its rating by two notches to AA. On Friday, Moody's cut the UK's credit rating outlook to negative. A rating downgrade can affect how much it costs governments to borrow money in the international financial markets. In theory, a high credit rating means a lower interest rate (and vice versa). S&P said that the leave result would "weaken the predictability, stability, and effectiveness of policymaking in the UK."*[1]

Readers may recall similar downgrades regarding American federal securities when there were U.S. crises over lifting the debt ceiling by Congress.[2] Then as now, there is a problem with such downgrades when it comes to countries such as the U.S. and U.K. What people look to rating agencies to provide is an assessment of the risk of default. What is the chance that the IOU, whatever it is, won't be paid off according to its terms? When it comes to private-sector entities or public-sector entities below the national government level, such judgments are made based largely on financials. You look at such things as the size of the debts outstanding relative to cash on hand or to other available resources. You look at the tax base. You look at budgets. You look at overall liabilities.

But if a country borrows in its own currency – as the U.S. and the U.K. do – its national government can potentially create whatever money it needs to meet any obligation. So its ratio of cash on hand to debt is effectively infinite. Of course, there is a political risk that for one reason or another, the country will default anyway. If the central bank is constrained by some legal arrangement, then the needed money creation might not occur unless there is legislative action to undo the constraints. So political inertia or gridlock could conceivably lead to default – not because the country *can't* pay it obligations – but because it *won't*. However, not paying in such situations has nothing directly to do with "a deterioration of… economic performance" as it might for subnational political entities (whose tax receipts might be reduced) or for a private-sector firm (whose sales and profits might be harmed). Money creation by the national government to meet debt obligations does not depend on tax receipts or economic performance.

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[1] http://www.bbc.com/news/business-36644934

[2] https://www.washingtonpost.com/business/economy/sandp-considering-first-downgrade-of-us-credit-rating/2011/08/05/gIQAqKeIxI_story.html and http://www.wsj.com/articles/SB10001424053111903366504576490841235575386

It might be noted in this regard that the kind of gridlock seen in the U.S. when you have divided government is unlikely to occur in the U.K. with its parliamentary system. In the U.K., you can't have a situation in which the Parliament is in the hands of one party and the prime minister belongs to another. So even if there were some grounds for the U.S. downgrade, the case for a U.K. downgrade is even less.

Really, the agencies shouldn't even be rating the sovereign debt of countries that borrow in their own currencies. At the subnational and private level, you can analyze such "financials" as the cash-to-debt ratio, and perhaps make judgments that "add value" for investors. But when the cash-to-debt ratios are potentially infinite, all you are doing is basing ratings in what is in the headlines. Obviously, when a British prime minister steps down and it is uncertain who will succeed him, you might say that event would "*weaken the predictability, stability, and effectiveness of policymaking in the UK*." But the headlines – that there was a Brexit vote, that there is uncertainty in both British political parties concerning leadership, that EU politicians are mouthing off – are available to anyone. S&P and the other agencies are no better than anyone else in making such nonfinancial assessments based on such headlines. And the link to default on sovereign debt of those headlines is questionable.

Indeed, we have a nice empirical test available in this case. If investors thought that the probability that Britain would default had risen, as the rating agencies are telling us, then British Treasury bonds should have fallen in price after the Brexit vote and so bond yields should have risen. But what actually happened? The British Treasury publishes an index of long-term Treasury bond yields as shown below for the month of June:[3]

06/01/16	2.36%
06/02/16	2.32
06/03/16	2.24
06/06/16	2.27
06/07/16	2.25
06/08/16	2.23
06/09/16	2.20
06/10/16	2.16
06/13/16	2.15
06/14/16	2.15
06/15/16	2.14
06/16/16	2.10
06/17/16	2.14
06/20/16	2.18
06/21/16	2.22
06/22/16	2.21
06/23/16	2.27
-- Post-Brexit vote --	
06/24/16	2.12
06/27/16	1.99
06/28/16	1.98
06/29/16	2.01

[3]https://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/TextView.aspx?data=longtermrate (as of June 30).

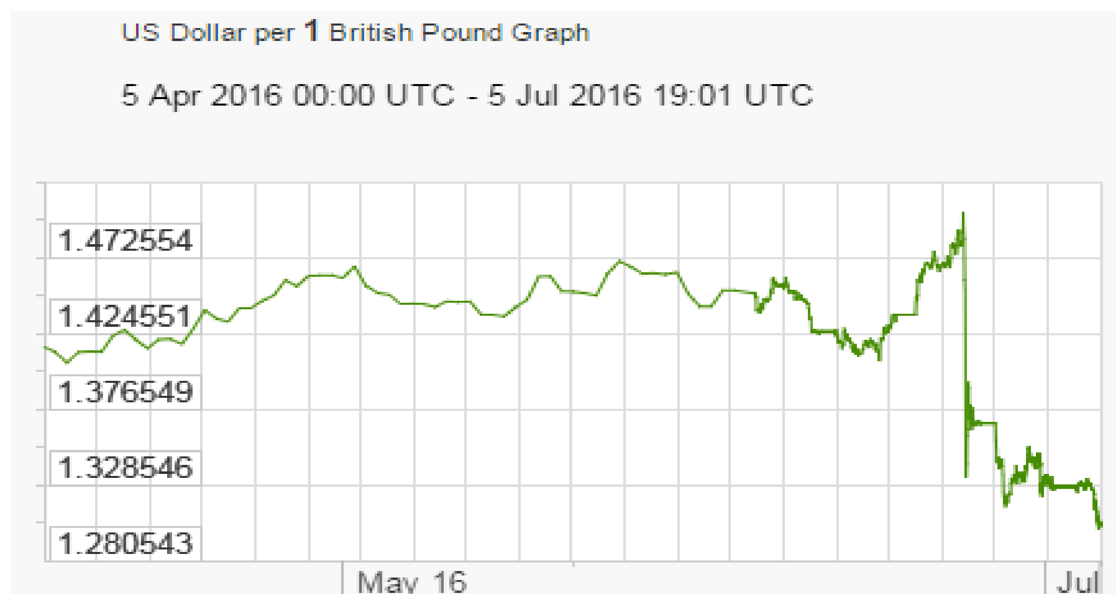
Yields *fell* (bond prices *rose*) after the Brexit vote. The ratings downgrades were thus seen by the market as irrelevant if not flat wrong. Put another way, the market implicitly downgraded the opinions of the rating agencies. And rightly so. When the rating agencies were caught giving high ratings to flaky mortgage securities as the 2008 financial crisis unfolded, it was said that their erroneous ratings were the product of greed. They were telling their paymasters what they wanted to hear. But this time, the only plausible explanation is that they were caught by the wider contagion of foolishness surrounding the entire Brexit affair.

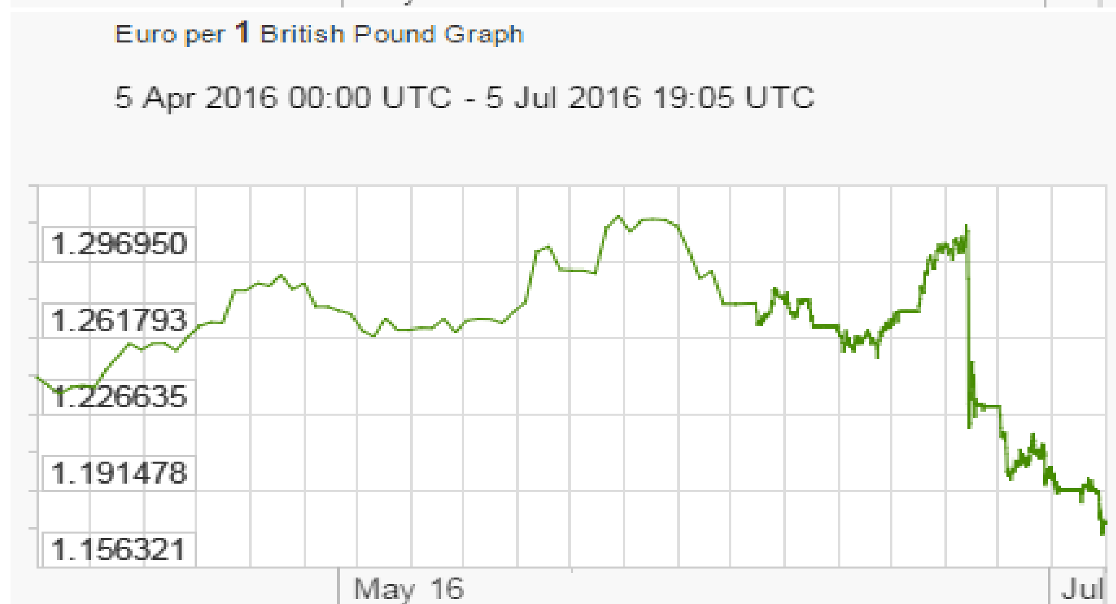
Mitchell's Musings 7-11-16: Brexit keeps on giving

Daniel J.B. Mitchell

The Brexit event keeps on giving, at least to this blog, since I have been writing about it in the past few weeks. But let's put aside the political ramifications of Brexit, which are big in Britain and – some think – within the larger EU. Let's put aside analysis of why a (slim) majority of British voters favored Brexit. And let's put aside the question of whether, in the long run, Britain would be better off inside or outside the EU. Apart from those important issues, there are lessons about exchange rates embedded in the aftermath of Brexit.

Let's start with the observation, as the three charts below illustrate, that immediately after the Brexit shock, the pound fell in value relative to the US dollar, the euro, and the yen, all of them major world currencies.





In effect, there was an immediate shock to financial markets at the time of the election. You can argue about the market reaction. Was it "justified" in depreciating the pound as much as it did? Was it an overreaction? Whatever it was, it led to a flight from the pound towards other currencies once the result of the election was known. So the pound fell in value in response.

Now consider two scenarios. First, suppose the British had attempted to hold the exchange rate to the level that it was before the shock. The British authorities would have had to buy up the unwanted pounds – as investors shed them – using Britain's foreign currency reserves to do it. Since they could not create US dollars, euros, or yen, they would have had to run down their reserves and possibly work out deals with foreign central banks to borrow needed currency. Those central banks might have demanded sharp increases in British interest rates to attract demand back to the pound. Even if they didn't, Britain might have raised interest rates to make the pound more attractive and reduce the shift away from the pound.

Such interest rate hikes might have caused a recession or slowed the economy. Recessions or slowdowns, by cutting imports, do tend to add to net demand for a currency. But they are painful. In short, under this scenario, Britain, given a Brexit-type crisis, would have had the kind of "balance of payments crisis" that was common when the world was on fixed exchange rates until the early 1970s.

Second, suppose the British had in the past become part of the euro-zone and then experienced a negative shock of the Brexit magnitude. For reasons dealt with in prior musings, we say "Brexit magnitude" rather than Brexit because pulling out of the EU for a country that was also part of the euro-zone would mean pulling out of that zone, which really is not feasible.[4]

To stimulate their economy, the British authorities might have wanted to provide a domestic demand boost to offset the shock. But they could not have used monetary policy since – under this hypothetical scenario - they had previously given up their national currency. They might have tried a fiscal stimulus. But that would likely have entailed running a budget deficit. And as any state or local government

[4]Yes, during the Greek crisis, there were many discussions of a "Grexit" involving giving up the euro and creating a new drachma. But no one ever laid out how that could be done.

official within the “US dollar zone” could point out, borrowing in a currency you can’t create leads to budget crises and rising interest rates on government debt.

So the first lesson is that having a floating exchange rate, as Britain does, acts as a kind of macro cushion. The exchange rate absorbs some of the shock. And it also allows more freedom in domestic macroeconomic policy. While Brexit brought out all the clichés about living in a global economy, the presence of a flexible exchange rate in fact acted as a partial insulation against globalism for Britain. If you like, Britain was already less global than those countries within the euro-zone.

There is another lesson. The ultimate in a fixed exchange rate is not having a national currency at all, as characterizes countries within the euro-zone. They have the least latitude in dealing with negative shocks. Countries with separate currencies, but some kind of target exchange rate, have more latitude. They can always, as a last resort, abandon their target. Countries with floating rates have the most flexibility – but represent the least global of the three options: 1) having no national currency, 2) having a separate currency but fixed exchange rate, and 3) having a floating exchange rate.

In its history within the EU and its predecessor agreements, Britain has moved from having a separate currency and a floating rate, to trying to maintain a target exchange rate relative to its partners, then back to having a floating rate in 1992 and after, and now to Brexit.[5] Viewed that way, Brexit was a further step toward autonomy within a British history of trying to balance autonomy and connection, rather than something totally new. There seems to be a need in the news media to see the eve of destruction in the Brexit vote. The latest such overheated prognostication is that the world is about to have a currency war due to Brexit.[6] In reality, there is a long history of Britain varying its economic linkage to continental Europe. So keep calm.

[5]Britain joined the European Economic Community (EEC) in 1973 as the post-World War II regime of fixed exchange rates was collapsing. At around that time, there was an attempt by various member countries – but not the UK - to maintain target exchange rates between them, an effort known as the “snake in the tunnel.” When that failed, other target rate systems were tried. Britain for a time was part of those efforts but pulled out in 1992.
[6]http://www.latimes.com/business/la-fi-brexit-currency-fallout-20160706-snap-story.html.

Mitchell's Musings 7-18-16: Cash on hand

Daniel J.B. Mitchell

At the moment, unemployment is low. We can debate about the state of the economy and whether unemployment or non-employment (or non-participation) is the best indicator of labor market slack. What we can say, however, is that when the Great Recession hit, one of the major casualties was the budgetary condition of state and local governments. And currently, with some exceptions, a calm in the state and local fiscal situation prevails. So it's a good time to look back and see what can be said about how such budgets get into trouble. There will someday be another downturn so now is a good time to learn about their fiscal implications.

Of course, in the simplest terms, the trouble for state and local budgets during recession results from a reduction in tax revenue; as the economy declines, taxes – which are largely based on economic activity – also decline. Budgets are pushed into the "red." But deficit budgets by themselves are not crises. If sufficient reserves are available, temporary deficits can occur without a crisis, at least until the reserves are exhausted.

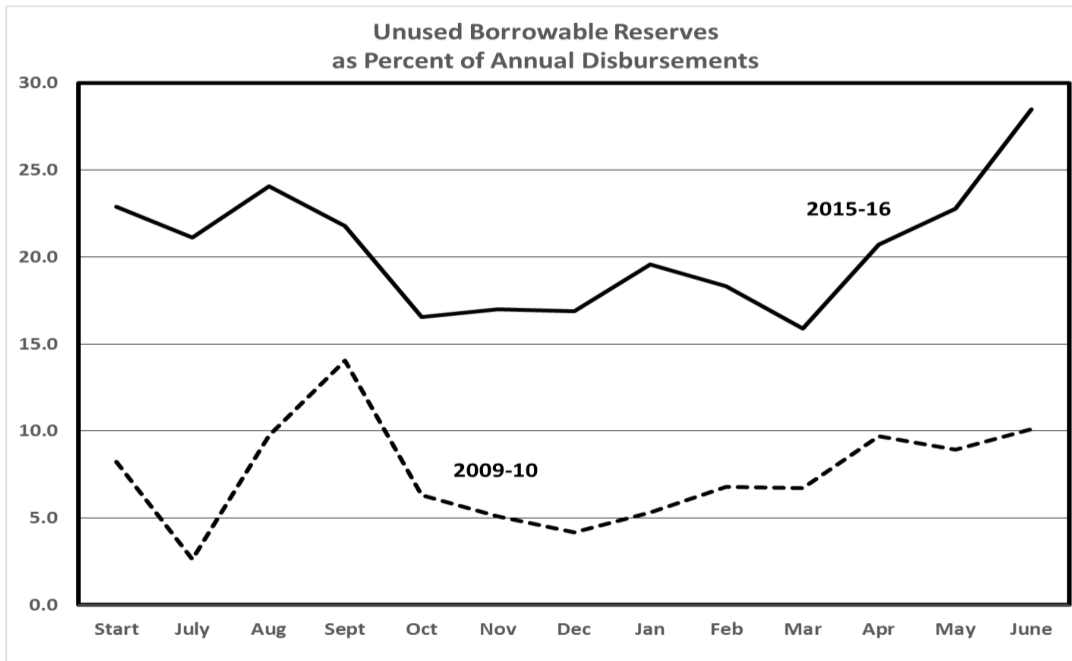
The State of California was particularly hard hit by the Great Recession. It had a disproportionate share of the flaky mortgage bubble and bust. Its revenue base was (and is) heavily tilted toward the personal income tax. And its personal income tax is highly progressive, with a large share of revenue coming from a narrow stratum of high income tax payers whose taxable income reflects capital gains and losses. In the immediate aftermath of the Great Recession, California had one of the highest unemployment rates of any state in the nation.

California state government by the summer of 2009 was unable to pay all its bills and instead began to issue registered warrants (IOUs) to some suppliers and taxpayers owed refunds. Most of the focus in the news media was on the General Fund budget, the operating budget of the state. In principle, the state is supposed to produce a "balanced" General Fund budget by July 1 of each year. But, at the time, budgetary rules in the state's constitution required a two-thirds vote for a budget enactment and the result was lengthy delays beyond July 1.[7]

[7]Partly as a result of the problems caused by budget delays, voters have since amended the constitution to require only a simple majority, and delays no longer occur. We are leaving aside troublesome problems related to budgetary language and accounting methodology.

The General Fund is operated as a kind of household checking account. So it may have a positive working balance which is a kind of reserve just as the balance in your checking account is available to cover checks.[8] But beyond what is in the official reserve is a hidden reserve of cash possessed by the state. That hidden reserve results from the fact that there are "special funds" outside the General Fund, which are typically earmarked with particular revenue sources to be used for designated purposes. The largest of these funds deal with transportation and receive revenue from the gasoline tax and other motor vehicle-related sources. But there are many other special funds created by the legislature, some quite small.

California's constitution forbids borrowing for current operations, but there are two exceptions. Court decisions have allowed short term borrowing *within* a fiscal year on the grounds that such borrowing is really just a technique for handling the seasonal ups and downs of revenue. (Examples: Income taxes are due in April. Sales taxes bump up during Christmas sales.) So the state can issue Revenue Anticipation Notes (RANS) – external borrowing - within a fiscal year to cover short periods while awaiting for taxes to arrive. But it can also engage in internal borrowing, effectively putting IOUs into the special funds and taking the cash there to cover expenses in the General Fund.



[8]California now operates with a separate "rainy day" reserve, separate from the General Fund, so the two reserves must be summed together to evaluate the state of the official budget.

As the chart above shows, California issues monthly reports on a concept known as "unused borrowable reserves."[9] Borrowable reserves are essentially the cash available from special funds from which the state controller is allowed to borrow for General Fund purposes. Unused reserves are those which either haven't been directly borrowed or which are covering short-term external borrowing from financial markets. The chart depicts unused borrowable reserves in 2009-10, the worst of the budget years that followed the Great Recession, and the just completed 2015-16 fiscal year.

In 2009-10 – the crisis year – the ratio of unused borrowable reserves fell twice below 5% of the level of disbursements (spending) for that year. The first time was in July, the month in which IOUs began to be issued. Essentially, despite the ability to dip into special funds to cover General Fund operating expenses, there just wasn't enough cash around to cover all bills which had to be paid. In contrast, in 2015-16 even the biggest dips left the ratio above the peaks of the crisis year.

Using the special funds as an *ersatz* reserve for operating spending has drawbacks, of course. If the special funds are loaded up with internal IOUs rather than cash, their ability to fulfill their earmarked purposes is constrained. Presumably, the legislature viewed carrying out those purposes was necessary or it wouldn't have created those funds. But if you are looking at sources of cash to deal with immediate budget crises, the special funds are part of the picture, even if potentially interfering with their designated purposes is a Bad Thing to do.

It's also important to note that although there was a tendency to view California's issuance of IOUs to external creditors as a kind of bankruptcy, as a technical matter states have no legal ability to declare bankruptcy. And if you think of *de facto* bankruptcy as an inability to cover contracted bond-related debt service, there was little danger of that kind of default occurring, even at the peak of the post-Great Recession crisis. At present, the ratio of General Fund debt service to revenue is around 7% and it wasn't much different in the crisis year of 2009-10. So there is always enough revenue around to cover debt service; you can always divert seven percent of revenue to cover debt service.

Other states will have different revenue bases, different institutions, and different spending priorities and politics. But one suspects in broad terms the stories will be similar. The use of a General Fund for operating expenses and special funds for designated purposes is common to state and local governments. If you are looking at how state and local entities manage their finances during recessions

[9]The monthly reports are available from the state controller: http://www.sco.ca.gov/ard_state_cash.html.

and budget crises, you have to look beyond their general funds to see what sources and cash reserves are available.

Mitchell's Musings 7-25-16: Old Gold: Bad Ideas Never Die

Daniel J.B. Mitchell

If you poke around in the Republican platform that was approved by the Party's national convention last week, you will find the following somewhat obscure statement:

> *Determined to crush the double-digit inflation that was part of the Carter Administration's economic legacy, President Reagan, shortly after his inauguration, established a commission to consider the feasibility of a metallic basis for U.S. currency. The commission advised against such a move. Now, three decades later, as we face the task of cleaning up the wreckage of the current Administration's policies, we propose a similar commission to investigate possible ways to set a fixed value for the dollar.*[10]

What does this section mean and why was it included? As you might expect, there is a long history. First, the phrase about "a metallic basis for U.S. currency" is in fact a reference to the gold standard. (Would anyone think it referred to tin or copper or iron?) But most people are nowadays barely aware of the gold standard as a monetary issue. It lives on in popular culture as an idiom. Look up its idiomatic meaning and you will find examples on the web such as:

> *Ferrari is the gold standard among automobiles*.[11]

The implication of the idiomatic expression is that the gold standard of something is the best of its kind. But would the gold standard be best today *as a monetary system*? In simple terms, the idea of the U.S. going on the gold standard is ridiculous. Setting up a new commission to study the idea of returning to the gold standard would be the gold standard of foolishness.

There is in fact a long history of the contentious development of the U.S. currency and the role of the gold standard in that development. Given all the latest discussion of "American exceptionalism," it's worth noting that the U.S. seems to be unique in its history of there being major political controversy around currency issues. Other countries seem to be content to have the authorities deal with monetary matters. They don't see grand conspiracies surrounding the issue. They don't see central banks as centers of evil.[12] But monetary conspiracy theories have always been part of U.S. politics.

Back in the late 1990s, through some odd circumstances, I became president of a professional academic organization then called the North American Economics and Finance Association. One duty of the organization's president was to write and deliver a presidential address. I decided to write about the gold standard in the American context. Part of the reason was that although (Republican) president Richard Nixon had essentially killed the remains of the gold standard in the early 1970s, segments within

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[10]https://prod-static-ngop-pbl.s3.amazonaws.com/docs/2012GOPPlatform.pdf. [page 4]
[11]http://www.idiomeanings.com/gold-standard/.
[12]Indeed, sometimes not questioning monetary affairs abroad can be a failing. So when experts in the EU proposed a monetary union and a super-national currency, it did not become a political issue. Of course now, the ready acceptance of the euro in place of national currencies within a subset of EU member states is a matter at least some folks in those countries now regret.

the GOP seemed unable to give it up. Such figures from Republican politics of the 1990s as Ron Paul, Jack Kemp, and Steve Forbes favored a return to the gold standard. And as the quote from the 2016 platform suggests, the idea lingers even now.

U.S. history of monetary controversy goes back to the early days of the country as I noted in my presidential address. But a good starting point for this musing is the 1896 presidential election in which the Democrats were taken over by the populist free silver movement in the form of the candidacy of William Jennings Bryan.[13] Bryan won himself the nomination with his famous "Cross of Gold" speech which attacked the gold standard using religious imagery. Republicans ran (and won) in 1896 with William McKinley and his support of the then-existing gold standard.

In my presidential address, I looked at the political situation a century later:

> *The ultimate triumph of William Jennings Bryan's battle against gold could be seen 100 years after the defeat of his first campaign for the presidency. Whereas incumbent Bill Clinton spoke of a "bridge to the 21st century" in the 1996 presidential campaign, candidates such as Steve Forbes and Jack Kemp tried to interest the public in returning to the gold standard. But such a monetary bridge to the 19th century simply did not resonate with the electorate. It just sounded odd. A candidate might as well have campaigned for a return to the bustle and the buggy. By the 2000 campaign, Kemp had dropped out of presidential politics. And Steve Forbes' gold position had been condensed into single sentence in his campaign book, easily lost in a sea of other agenda items.*[14]

In the modern view, the old gold standard was one version of a fixed exchange rate system. If all currencies are pegged to gold, then they are also fixed in relation to one another. But you don't need gold to have fixed exchange rates. For example, before the euro-zone was fully created with its own single currency, it went through a stage in which the various currencies that were to be replaced (marks, francs, lire, etc.) were fixed relative to one another. No gold was involved in the fixing nor was gold needed to create such a system.

The odd platform plank envisions pegging the dollar to gold despite the fact that no other countries have any interest in doing so. So it wouldn't be a fixed exchange rate system. It would instead create a system in which volatile gold price swings relative to currencies other than the dollar would cause the dollar to appreciate and depreciate. The chart below shows fluctuations in euros per ounce of gold over the past ten years. Do you think it would be helpful to the U.S. economy if the dollar moved up and down depending on the vagaries of the volatile and speculative gold market depicted on the chart?

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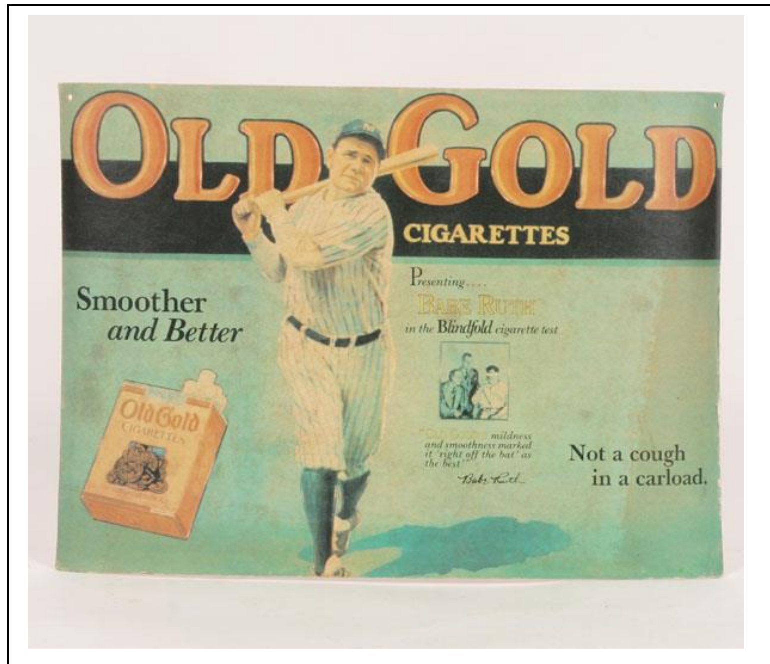
[13]Bryan remained a popular figure and folks liked to hear him give the address many years later. He made a phonograph record with excerpts from the speech which can be heard at: https://www.youtube.com/watch?v=HeTkT5-w5RA.

[14]Daniel J.B. Mitchell. (2000). "Dismantling the cross of gold: economic crises and U.S. monetary policy." *North American Journal of Economics and Finance*, 11 (2000) 77-104. Available at: http://www.anderson.ucla.edu/documents/areas/fac/hrob/mitchell_gold.pdf.

Now there could be value in at least considering a return to fixed exchange rates. But the point is that pegging the dollar to gold when no other currency does so is not fixed exchange rates. It would be flexible rates on steroids. The current flexible exchange rate system obviously has some volatility, maybe too much. For example, over the same ten year period, comparing the dollar's lowest point relative to the euro to its later high is an appreciation of the dollar in the 50% range (euros per dollar). But peak to trough of the gold price (euros per ounce) is about *three fold*.



It's hard to find the once-popular brand of Old Gold cigarettes nowadays, but some folks can't quit the habit, just as others can't quit longing for the gold standard. Bad ideas never die. They apparently don't even fade away.

Mitchell's Musings 8-1-2016: Friedman in Flatland

Daniel J.B. Mitchell

With the presidential election in full swing after the two national conventions, there is no shortage of interpretation by opinion leaders floating through the news media. I was struck by a recent column written by Thomas Friedman of the *New York Times* who is famous for arguing that the world has become "flat." By flat, Friedman was referring to "globalism." Now it may seem odd to characterize a round globe as flat. But I don't write best sellers and he does – so what do I know? Anyway, here is an excerpt from his recent column:

> *Yes, we're having a national election right now. Yes, there are two parties running. But no, they are not the two parties that you think. It's not "Democrats" versus "Republicans." This election is really between "Wall People" and "Web People."*
>
> *The primary focus of Wall People is finding a president who will turn off the fan — the violent winds of change that are now buffeting every family — in their workplace, where machines are threatening white-collar and blue-collar jobs; in their neighborhoods, where so many more immigrants of different religions, races and cultures are moving in; and globally, where super-empowered angry people are now killing innocents with disturbing regularity. They want a wall to stop it all.*
>
> *Wall People's desire to stop change may be unrealistic, but, in fairness, it's not just about race and class. It is also about a yearning for community — about "home" in the deepest sense — a feeling that the things that anchor us in the world and provide meaning are being swept away, and so they are looking for someone to stop that erosion.*
>
> *Wall People have two candidates catering to them: Donald Trump, who boasts that he is "The Man" who can stop the winds with a wall, and Bernie Sanders, who promises to stop the winds by ending our big global trade deals and by taking down "The Man" — the millionaires, billionaires and big banks…*[15]

[15] http://www.nytimes.com/2016/07/27/opinion/web-people-vs-wall-people.html

I don't have to tell you who the web people are. They are, of course, the sophisticated high-tech folks who are sufficiently gifted and wise to understand the world (almost) as well as Friedman. They are smart enough to agree with Friedman. They understand that the wall people are relics. Etc. Etc. Etc.

The idea of a flat world – rather than being somehow a representation of globalism – is really one that is two-dimensional. In fact, before Friedman appropriated the concept of being flat, a flat world might well have brought to mind the 19th century book *Flatland*.[16] In that book's Flatland, the people lived on a plane and could not imagine a third dimension. One character in fact is given the knowledge that there is a third dimension. But, of course, he can't convince anyone that a third dimension exists since it is impossible for two-dimensional creatures to imagine. So perhaps a flat columnist who believes that the electorate is two-dimensional – wall people vs. web people – can be forgiven for his limited view. He can't see beyond a world of dichotomy.

The problem, however, is that the flat view of the election – which is not unique to Friedman – is a major contributor to the Trump and Sanders phenomena which Friedman so dislikes. First, globalism is a term so widely used that it lacks meaning. As we have noted in past musings, there is a difference between trade "protection" as that term is generally used (tariffs, quotas, and other devices designed to limit imports) and changes in exchange rates. When the dollar depreciates relative to other currencies, imports are discouraged (and exports are encouraged). But no one says during times when the dollar falls that the U.S. is becoming protectionist. And no one says when the dollar appreciates that the U.S. is becoming global. Dealing with currency manipulation by trading partners of the U.S. is not normally viewed as "protectionist."

If all you know about trade is "comparative advantage" which you learned in Economics 1A, you are in another Flatland. The model – used to demonstrate the idea in basic textbooks – involves two countries trading (bartering, actually) two products. More two-by-two dichotomies! There is a more nuanced view of trade in Economics 1B that notes that trade can affect income distribution. But that takes you out of Flatland and into a third dimension. And still more nuance arises when you get away from barter into a monetary international economy with the possibility of trade deficits and surpluses.

Moreover the protection (Bad Thing) vs. free trade (Good Thing) is yet another two-dimensional view of the world. Take the word "protection" out of the trade arena and it has no negative connotation. Is

[16]https://archive.org/details/flatlandromanceo00abbouoft

Friedman against insurance (whether social insurance or private insurance)? Isn't the function of insurance to *protect* those covered from future risks?

Even in the trade context, there is an important difference between trade in goods and trade in technology. Technology can be traded and transmitted easily, whether a country is "protectionist" in its trade policy or not. So nothing in "protectionist" trade policy inherently deprives "web" people from using the Internet. In fact, when "protection" is applied to information, it often means devices such as patents, copyrights, and other restrictions designed to *limit* exports, not imports. In the early days of the industrial revolution, Britain sought to ban exports of designs for its valuable new textile machines. But it was hard to prevent folks from memorizing plans for the machinery and then traveling abroad. That's how early textile machinery made its way from England to New England. (The problem of the difficulty of limiting technology transmission continues today with regard to scientific knowledge deemed to have military significance.)

In the end, the two-dimensional portrait espoused by Friedman of those "economic" backers of Trump and Sanders is fuel for their sense that there is an elite establishment that is uninterested in their fates. Depicting folks as relics – wall people - is unhelpful. Indeed, it's hard to know what could be more infuriating than the condescending wall vs. web dichotomy. True, Friedman goes on in his column to say that Hillary Clinton should find some especially compassionate web people to add to her coalition. They presumably would support burial insurance for wall folks, due to their compassion. But in the end, Friedman wants everyone who has not done well in Flatland just to accept his two-dimensional world view and not to consider the possibility of any third way.

Mitchell's Musings 8-8-16: It's no longer 1944 or 1968 or 1971 or 1973

Daniel J.B. Mitchell

I happen to be vacationing as this musing is written at the Mount Washington Hotel in Bretton Woods, New Hampshire. That's right; it's the very place where the 1944 Bretton Woods monetary conference took place, the conference that created the International Monetary Fund (IMF) and the World Bank.[17] The World Bank was established to provide loans for the reconstruction of Europe after World War II and later for development loans to third world countries. Although World War II reconstruction was accomplished long ago, there are still third world countries. So arguably the World Bank still has a well-defined function. But it's harder to make that statement about the IMF.

The function of the IMF, as seen in 1944, was to oversee a new postwar international monetary system – the Bretton Woods system. Note that in 1944, World War II was still in progress in both the European and Pacific theaters. So the system being proposed was something that did not then exist. If there was ever an example of economic planning, the Bretton Woods system was it. Although many countries sent representatives to the Bretton Woods conference, the ultimate plan was largely a matter worked out between Britain (which had been the center of world finance historically) and the U.S. (which was to be the center after the War).

Although the Bretton Woods system was new, it was built on elements of the old order – primarily fixed exchange rates and elements of the old gold standard. But it was infused with the idea that the postwar world should have institutions of international cooperation to avoid World War III. For example, the failed League of Nations was to be replaced by the United Nations. On the other hand, part of the reason that the League had failed was isolationism in the U.S. after World War I. So much was done to make the new institutions palatable to U.S. politics.

It's not an accident that the UN, the IMF, and the World Bank are all located within the borders of the U.S. And it's not an accident that the two financial institutions were to be located in Washington, DC and not New York City. American politics of that era had an anti-banking tilt, so keeping the financial institutions in DC was a statement that they could be watched by the federal government and not be captured by Wall Street. Back in those days, the federal government enjoyed a higher degree of popular trust than today.

[17]https://www.youtube.com/watch?v=GVytOtfPZe8

The two key players in creation of the Bretton Woods plan – John Maynard Keynes for Britain and Harry Dexter White, a U.S. Treasury official – did not see gold as a necessary component of a fixed exchange rate regime. (And it isn't.) But because gold had historically played a major role in the international monetary system, it was continued as a kind of third wheel of the Bretton Woods system. Keynes wanted the IMF to be a *de facto* world central bank with the ability to create money. But American politics would not allow creation of new financial institution with that much authority. So the IMF ended up in 1944 as a world savings and loan, in effect borrowing and lending funds, but not creating money. And there was a cumbersome arrangement of quotas (essentially deposits) assigned for each member country. Apart from their monetary aspect, the quotas were also votes in the new organization and they were originally specified so as to guarantee the U.S. and Britain effective control.

This musing is not the place for a detailed history of the Bretton Woods system in actual practice. But let's just say it never quite worked as planned. The new fixed exchange rates that were set overvalued major currencies relative to the U.S. dollar creating an initial "dollar shortage" after the War. By the late 1950s, exchange rate crises and adjustments led to the opposite condition: a dollar surplus. Much of U.S. economic policy in the 1960s revolved around the American "balance of payments problem."[18] By 1968, the U.S. stopped trying to maintain the market price of gold at the prewar $35/ounce price. By 1971, after a series of currency crises involving the dollar, President Nixon essentially ended the Bretton Woods system.[19] A quickly modified fixed exchange rate arrangement – the Smithsonian system - lasted only until 1973.[20] Thereafter, the U.S. ended the Smithsonian regime and the world moved to flexible exchange rates.

From 1973 onwards, international monetary arrangements were regional affairs, the euro-zone being the prime example. So the Bretton Woods plan the IMF was created to oversee ended in the early 1970s. Yet the IMF continues to exist. If you ever need an example illustrating that institutions are easier to create than terminate, the IMF has to be it.

The years 1971 and 1973 (whichever you prefer as the date of the end of the IMF's function) came and went over four decades ago. The function planned for the IMF at Bretton Woods disappeared less than three decades after the 1944 conference. So one might say that the IMF has been around without a function longer than it existed with a function.

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[18] https://www.youtube.com/watch?v=eSl5IZryxOs
[19] https://www.youtube.com/watch?v=iRzr1QU6K1o
[20] https://www.youtube.com/watch?v=8cNGeScxJNw and https://www.youtube.com/watch?v=g6vzDDo6J1Y

Of course, many folks in international circles would argue with my unkind characterization and would point to the IMF as a forum (like the UN) for discussion and a forum for research and data gathering (also like the UN). But here's the thing. In the current U.S. election campaign, the issue of exchange rate manipulation has come to the fore, both in the (now-failed) Bernie Sanders campaign and the current Donald Trump campaign (we don't know the outcome of that). The prime example of regional international monetary cooperation – the euro-zone – has been beset with problems. And when the IMF has gotten involved with local currency matters, it has become identified with "austerity" policies. Whatever you might say about austerity prescriptions, no one in 1944 had such a role for the IMF in mind.

Given the developments in world monetary affairs since the early 1970s, and given the fact that the IMF seems destined to continue as an organization indefinitely despite its loss of original function, wouldn't a new Bretton Woods-style conference – not necessarily in New Hampshire - be in order? From 1944 until the early 1970s, there were lessons. We learned that rigid fixed exchange rates present major problems of maintenance and are difficult to sustain. And we learned that trying to tie such a system to gold just adds to the inherent problems. From the early 1970s until the present, we learned that flexible exchange rates with no *effective* rules as to how they operate also present major problems. What seems to be called for is an agreement on a flexible system, but with agreed-upon rules and an effective set of regulations and regulator. In particular, the issue of currency manipulation – which is now a feature in U.S. presidential politics - needs to be addressed.

Mitchell's Musings 8-15-16: Not to the Swift

Daniel J.B. Mitchell

> *I returned, and saw under the sun, that the race is not to the swift, nor the battle to the strong, neither yet bread to the wise, nor yet riches to men of understanding, nor yet favour to men of skill; but time and chance happeneth to them all.*
>
> Ecclesiastes 9:11

A profound thought in that quote. It has something to do with accidents of life and uncertainty of outcomes and experiences. When I was a senior in high school – Stuyvesant High School in New York City – I got a job at the Swift Messenger Service – by accident. One of the other boys at the school told me about the job. Stuyvesant at the time was an all-male school requiring an entrance exam to get in and was located in 15th Street west of First Avenue.[21] The Swift Messenger Service was located just west of Fifth Avenue on 47th Street, which is (was) in the heart of the Diamond District.[22]

To get the job, I simply accompanied the guy who told me about the job to the office, spoke to the owner/boss who hired me on the spot and told me to get the necessary New York State working papers, which I did. There was nothing that could be called an "interview." I walked in on my own two feet which qualified me to be a messenger boy – since the job mainly involved walking around midtown Manhattan.

There still are messenger services in Manhattan. But based on a Google search, only a few. (Uber seems to have one.) There were more such enterprises back then (1960) before the invention of the fax machine, email, etc. Many of the clients of the Swift Messenger Service were advertising agencies. The agencies had their own messengers on payroll, but there was a peak period in the late afternoon when apparently a lot of last minute material had to be picked up and delivered. The late afternoon corresponded to the time when high school kids were available since school let out at 3 pm.

In some cases, there appeared to be an ongoing business relationship with particular agencies and there were dedicated phone lines by which they could call Swift. But a lot of the business came from sporadic callers. The sporadic callers had the idea that when they called for a messenger, he would pick up their package and deliver it directly to where they wanted it sent. "It" typically was a manila envelope. If they were in a hurry, they could pay extra for "rush" service.

Actually, the Swift Messenger Service ran like a post office. Messengers were sent out on routes to pick up packages from addresses in particular areas. All of the packages were brought back to the office on 47th Street; they were not directly delivered. When a pile of packages accumulated in the central office, delivery routes to particular areas were made up and boys were sent out again. The only thing that rush service seemed to buy was a label on the package that said "rush."

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[21] http://stuy.enschool.org/apps/pages/index.jsp?uREC_ID=126631&type=d&pREC_ID=251657. The school became coed in 1969 and is now located near the World Trade Center. (It was closed for an extended period after 9-11 during the clean-up.)

[22] https://en.wikipedia.org/wiki/47th_Street_(Manhattan)#Diamond_District.

Messengers would arrive from school around 3:30 pm and sit on a bench in the office. As orders came in, boys would be dispatched on routes. Messengers were paid the minimum wage, then $1 per hour. But the "clock" didn't start when you came in. It started when you were dispatched. So if business was slow, you would be on the bench longer and weren't paid for the waiting time.

Before coming back to the office after completing pick-ups or deliveries, you were required to phone in from a pay phone (there was no shortage of pay phones back then). Calls cost a dime for which you were reimbursed. But you were supposed to make sure you had a dime for the call with you. When you called in, you might be told to go to some new addresses for pick-ups near to where you were that had been requested during your travels.

The office on 47th Street was staffed by the owner/boss plus a couple of other adult workers. Owner/boss sometimes took the day off and went to the races – or somewhere – leaving the others in charge. There were also one or two adult messengers who appeared to be "cognitively impaired" (if that is the correct term nowadays) and seemed to be used for special trips, such as overnight trips to Philadelphia.

OK. You now have a basic outline of the enterprise and its practices. But note that it is a rich source of labor market anecdotes and issues, some of which I used to cite in my labor markets class.

Let's start with hiring. Note that there was no formal posting or advertising of jobs. It was all word of mouth. And incumbent workers just brought in friends when there were vacancies. In more recent years, this type of recruitment via network has been particularly identified with immigrant labor markets. But obviously it has existed for a long time. In my own case, I wasn't particularly looking for an after-school job. The potential workforce is typically divided between 1) the employed, 2) those looking for work but without jobs (the unemployed), and 3) those out of the labor force (and not actively looking for work). Studies indicate that jumps from the third status to the first, i.e., recruitment of people into employment among folks who were not actively seeking a job, are common.

Another point to note is that all the messengers were boys. Was that because the network was linked to an all-boys high school? Or was it that girls in 1960 would not have wanted to be messengers? Or that the Swift Messenger Service just didn't hire females? (None of the adult workers were women.) Interesting questions. There were no laws at the time that would have prevented an employer from discriminating on the basis of sex. If you were to look at help-wanted ads in the newspapers of that era, you would find male and female jobs listed separately.[23]

What about the lack of a real interview? Since the job really required very little that could be called "skill," that lack wasn't surprising. If you could read an address and walk to it, or on rare occasions take a bus or subway to it, you were "qualified." So there was little risk to the employer of a bad hire. If you nonetheless turned out to be a bad hire, you could be fired. No big deal. And the fact that an incumbent worker – who was presumably OK or he wouldn't have

[23]I used to run a video in class illustrating attitudes toward working women in the 1950s: https://www.youtube.com/watch?v=BA3uryDJzI0.

been incumbent – brought you, was a kind of screening. Why would he want to bring someone who wouldn't work out?

The pay system also has some lessons. First, there is some question about the process of having workers sit on a bench unpaid until dispatched. It at least skirts on the edge of illegality. A lawyer would probably want to examine the degree to which you were *required* to arrive by a certain time, even if no work was available. But note that if the practice was illegal, i.e., you should have been paid from the time of arrival, who was going to enforce the law? The amount that would have been due to any particular worker would have been trivial. And workers would have had to file complaints – assuming they knew about the law and where complaints had to be filed.

Moreover, the Swift Messenger Service was a small business. So if the practice was illegal, there was at least a good chance the owner/boss may not have known that it was. There were no lawyers on staff. It is one thing to enact labor laws; it is another to enforce them.

Second, you were paid on a time wage, $1 per hour. When I first got the job, the boy who recruited me took me aside and the following dialog ensued:

> *Mitchell, do you know what the motto is of a Swift Messenger Boy?*
>
> *What?*
>
> *Don't be Swift!*

What we have here is a classic principal/agent problem associated with paying by time. The faster you accomplished your task, the less you were paid for it. So there is an incentive not to be swift. One remedy used in some jobs for this problem is to pay by the task, not by the time. But in the case of messenger boys, the task varied from assignment to assignment. Moreover, one could form at least a rough idea how long it would take to walk to the various addresses and then phone in. So "too much" dawdling would have become apparent. Even without detailed monitoring, while there was no incentive for messengers to be superfast, a snail's pace would have been detected.

The practice of reimbursing dimes for phone calls also exposed an agency problem. There was a draw full of dimes used to reimburse the messengers. And there was what nowadays might be called a problem of "corporate culture." The adult workers in the office hated the owner/boss. When he went off to the races or wherever, leaving them in charge, they would "reimburse" us for dimes we hadn't spent. Giving away the owner's money gave them pleasure. We didn't complain. When you make $1 per hour, an extra dime is 10% of your hourly wage.

And talking about being reimbursed for dimes we hadn't spent, there was yet another perversity entailed in the practice. But it was a negative externality borne by the telephone company, not the Swift Messenger Service. Word got around the messenger boys that you could make calls from payphones *without a dime*.

What you needed was an uncurled paper clip. You would shove one end into one of the little holes on the microphone and touch the other and to the body of the phone. A contact would be made and you would get a dial tone. You could then call into the office as required and get reimbursed for the 10 cents *that you hadn't paid*. Of course, that was 10 cents less for the phone company. Moreover repeated sticks of the paper clip into a phone's microphone

damaged it, worsening the sound quality until finally it was unusable. The phone company was aware of the problem and was in the midst of replacing phones – or at least phone microphones – with ones where the trick wouldn't work. But the messenger boys passed word around about where there were still phones in operation which were vulnerable.

Apart from the labor market lessons embedded in this tale, there is also one more about misinformation in the marketplace that is more general. Remember the folks who believed that the messenger they summoned was taking their package directly to its destination (and not back to the central office)? Or those who paid extra for "rush" service that they didn't get? The lesson is clear: *Caveat emptor*.

Mitchell's Musings 8-22-16: A Clue from the Wages Fund

Daniel J.B. Mitchell

An important element in the current presidential campaign is wage stagnation and the potential role of trade competition in retarding wage growth. So an interesting question is how much higher real wages might be if policy on trade or whatever you might think was depressing wages was changed. The question is a bit like one we asked about manufacturing jobs we reviewed in prior musings. In that case, we asked how much larger that sector could be if the trade deficit were eliminated.

The answer we found in the manufacturing case might be described as "somewhat," but not a dramatic return to the kind of manufacturing share of jobs that existed in, say, the 1950s. Note that the answer being only "somewhat" (and not "huge") is not a reason to do nothing. Indeed, I have urged that there *should* be a policy in place to get to balanced international trade. But what the "somewhat" answer means is that there are limits to what the effect of a policy shift might be.

What about real wages? It might not surprise you that a back-of-the-envelope calculation also suggests a "somewhat" type answer. But that the "somewhat" in the wage case comes from a variant of the "wages fund" doctrine of the 19th century (and even earlier) might be a surprise. The old wages fund doctrine relates to a supposed constancy of labor's "share" – the dollars going to labor in the form of wages and benefits – as a proportion of national income.

Despite the wages fund doctrine, there really isn't a theoretical reason why the share of labor has to be constant. And there is some cyclical variation in the share. Empirically, the share doesn't literally stay constant, even adjusting for the business cycle. But it does change slowly over time. The table below shows the share and the ratio of employment to population, both in percentage terms.[24] Years shown on the table roughly are business cycle peaks. (The year 2015 – the last full year available – was not a peak; we, of course, don't know when the next peak will occur.)

	Labor's Share of National Income	Employment-to-Population Ratio
1949	60.2%	55.4%
1959	62.3	56.0
1969	65.1	58.0
1979	65.9	59.9
1990	66.4	62.8
2000	65.8	64.4
2007	64.1	63.0
2015	61.9	59.3

[24]Labor's share data are from the U.S. Bureau of Economic Analysis national income account Table 1.12. Employment data are from the U.S. Bureau of Labor Statistics.

Generally, labor's share rose until 2000 and declined thereafter. Although there is not a simple, mechanical link evident in the data, the working population (represented by the employment-to-population ratio) also rose until 2000 and then fell. Possibly, there is some connection between those two trends. Perhaps growth in the labor force was a factor in enlarging the share.

If you think that, say, international trade was squeezing the share of labor compensation, and if you think you have a policy that could offset that squeeze effect, how much would wages rise with an implementation of your policy?[25] A simple answer might be developed from the observation that at its peak, labor's relative share was about 66% of national income, and now (2015) it's about 62%. If you were to raise the share back up to 66% - that is, push it up by 4 percentage points – and if the number of workers receiving the share remained unchanged, dollars per worker would rise by something like 4/62 or 6.5%.[26] In magnitude, that's a "somewhat" answer.

If you think the proportion of the population working has something to do with the size of the share, you might note that the last time the employment-to-population ratio was in its current range of around 59+ percent was the 1970s. And back then, labor's share was about 66%. So, even standardizing for employment, you'll still get 4/62 or 6.5%.

Of course, even if the average wage/employee rose by something like 6-7%, that gain says nothing about how the dollars would be distributed, demographically or occupationally, *within* the workforce. That is, some groups might be benefited by an average wage increase more than others. Overall, however, the effect is modest. Still, no one would turn down a pay raise, even if it isn't huge.

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[25]There are other candidates than international trade for being the cause of wage stagnation such as the decline of private-sector unionization, slippage in the minimum wage, and/or "technology."

[26]If you think the rise in wages would pull more folks into the workforce, i.e., that the labor supply curve has a positive slope, the gain in wages might be reduced a bit. Or if you think there is a backward-bending curve (with a negative slope), the gain might be a bit more. But for back-of-the-envelope purposes, what you assume about supply is not going to matter much.

Mitchell's Musings 8-29-16: Not Persuasive

Daniel J.B. Mitchell

When LERA, the Labor and Employment Relations Association, changed its name from the Industrial Relations Research Association (IRRA), it was attempting to be more modern in its terminology. Perhaps "industrial" suggested only blue-collar sectors such as manufacturing. Moreover, the terms "labor relations" and "industrial relations" tended in the past to mean only union-management relations and not relations in the much larger nonunion sector.

Still, in looking for a new name, the Association did not adopt the contemporary "human resources" terminology. Human resources as a phrase – whatever it might mean to those folks who have those words in their job titles (e.g., VP of Human Resources) – doesn't suggest a relationship. Steel is a resource. Money is a resource. But you don't have a relationship with either of those "resources." In particular, there is no need to be persuasive with regard to steel or money; you use them as you see fit without worrying about how they might feel or react.

It is true that the IRRA, now LERA, developed at a time (the late 1940s) when unions were in a period of ascendency. And it is also true that LERA remains linked to the world of collective bargaining in its structure and interests. However, the idea of a relationship that needed to be studied was always strong. The union sector has in fact two levels of relationships. There is the standard employer/employee relationship with the usual hierarchy of boss/subordinate. But that interpersonal relationship is mediated by the employer-union relationship. Much of the work of the Association was (is) about the complexity of the dual relationships and their interactions.

When the general public thinks about unions, it is often in the context of conflict (strikes). But a good deal of the research of the Association had to do (has to do) with avoiding or reducing conflict. The study of arbitration and mediation, or just case study comparisons between amicable and hostile relationships, are all examples of such research.

Of course, there are situations in which people can simply be ordered to do things. As in the "Charge of the Light Brigade": …*Theirs not to reason why; theirs but to do and die*… But, then again, the Charge of the Light Brigade did not work out so well. Maybe if someone had asked why, the result would have been better. Maybe if the members of the light brigade had been asked about their thoughts on the likelihood of success, things might have been different. In many cases, and certainly in labor and employment relations, some element of consultation and persuasion can produce better results. Providing some legitimacy or rationale through obtaining a "buy in" of participants can reduce conflict.

Even when conflict arises and third parties are brought in to help, persuasion is an element in the ultimate resolution. Mediators may suggest alternatives or reinterpret positions and outcomes. Arbitrators – even though they ultimately make the decision – try to provide persuasive arguments as to how they arrived at those decisions. Arbitration decisions typically are accompanied by explanations. In those written decisions, they will review what the parties presented and explain their responses. That is, arbitrators will demonstration that they listened, even if they did not agree with the interpretation being proffered.

Of course, there remain those conflicts that are settled by infliction of economic pain via strikes and lockouts. Persuasion in those cases – as we have been using that word - is less of an issue. But typically, use of such tactics is seen as a last resort if no other means of resolution seems possible.

What brought all this to mind was an observation that there is a tendency nowadays to ignore what is persuasive in situations in which, in the end, there is no option to order someone to do something; no option to inflict enough economic pain to make anyone agree. As an example, I happened to peruse the opinion section of the website for the UCLA undergraduate student newspaper recently and came across the listing below of four opinion pieces:

Chris Campbell: Beverly Hills must stop fighting expansion of Purple Line to Westside

Beverly Hills has sent a clear message to the Metropolitan Transportation Authority about its proposed Purple Line subway extension route running under the city. Quite... Read more »

Submission: Voters should cast ballots with principles and values in mind

Submission: College students should advocate for modern, relevant sex education

Editorial: UC publicity campaign countering state audit unnecessary, misguided

Let's put aside the merits and demerits of the topics of the items. The first one tells somebody what they MUST do or they MUST think. The next two tell somebody what they SHOULD do. And the fourth just expresses an opinion about the subject. Let's think about those lead-ins.

The use of MUST would surely be a turn-off to anyone who might actually have some authority to – in this case - change transportation policy in Beverly Hills. So the author either doesn't actually care if policy is changed or not, or doesn't realize that starting with MUST is likely to be offensive. In fact, nobody MUST do anything or think anything. Who is the author to say otherwise?

SHOULD in the middle two items is a bit softer than MUST. But it's still pretty directive and a potential turn-off. Before the reader even gets into the argument to be presented, he/she is told what he/she SHOULD think. Why is the reader being told in advance of any rationale what he/she as a voter or a college student SHOULD do?

The fourth item simply gives an opinion and invites you, as the reader, to find out what it is that the author believes. It doesn't tell you what you should or must do. Of course, I have no way of knowing

whether the authors of any of these pieces thought about being persuasive or about what form of presentation might be most persuasive. My experience, however, in teaching undergraduates is that they haven't had much experience in persuasive policy writing.

But it isn't just youthful undergraduates nowadays who seem intent on expressing opinions without regard to persuasiveness. My high school class (of 1960) maintains a website whereby members of the class can post whatever they like. It was intended for recollections of the school, updates on careers, personal items, etc. At present, however, it is dominated by a few individuals who post – sometimes in vituperative terms – their opinions about the current presidential election. There are pro-Trump and pro-Clinton views and views that both candidates are terrible. And there are endless back-and-forths refuting each other, sometimes with lengthy essays that others in the class have no interest in reading. Although there have been suggestions by others who look at the website (including suggestions by yours truly) to the offenders that enough is enough, their "debate" continues. And it continues without apparent interest in putting forward positions in ways that will engage rather than offend.

So expressions of opinion without apparent thought of persuasiveness seem to be found at both ends of the age spectrum, undergrads and folks in their seventies. Sadly, the practice is not found only at the extremes of the age distribution. You have only to look at the comment sections on newspaper websites, you find the similar results – presumably mainly reflecting the ages somewhere in between current undergrads and the high school class of 1960. Opinions in the comment sections are also commonly expressed without any apparent interest in persuading readers of their validity. Even the basics of spelling and grammar are absent, despite the ready availability of automatic spellcheckers on computers.

As with the student examples, I have no way of knowing whether the authors of newspaper comments know about, or care about, persuasive presentation. LERA members – by virtue of their field of study – presumably do care since persuasion is an inherent element in labor and employment relations. Perhaps it's time at some future LERA meeting for a session on the art of persuasion and on why it seems to be becoming a lost art.

Mitchell's Musings 9-5-16: Labor Day Thoughts

Daniel J.B. Mitchell

Labor Day – which happens to fall on the date of this musing – traditionally features news articles that rehearse the decline of organized labor and then add some pundit observations as to whether unions will ever "come back." Possibly, because this is a presidential election year – and because of the Trump candidacy – there will also be some observations about whether international trade and/or immigration is good or bad for labor. "Globalization" will likely be cited.

There is no doubt that economic forces have a role in providing an understanding of the Trump phenomenon. The standard view seems to be that underlying it all is that there is a segment of the workforce – mainly white males with less than a college degree – that has been disadvantaged by the decline of good jobs in manufacturing and that the political elite has not responded. So, in this view, Trump supporters have turned to an outsider candidate who promises to do something about it – block illegal immigration, negotiate advantageous trade deals, or whatever.

At that point, the analysis tends to run two ways. One is that globalization - a loose concept which seems to include both trade and immigration – is an inevitable trend so the Trump supporters have picked an anachronistic cause and a leader who is misleading them. Another is that what's bugging the Trump supporters is really the loss of good manufacturing jobs to technology – also an inevitable trend – so Trump is deluding his followers by promising to do what he can't do.[27]

A variant is that there *are* things that could be done (and maybe should be done), but the political elites of both parties refuse to do them out of ignorance and/or self-interest. Trump is promising to do something, but actually – if he were elected - he won't. So, again, his followers are deluded. And the basic cause is economics.

Still another variant is that Trump has mixed up racist messages with his economic message so that what he says on economic issues, assuming he loses in November as current polls suggest, will be incorrectly discredited. Within this approach, it is possible to pick and choose between immigration and trade as the valid issue which Trump's defeat will kill.[28] (Of course, current polls could be wrong or what they show could change between now and November.)

But as noted, there is an assumption throughout most of this type of prognostication that the base of the Trump phenomenon is economics and jobs and that the racial and other "social" messages are a kind of gravy on top of the campaign, albeit unfortunate gravy.

Now nobody with an economics PhD (such as yours truly) is going to argue that economics is not a *factor* in the Trump phenomenon. But other issues including the "guns and God" issues that then-candidate Barack Obama made famous (or infamous), may not be just a product of economic concerns. If you look at Big Issues in American history, "social" issues stand out. Yes, before the Civil War, there were tariff disputes (economics) between the North and South. (The North favored high tariffs; the South, low.) But would there really have been a Civil War over tariff levels? Slavery was an economic issue for the South.

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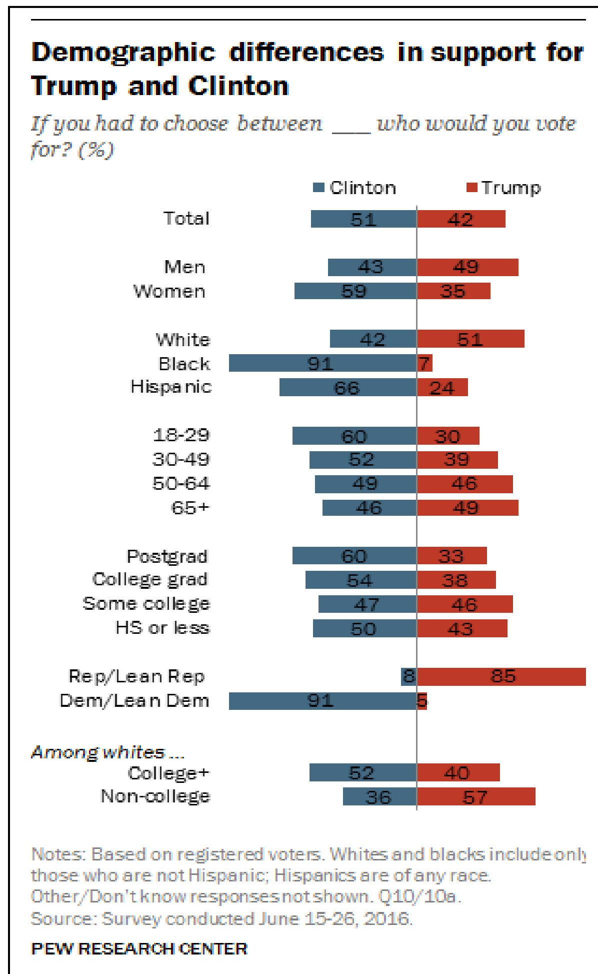
[27]http://www.foxandhoundsdaily.com/2016/09/middle-class-lost-election/.

[28]For an example where immigration is taken as the valid issue, see http://www.politico.com/magazine/story/2016/09/rich-lowry-donald-trump-immigration-214205.

But for the North, it was a social issue, a moral issue, even a religious issue. The "truth" that John Brown's body lies a-moldering in the grave for is not lower tariffs.

Or consider Prohibition. Amending the U.S. constitution is a difficult process and is rarely done. But the issue of Prohibition sparked *two* amendments, one putting Prohibition into place and the other repealing it. Prohibition was predominantly a social (and religious) issue. It would be hard to argue that the anti-liquor forces had an economic interest in implementing Prohibition. And there was more to Prohibition's repeal than job creation in breweries.



Those on the left want to see a linear, economics-based story – and some on the right who are anti-Trump seem to share that desire. Economics (loss of good jobs, etc.) leads to discontent which gets expressed in dysfunctional ways that really run against the interests of those doing the expressing. Trump supporters are deluded in thinking he will fix their jobs problem because a) it can't be fixed due to inevitable globalization and/or technology or b) if elected, he won't do the things that would be a fix. Perhaps we should be empathetic to the plight of Trump supporters, in the view of some liberal observers.[29] But empathetic or not, the real story is economics leads to "guns and God" (and racism).

There is a more nuanced view, however. Perhaps for some – even many – Trump supporters, the key appeal *is* "guns and God" and economics/jobs is the side show. The Pew poll in the accompanying graphic shows significant overlap in Trump support in all groups except blacks.[30] Trump supporters are not just angry older white males without college degrees who have been displaced from manufacturing. Trump gets support from about a third of women, about a third of the young, and about a third of the college-educated.

The fact is that even on Labor Day, jobs are not the whole story.

[29] https://www.bostonglobe.com/arts/books/2016/09/01/why-many-red-states-back-politics-contrary-their-own-self-interest/CBgJxmatmzjwcVrSjNwpCK/story.html.
[30] http://www.people-press.org/2016/07/07/2-voter-general-election-preferences/.

Mitchell's Musings 9-12-16: Chicago

Daniel J.B. Mitchell

We are used to the idea that movies are rated for "mature" content (PG-13, R, etc.). TV shows also are similarly rated. Sometimes radio and TV programs are prefaced with a statement that there is language some might find offensive. So is there any real difference between these types of warning systems and the "trigger warnings" for college courses that have been in the news in recent years?

The use of such warnings in course syllabi – in contrast to movie, TV, and radio warnings – has produced (triggered?) substantial controversy. An engineering professor at Auburn University recently got himself fifteen minutes of fame by putting the statement "*TRIGGER WARNING: physics, trigonometry, sine, cosine, tangent, vector, force, work, energy, stress, quiz, grade*" at the top of his syllabus as a parody.[31] Much more attention was paid – because it wasn't intended as a joke – to an orientation statement from a dean at the University of Chicago: "*Our commitment to academic freedom means that we do not support so-called trigger warnings, we do not cancel invited speakers because their topics might prove controversial and we do not condone the creation of intellectual safe spaces where individuals can retreat from ideas and perspectives at odds with their own*."[32]

Obviously, despite the noncontroversial precedent of movie ratings, the trigger movement is being taken by some as a serious matter, although how widespread the concern is among practicing academics can be questioned.[33] In particular, the Chicago statement received substantial attention and applause – more from the political right than elsewhere.[34] *LA Times* columnist Maureen Daum – who is not a right-wing observer – argued that the use of triggers, by itself not a big deal in her view, has become mixed up with "*the much larger phenomenon of leftist groupthink masquerading as*

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[31]https://www.insidehighered.com/quicktakes/2016/09/01/professor-tops-syllabus-mock-trigger-warning.
[32]https://www.insidehighered.com/news/2016/08/25/u-chicago-warns-incoming-students-not-expect-safe-spaces-or-trigger-warnings.
[33]NPR reported on a survey it conducted – which it qualified as nonscientific – in which half of college instructors said they used trigger warnings. That result seems implausible since there are many fields – math, the sciences, computer science, etc. – where (other than the parody of footnote 1) – it's hard to see how they would be used. See http://www.npr.org/sections/ed/2016/09/07/492979242/half-of-professors-in-npr-ed-survey-have-used-trigger-warnings. (Would there be a warning for religious fundamentalists that there is scientific evidence of evolution or that there is evidence that the Earth is more than 6,000 years old?)
[34]http://www.realclearpolitics.com/articles/2016/09/02/higher_education_beyond_parody_131683.html. However, the Chicago approach was supported by a former Obama administration official: https://www.bloomberg.com/view/articles/2016-09-07/a-fix-for-the-culture-wars.

liberalism."[35] That is, in her view a practice that is relatively harmless has come to stand for something else.

Note that the Chicago statement is self-contradictory. In order to protect free speech, it seems to support a ban on the use of a type of statement (speech) by an instructor on a syllabus. You can argue whether a policy of "not supporting" use of trigger warnings is an absolute ban on them. But given that statement, if you were a junior (untenured) faculty member at Chicago, might you not be reluctant to use a trigger? Would you want to be doing something which the university doesn't "support"? The statement, after all, is being made by a campus authority figure. If the dean were just expressing his personal opinion, he could have said so, and then further clarified that he was not articulating an official policy. But that wasn't what he did.

There *is* a difference between someone deciding not to go to an R-rated movie to avoid the offensive content and a student responding to a trigger warning on a syllabus. The former situation represents a choice about an entertainment. The latter might be interpreted by the student as meaning you don't have to read material that might offend you *and yet you would nonetheless receive credit for the course*. Or it might be taken to mean that you don't have to read what offends you and that the instructor is bound to supply you with alternative readings that you prefer.

Just putting a trigger warning on a syllabus without further comment is potentially confusing. If the potentially offensive readings are nonetheless required, the syllabus should so indicate. You don't have to go to an R-rated movie and there really is no consequence if you don't. But if you take a course, you do have to do the assigned work. And some courses, moreover, are required for completing a major, or even to graduate. A syllabus trigger warning has an element of importance that a movie rating does not. So it needs to be explained.

I am unaware of any university requiring the use of trigger warnings. And it is not clear how you would mandate their use without also defining what kind of content is offensive. Is it any content with violence? Any content with sex? Would the warnings cover reference to wars – inherently violent - in history courses? Could students complain about a lack of a warning on any topic of their choosing in some university tribunal? That kind of complaint mechanism could lead to *de facto* censorship by anyone who didn't like the way a topic was discussed.

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[35]http://www.latimes.com/opinion/op-ed/la-oe-daum-trigger-warnings-20160831-snap-story.html.

So we might add a proviso to our view that the Chicago dean should have made it clear that he was merely expressing a personal opinion and not a university mandate (if he was just expressing a personal viewpoint). Sometimes, norms can become quasi-mandates without any official policy change. What started out as a fad of adding trigger warnings could become an expectation of more. Harvard law professor Jeannie Suk Gersen noted in a *New Yorker* article that the discussion in criminal law classes has been impeded by student objections to including as a topic the law of sexual assault.[36] That is, the demand for trigger warnings – which are not mandated by Harvard – has morphed into a demand to omit a section of the curriculum that lawyers are supposed to know something about.

Perhaps, therefore, the Chicago dean might better have said that while the use of trigger warnings was a matter of instructor discretion, their use did not mean that potentially offensive topics would be avoided or that dealing with such topics is at the option of those enrolled. My guess is that is what he meant to say.

As far as articulating official policy, he might further have focused on what the University of Chicago is not doing. Chicago is not creating the "bias-response teams" which have embarrassed other universities by censoring courses and speech in response to someone's complaints of offense. You don't have to be an expert in organizational behavior to know that such teams, once they are created, will seek out work to do to justify their existence. At least two universities that created such teams have had to disband them after the teams started to do what they shouldn't do or seemed poised to do so.[37]

Daum is correct; trigger warnings by themselves are relatively harmless. But if they are used, their implications should be explained to students. And going beyond such warnings in the direction of institutionalized thought police should be avoided. There will always be a few cases of academics who misbehave in some extreme manner – teaching wacko conspiracy theories or whatever. But they can be dealt with in an *ad hoc* manner. And, if you are wondering about yours truly, I don't have anything labeled "trigger warnings" on my current syllabus, but I have long provided a very brief description of what each assigned item is about. And it is clear that all the items listed as assignments are required.

[36]http://www.newyorker.com/news/news-desk/trouble-teaching-rape-law.
[37]http://www.chronicle.com/blogs/ticker/u-of-northern-colorado-will-disband-controversial-bias-response-team/114095.

Mitchell's Musings 9-19-2016: Measurement for What?

Daniel J.B. Mitchell

I am going to take up defined-benefit pensions in this musing, but let's start with a simple example. Suppose I wish to have $1,000 thirty years from now. How much should I put aside today as a lump sum to have that target amount in thirty years?

Clearly, the answer has to depend on what I think I will earn over the thirty-year period with my lump sum. But it is hard to be sure what the earnings rate will be unless I invest in something that is relatively riskless and that has that thirty-year duration. Let's suppose that there is such an asset in the marketplace and it carries an annual yield of 4%. As it turns out, if I put aside about $308 today and invest it in that asset, I will have my $1,000 in thirty years.[38]

However, suppose I were to invest in a reasonably prudent mix of stocks and bonds which are not as secure as the asset yielding 4%/annum, but which I believe – based on advice of experts – can be expected to yield 6%/annum. "Expected" is not the same as a sure thing, but the experts, looking at past long-term history and what they can see looking ahead, think 6% is a reasonable expectation. Of course, the experts note as a proviso that they could be wrong and that the actual result might turn out to be more or less than 6%.

As it turns out, if I were willing to take the risk that the 6%/annum target might not be achieved, I could put aside only $174 today to get my hoped-for $1,000 in thirty years.[39] That is, if things work out as expected, my $174 will grow with compound interest at 6% and become the target $1,000. And had I instead put aside $308, I would find myself thirty years from now with an "extra" $771.

Suppose further that in the period before I made the decision on how much to put aside today, expert advisors had been telling me that one could expect 7%/annum on average over a thirty-year period. But at the moment of decision, they told me that in view of recent adverse developments, they now believed 6% was more realistic. What would happen if I chose to believe that my advisors were being overly pessimistic due to recent developments (panicking) and that it would be better to keep the 7%/annum assumption? In that case, I would put aside only $131 today.[40] If keeping to 7% turned out to be correct, I would have my $1,000 in thirty years. But if my advisors were correct with their downward revision and the actual return was 6%, I would be short by about $254.

The most obvious point of this tale is that the more I put away today, the more likely it is that I will have *at least* $1,000 in thirty years. Put another way, if I follow what a low long-term rate of return implies in deciding how much to put away, I increase the odds of at least achieving my target. Note that there are really two steps implied. First, I assume a low rate. Second, because I assumed a low rate, I decide to put more money away today. These are separable events.

Suppose we translate these numerical examples into pension terms and suppose that actual rate of return turned out to be exactly the advisor-forecast of 6%/annum. The liability of my plan is $1,000 thirty years from now. If I had discounted that liability by 6% and had – as a result - put away $174

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[38] $\$308.32 \times (1.04)^{30} = \$1,000$
[39] $\$174.11 \times (1.06)^{30} = \$1,000$
[40] $\$131.37 \times (1.07)^{30} = \$1,000$

today, the plan would turn out to be fully funded. (My current ratio of assets to discounted liabilities = 1 or 100%.) If I had put away $308, the plan would be overfunded by 77%. ($308/$174 = 1.77) If I had put away only $131, my funding ratio would be only 75%. ($131/$174 = .75) I would be underfunded by 25%.

I have gone through this arithmetic because the University of California (UC) defined-benefit pension is officially underfunded and the UC Regents – as plan trustees – periodically mull over what to do about it. The plan uses a methodology which estimates the discounted value of its liabilities to future retirees by using the same discount rate as the rate officially estimated by the UC Regents to be their long-term expected annual rate of return. Currently, the officially expected rate of return is 7.25%/annum.[41] However, it is clear from public statements of the Regents' chief investment officer and his staff that they (the CIO and his staff) believe a 6-ish long-term rate is more realistic going forward than a 7-ish rate.

Moreover, there is at least one *outside* advisor on the Regents' Committee on Investments who is arguing that even if the 6-ish rate is a reasonable expectation of the long-term return, the discount rate that should be applied to the liability of the plan is a 4-ish number.[42] That 4-ish number, in his view, seems to equate to what the State of California pays on long-term general obligation bonds. (The state in fact pays less than that because its bonds are tax-exempt, but if you adjust the yields to the equivalent taxable rate, they would have a 4-ish return.) His argument is that if the state's pension liabilities are as firm as its bond liabilities, the same rate would be used for both.

There are two different issues here. The first is whether the Regents should lower their official expectation of a return to the level their own expert is telling them is appropriate (i.e., from a 7-ish expectation to a 6-ish rate). Presumably they should, unless they truly believe he is being panicked by recent developments and that the old official 7-ish assumptions are still valid. But if they instead believe what their expert is saying to them now, that belief will tell them that the plan is more underfunded than current methodology indicates. So the corollary is that if they lower the official expected return, they should also up the contributions to the plan appropriately. Again, as in our earlier example, there is a two-step process here. First, a change in the assumption and, second, acting on that assumption.

If they don't take the second step, the plan would gradually have a lower and lower asset balance relative to liabilities and would someday become a pay-as-you-go arrangement. That is, each cohort of employees would – at some date in the future - end up being "taxed" to pay the pensions of previous cohorts. As a practical matter, without the availability of earnings from a large investment pool of assets, the pay-as-you-go cost would be very high.

Another issue, however, is whether it makes sense to have a lower discount rate than the expected earnings rate, as the outside expert is arguing. Lowering the discount rate for liabilities will up the *measured* value of those liabilities and thus lower the *measured* value of the funding ratio. If more contributions result, the likelihood of at least having the assets needed to pay those liabilities goes up. But note that *measured* value is not the same as *actual* value. The actual value will depend on actual future earnings. If you believe those earnings to be 6-ish, and yet you fund on the basis of 4-ish, your

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[41]The rate was recently lowered from 7.50%.

[42]You can hear the September 9, 2016 meeting of the committee at https://archive.org/details/RegentsCOI9916. The comments of the outside advisor are at approximately 1:29 on the audio recording.

plan assets will gradually rise relative to liabilities and will do so indefinitely. Presumably, at some level of overfunding, the contributions would be halted.[43]

A key point about a pension plan – which differentiates it from the $1,000-in-thirty-years example – is that a pension plan goes on indefinitely; there is no finite maturity. On a regular basis, estimates of liabilities and expected future rates of return should be adjusted iteratively. There really isn't a behavioral reason to pick a number such as 4% for discounting on the grounds that pension liabilities are in theory similar to state bond liabilities. The 4% vs. 6% differential might be taken to be an indication some measure of risk to employees. That is, other things equal, employees might be willing to contribute more to a plan which guaranteed an outcome rather than one that produced only an expected outcome. (But there is much research to suggest that ordinary folks have big problems in evaluating risk.)

Just blowing up the measured liability relative to assets by assuming a lower discount rate than the assumed earnings rate might well have perverse results. It could make the current underfunding problem seem intractable and lead to Regental paralysis and no solution. The purpose of computing the funding ratio is *managerial*, not theoretical. You make the calculation to help guide management decisions.

The best outcome, and the one most feasible, would be for the Regents a) to lower their expected earnings rate (and their liability discount rate) to what the CIO and his staff are suggesting is reasonable, and b) to modify their funding plan to accord with that rate, used as both the projected earnings rate and the discount rate. And they should follow that approach periodically and make iterative adjustments as needed.

[43]We know in fact that when the plan became overfunded in the 1980s as officially measured, contributions were halted for two decades. So there is evidence that actual contribution behavior responds to the measured value of the funding ratio. We know in fact that – with a long lag – when the official measure of the ratio came to show underfunding, contributions were resumed. There may well be asymmetry between the reaction to overfunding and the reaction to underfunding. And, as noted below, a high measured level of underfunding could cause paralysis.

Mitchell's Musings 9-26-16: Measurement for What? – Part 2

Daniel J.B. Mitchell

I had hoped to be done, for a while anyway, with defined-benefit pensions with last week's musing.[44] But it was not to be. Recently, the *New York Times* got interested in CalPERS, the giant California pension fund that covers most state employees (other than employees of the University of California [UC]) and many local government employees.[45] The essence of the *Times* article is that something nefarious is going on because when a local government wanted to terminate its pension plan with CalPERS, CalPERS used a low interest rate to calculate the liability that the government would have to pay to CalPERS. The rate was lower than CalPERS official expected rate of earnings which is otherwise used by CalPERS as a discount rate for liabilities generally.

So let's separate some issues here. Last week, we dealt with the question of using a lower interest rate for discounting pension liabilities than is used for expected earnings on pension assets. We noted that some folks argue that because the pension liability to employees and retirees is ironclad, the discount rate should reflect a riskless investment. What we indicated last week was that an ongoing pension plan has no finite duration and that, if over a long period it earns what it expects and funds the plan in accord with that expectation, it will have enough money in the till to meet its liabilities. Apparently, there are some folks (including an adviser to the UC Board of Regents) who think that if you expect to earn, say, 6% per annum, you fund accordingly, and you in fact earn 6%, you will still run out of money unless you discount liabilities by a lower rate than 6%. Simple arithmetic says that conclusion is wrong.

Of course, the big IF in that idea is that you in fact earn in the long run what you today reasonably can expect. If you use an unreasonably high rate of return to discount future liabilities and to estimate future earnings, you will indeed come up short. The lesson is that you should use a reasonable rate. And you should keep adjusting that estimated rate based on incoming information. There is little question about that simple notion.

What the *Times* seems to be saying is that using the lower rate for the local government that wanted to terminate its plan proves somehow that CalPERS' expected earnings rate is too high and that really the termination discount rate for liabilities is what it should be using to calculate its funding ratio. To be fair, the article is not entirely clear about what is wrong, but the reader is left with the impression that using two rates shows something is phony. The headline with "two sets of books" suggests outright corruption and false measurement.

According to the CalPERS actuary, CalPERS' official estimate rate of earnings, 7.5%/annum, is too high. But that view has nothing to do with the rate charged to terminating plans. The actuary simply believes that, looking ahead, earnings will be lower over the long term than 7.5%/annum.

CalPERS should be using a reasonable rate, as recommended by its actuary. If it isn't, that failure is a sign of bad governance. (And there have been problems over the years with bad governance at CalPERS, including outright corruption.) But none of this concern is related to the low termination discount rate.

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[44]http://employmentpolicy.org/page-1775968/4254643#sthash.o4FvbDLf.dpbs.
[45]http://www.nytimes.com/2016/09/18/business/dealbook/a-sour-surprise-for-public-pensions-two-sets-of-books.html.

CalPERS is actually a set of plans, not a single plan. If a local jurisdiction has a pension plan for its employees, CalPERS separately calculates its liabilities. Liabilities will vary from jurisdiction to jurisdiction depending on employee demographics and behavior. If a local government decides to terminate its plan, the plan still has a liability to covered incumbent workers and retirees. Termination shifts the plan from one with an indefinite duration to one with a finite end. Someday, the last participant will die and the plan will truly end. CalPERS must ensure that it has enough money *in that plan* to pay off that last participant. By law, it cannot take money from other jurisdictions' plans and subsidize any remaining shortfall in the terminating plan.[46]

Given the shift from an indefinite duration to a finite duration, and given the bar against moving money from one plan to another, CalPERS must take a reduced risk approach to the terminating plan. It must invest in low risk assets. So, of course, it uses a low discount rate because the plan itself will earn a low rate on its low-risk assets. There is nothing nefarious about using a lower rate for terminating plans; it is just prudent pension management.[47]

In short, CalPERS does have management problems. It should be using realistic estimates of future earnings. But the fact that it discounts terminating plans using a low interest rate is entirely appropriate.

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[46]California governor Jerry Brown recently vetoed an *ad hoc* bill that would have allowed moving money from one plan to another because it would violate the longstanding principle that each plan is a separate entity. See https://www.gov.ca.gov/docs/SB_1162_Veto_Message.pdf.

[47]The California Legislative Analyst's Office recognizes that prudence requires low-risk (and thus low-return) assets for plans that are terminating. It provided an analysis of a proposed ballot initiative (that never made it to the ballot) that would have phased out defined-benefit pensions and noted that "*there are costs related to the closure of defined benefit plans. As these plans 'wind down' over the decades, their pension boards likely would change investments to those with lower risk and lower expected returns. This would result in higher costs for these closed plans*." Source: http://www.lao.ca.gov/BallotAnalysis/Initiative/2015-033.