Mickey Levy

Bank of America, based in Charlotte, N.C., is the nation's second largest commercial bank, trailing only J.P. Morgan Chase. As chief economist for Bank of America, Mickey Levy analyzes economic conditions and financial market behavior both at home and abroad, as well as conducts research on monetary and fiscal policies. His economic forecasts have consistently ranked among the top of private sector firms. (For an analysis of Blue Chip forecasting performance, see the Federal Reserve Bank of Atlanta's *Economic Review*, Second Quarter 2003.)

Before joining Bank of America, Levy worked in Washington, D.C, as an analyst at the Congressional Budget Office and the American Enterprise Institute, where he examined a wide array of public-policy issues. Since 1983, he has served as a member of the Shadow Open Market Committee (SOMC), a group of academic and business economists that meets twice a year to comment on the actions of the Federal Open Market Committee (FOMC), which conducts the nation's monetary policy. Levy also sits on the Board of Academic Advisors to the Federal Reserve Bank of New York.

In addition to his responsibilities with Bank of America, Levy continues to speak to academic and business audiences around the world and to publish his research in top policy journals. Aaron Steelman interviewed Levy in his office overlooking New York's Central Park on June 26, 2003.

RF: How has your formal training in economics and your experience working in Washington, D.C., helped prepare you for a career on Wall Street?

Levy: I try to apply sound, neoclassical economics to financial markets. Over time, the markets tend to abide by economic fundamentals, and if you stick to the fundamentals you will forecast the market direction right more often than not and avoid big mistakes. Many Wall Street economists seem to jump from theme to theme, which can provide an unstable basis for analysis.

My training in public policy also has helped. For instance, having a sound understanding of fiscal-policy research can be very useful in forecasting. I try to apply a combination of sound economics and public-policy analysis to financial market behavior.

RF: One area in which you have done a lot of work—both as a policy economist and as a business economist—is fiscal policy. How would you assess the current situation, given the increasingly large deficit projections coming from the Congressional Budget Office and other organizations?

Levy: Often, the size and structure of government—and what they imply for resource allocation and private sector decisionmaking—take a backseat to a narrow debate about the size of deficits. We need to ask: What is the proper size of government? What sort of activities should the government fund? And what should be the proper tax structure?

The emphasis on deficits also dominates the fiscal-policy debate overseas. In the European Union, fiscal policy is guided by the Growth and Stability Pact that limits deficit-to-GDP ratios to 3 percent in member nations. Recently, I presented a paper at a symposium sponsored by the Central Bank of Austria in which I argued the Pact was a poor guideline for conducting fiscal policy and recommended changes that would refocus the debate.

Using a deficit-to-GDP ratio to evaluate and coordinate fiscal policies across nations is misguided. For instance, Germany and the United States have comparable deficit-to-GDP ratios. But Germany's public spending amounts to nearly 50 percent of GDP, while the United States' ratio is about 20 percent at the federal level and about 35 percent including state and local spending. The composition of government spending varies across European nations, and they have different tax structures. So deficits often drive the debate, but they are not a good reflection of fiscal responsibility or thrust. Analogously, consider an investment analyst preparing a financial report on a business. In most cases, the company's debt level provides insufficient information. Importantly, what is the company doing with the capital? What is the rate of return on the capital relative to its financing costs? Deficits are important. But they don't tell you most of what you want to know about fiscal policy.

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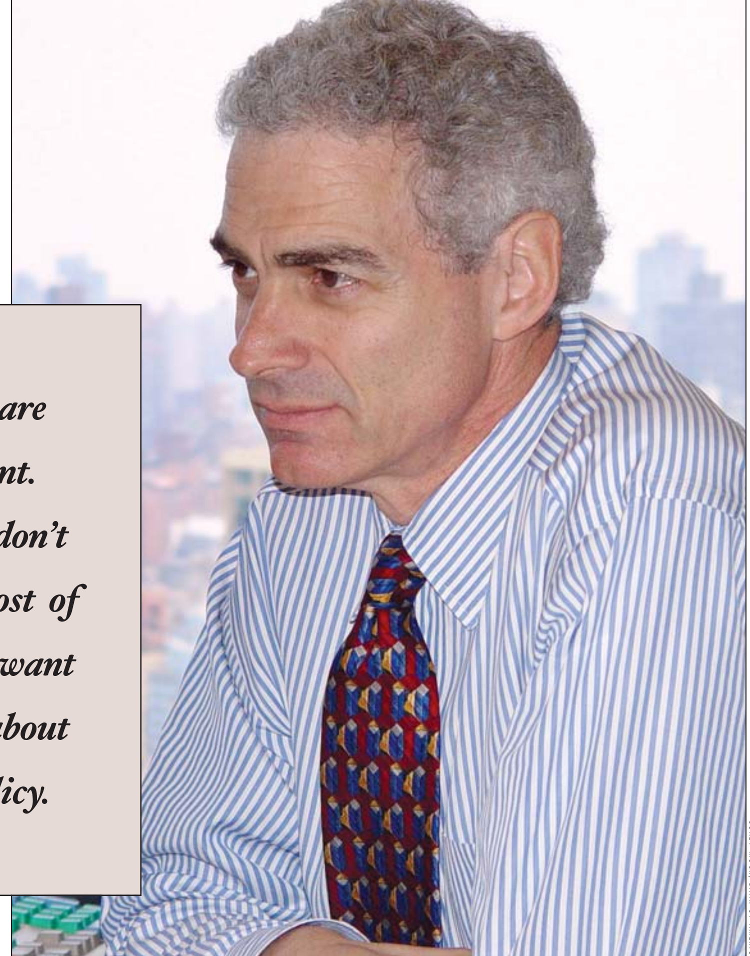

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I would revise Europe's Growth and Stability Pact by adding two new criteria: caps on spending-to-GDP and taxes-to-GDP that are well below their current ratios. And to the extent that taxes are cut prior to spending cuts, which would temporarily increase deficits, the deficit criterion would be relaxed. What would this accomplish? Research shows a clear inverse relationship between government spending and economic growth and also an inverse relationship between taxes and economic growth. On the other hand, the impact of deficits on economic growth is ambiguous. These recommended changes would force EU member nations to shift their attention toward the true sources of their problems in order to achieve greater economic performance.

RF: How would you assess the performance of the European Central Bank (ECB), now four and a half years after the introduction of the euro?

Levy: My overall view is that the ECB has conducted itself well in that it has steadfastly pursued its mandate of price stability. It has clearly favored rules over discretion in an extraordinarily difficult environment in which it has tried to maintain low inflation and establish credibility. By its very nature as a supranational institution, though, it may be destined to never earn the credibility it deserves or desires because it will always be the fall guy for Europe's problems. Europe's lackluster economic performance, especially in the core of Europe, has little to do with the ECB and much to do with the excessive scope of government, anti-growth taxes, and burdensome regulatory policies.

I should note that some European nations enjoy healthy growth. But they are not in the core of the continent: France and Germany are struggling, while Ireland is doing very well. And when you compare the two groups, you see that sound pro-growth economic policies are rewarded by stronger economic performance while misguided policies, though often well-intended, result in poor economic performance. I don't think Ireland and other fast-growing countries in western Europe will serve as a model for the struggling countries of core Europe. That is asking too much. But as new nations ascend into the EU, they will become very attractive destinations for jobs, production facilities, and capital from core Europe. Core Europe's policymakers will then respond to the political pressure to reform.

RF: There is debate among economists about the effects that budget deficits have on interest rates. What is your view?

Levy: The empirical research does not give us an unambiguous answer on the relationship between budget deficits and interest rates. As an economist working on Wall Street who follows the markets day to day, it is absolutely clear that interest rates are driven primarily by economic performance and inflationary expectations. If deficits do, in fact, affect interest rates, their impact is relatively minor. Just look at history. In recent years, we have seen a dramatic shift from budget surpluses to huge deficits, and interest rates have fallen to 40-year lows. During sustained periods of the 1990s, rates were rising as deficits were falling sharply. It's interesting how certain notions persist among financial market participants and the public even though they are not supported by hard evidence. The idea that deficits strongly affect interest rates is one case; another is the Phillips Curve notion that there is a tradeoff between unemployment and inflation.

RF: You have been analyzing Social Security for more than 20 years. During that time, the program's fiscal problems have become increasingly clear, inspiring many reform proposals. How would you recommend reforming the system?

Levy: The unfunded liability for Social Security overwhelms current cash-flow deficits; this has not changed. I think you need to deal with this on several fronts. First, you need to remove disincentives to work. The elimination of the Social Security earnings test, for instance, was very favorable. Second, you need to increase the average age of retirement in order to receive full benefits. Third, I would favor a partial and gradual privatization of Social Security with income supports to help low-income people.

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The arguments against privatization aren't particularly convincing. Some have claimed that ordinary people just aren't smart enough to invest their own money. I work for an organization with approximately 150,000 employees spread throughout the United States with a wide variety of educational and economic backgrounds. They seem to have little difficulty with their retirement plans and determining how to allocate their assets into investment funds. Another claim made by opponents of privatization is that Wall Street favors privatization because it would benefit at the hands of workers. This is simply wrong. Wall Street is a very competitive place, and the management fees of the big mutual funds are below the administrative costs of the Social Security Administration. When you cut through all the smoke, the real issue is that opponents of privatization want Congress to maintain the power of the purse, and they don't want that power reallocated to private households. This theme of who controls national resources is a common theme in the debate about a number of fiscal issues.

RF: Does deflation pose problems for monetary policy that are substantively different from those associated with fighting inflation?

Levy: Let me say at the outset that I don't see destabilizing deflation as a major threat and I think the Federal Reserve has overstated the concern about it. Currently, I think three questions about deflation are relevant. First, under what conditions would it occur? Second, would it be destabilizing? Third, if it occurred, could you get out of it?

In my mind, just as inflation occurs when you have excess demand relative to productive capacity, deflation occurs when you have insufficient demand relative to productive capacity. With nominal GDP well above productive capacity, there is sufficient aggregate demand. Currently, even though the recovery has been sluggish, nominal spending has grown 3.8 percent in the last year, the Fed is pursuing a monetary policy that is easy by any measure, and the U.S. dollar is falling. The probability of a persistent decline in the general price level is very, very low. If deflation were to occur, would it be destabilizing? Not necessarily. The prices of many goods are falling because of positive supply shocks and technological innovation, while the prices of services are rising at a 3 percent pace. That's not destabilizing. In this regard, history is instructive. Certainly, the Great Depression was associated with deflation, but falling prices were a symptom of other problems. Other episodes of mild deflation have been associated with strong growth. As for the third issue, Japan has had trouble getting out of deflation, in large part because of the Bank of Japan's misguided policies and the dysfunctional banking system that has muddled the channels through which monetary policy affects aggregate demand. But in the United States, monetary policy is accommodative and the banking system is very solid and very well-capitalized. The zero nominal bound on interest rates would not inhibit required monetary easing. So there are big differences that would permit the United States to deal with the problem much more successfully than Japan.

RF: The state of monetary policy has changed dramatically since Allan Meltzer and Karl Brunner founded the SOMC in 1973. How does that change the job of the SOMC and the focus of its meetings?

Levy: Let's consider two major changes since the SOMC was founded. First, inflation has fallen dramatically from its high levels in the 1970s to close to zero. Second, in sharp contrast to 1973, virtually everybody now agrees that in the long run inflation is a monetary phenomenon. The SOMC was founded because Meltzer, Brunner, Anna Schwartz, and other early members were frustrated that policymakers didn't really understand what drove inflation.

Now, with low inflation, the focus of the SOMC has changed. In many ways, our focus has broadened to cover many issues beyond monetary policy. We discuss fiscal policy, trade policy, and a whole host of headline issues where the public debate is misguided. When I joined the SOMC in 1983, I focused on fiscal policy, and now I also contribute to the committee's thinking about the economic forecast and monetary policy. Perhaps the SOMC's role has been diluted because the Fed has followed largely the right prescriptions and the battle against inflation has been temporarily won. That's a big plus for economic performance, but there are still important issues.

Consider the issue of inflation targeting and the ongoing debate between rules versus discretion. I believe Alan Greenspan has been an outstanding Chairman — the best ever — but you have to ask: What happens next? Will the next monetary regime have the same skills and luck? I think now is the time to make institutional changes and establish guidelines, so that the recent success is not transitory. I strongly favor inflation targeting.

RF: Much of your early work focused on the economic effects of the initiative process, specifically tax and spending limitations. We are approaching the 25th anniversary of Proposition 13 in California, which limited property taxes in that state. Looking back, would you judge it to be a success? And, more generally, has the initiative process lived up to its promise and moved policy in a positive direction?

Levy: In the 1970s, inflation was rising, pushing people into higher tax brackets, and the state's tax receipts were soaring. That led to a ballot initiative in California to limit both taxes and expenditures. It failed but on the rebound an initiative to cap property taxes, Proposition 13, was enacted. It may have contributed marginally to keeping a lid on the scope of government. But it wasn't really a well-conceived law and it created unintended distortions. For instance, by limiting property taxes, Proposition 13 drove up property values and led to increases in other taxes. In contrast, the tax-and-expenditure limitation, though very simple, would have been much more successful in rationalizing government spending programs and would have avoided many of the unintended distortions.

Fiscal policy on the state level now is extremely disappointing. In the 1990s, when the economy was expanding more rapidly than its long-run trendline and tax receipts were accelerating sharply, federal policymakers generally held the line on spending, but many state and local elected officials viewed the higher tax receipts as an opportunity to put in place very expensive programs. Since then, tax receipts have fallen dramatically, and now the states are running big deficits. To a large extent, this reflects fiscal mismanagement. What happens now? I'm very concerned that some portion of the deficits at the state and local levels will be closed by tax increases. Those increases could be sizable and could offset the stimulus provided by the federal tax cuts, while at the same time validating those costly new spending initiatives. The economy's long-run potential growth may eventually be constrained by the sharp rise in defense spending and the rise in taxes at the state and local level, which involve more government absorption of national resources that will crowd out private consumption and investment.

RF: Which economists have influenced you the most?

Levy: I have been fortunate to have worked with and learned from a number of economic scholars. Of course, Allan Meltzer has been a guiding light for me ever since I joined the SOMC. Other past and present SOMC members, like Bill Poole, currently the St. Louis Fed President, have made strong impressions. Bill Niskanen has been very influential. And I must add a non-economist to this list: the late political scientist Aaron Wildavsky, who was Dean of the Graduate School of Public Policy at Berkeley. **RF**

Mickey Levy

➤ Present Position
Chief Economist, Bank of America

➤ Previous Positions
Analyst at the American Enterprise Institute (1978-1982) and the Congressional Budget Office (1975-1978)

➤ Education
B.A., University of California, Santa Barbara (1972); M.P.P., Graduate School of Public Policy, University of California, Berkeley (1974); Ph.D., University of Maryland (1980)

➤ Selected Publications
Author of numerous book chapters and articles in such publications as the *Journal of Monetary Economics, Journal of Risk and Insurance, National Tax Journal, Cato Journal,* and *Milken Review*


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