

An Interview with Nobel Prize Winner Kenneth Arrow

“This is the best international economy ever”

**Yes, there are some imbalances, but positive elements outweigh them.
The ‘70s with their vicious inflationary spiral are not coming back.
And the dollar, hopefully, will adjust gently.**

Born in 1921, Professor Arrow was a child during the roaring ‘20s, a teenager during the Depression, and a young man during the Second World War. In other words, a giant of his discipline and a man with life-long experiences gathered from a range of real economic situations. Therefore we are quite happy to listen to what he has to say. And what he says is that the international economy is in enviable shape. Better than in any other period in which he has lived. Market participants, you may want to hear his words on the dollar and inflation.

Some say that this is the best international economy in at least a few generations: the opening up of China and India, technological improvements, and a period of relative peace compared to the past mutually reinforce one another to produce non-inflationary growth. On the other hand, others argue that there are a lot of imbalances, as shown by the size of the US current account deficit, and therefore we are on the verge of some kind of crisis. What is your view?

“I lean towards the former scenario. Of course, there is no perfection and for instance, the US current account deficit is a big problem. But overall I think the former statement depicts better prevailing conditions. The two most populous countries in the world have been increasing their income at a rate not seen in

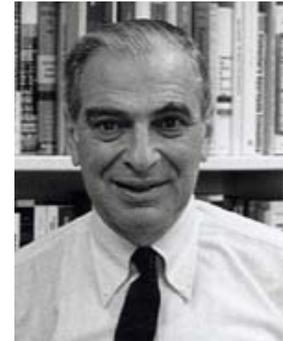
the last century. And the large and growing magnitude in trade flows attests to the degree of specialization.”

Of course this helps to keep inflation under control...

“There is no question that cheap imports help to satisfy excess demand and to keep down the price level. I was born in 1921, and it is difficult to find a period when there has been so little inflation internationally.”

Yet, the press has noted some similarities between now and the ‘70s. The American twin deficits, a bull market in commodities, and the need to finance the war on terrorism offer fertile ground for inflation. Do you share these fears?

“No, I don’t. Back in the ‘70s, an inadequate monetary policy led to runaway inflation. The Federal Reserve, to some extent, did not pursue its obligations. I am afraid that



Professor Kenneth J. Arrow

Kenneth Arrow is the youngest person ever to receive the Nobel Prize in Economics, at age 51, for “pioneering contributions to general equilibrium theory and welfare theory.” He once said, “the idea that a society has to be responsible for all its citizens, those who do well and those who do not, is really a precondition of a good society.” His first intellectual passion was mathematical statistics, moving thereafter to economics.

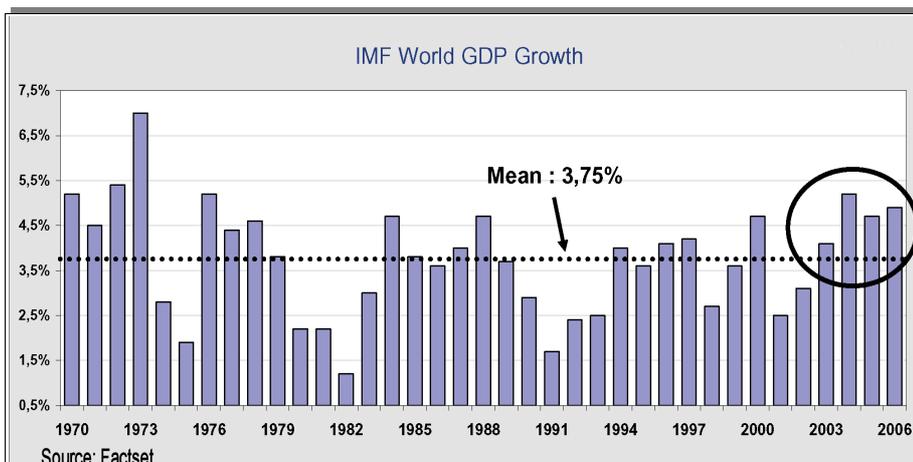
Arthur Burns, the Chairman of the Fed, who by the way was a former professor of mine, was too politically involved with the Administration to do what Chairman Volcker did ten years later.”

That is your way of saying that you trust the Federal Reserve of today, isn’t it?

“Yes, I think Bernanke (the current Chairman of the Fed, ed. note) is conservative. Major central banks around the world have a strong anti-inflationary bias.”

What about the need to finance a strong military posture in confronting what George Bush considers the terrorist menace?

“It is true that defence spending is rising, but I have seen the Second World War, the Vietnam War, and the Cold War. What we have now is still manageable, economically speaking. At the same time, the overall public deficit is worrisome but not huge. Thus, I am inclined to be optimistic: with good central banks we are not going to experience the ‘70s again.”



“The International Monetary Fund has revised up its world GDP growth estimates from 4.3% to 4.9% for this year and from 4.4% to 4.7% for 2007. If the IMF is right, the world economy will post 4%-plus growth rates for five years in a row, something it has not done for the past 35 years.”

But inflation is higher than they say



Bill Dunkelberg, the man who pays attention to small-businesses

He is William Dunkelberg, the chief economist of the National Federation of Independent Business, an advocacy group representing 600,000 small businesses in the United States, and he believes that inflation is noticeably higher than officially stated.

"Our members declare they have been raising the prices of goods and services. Inflation based on our models, which hinge on what small businesses are actually doing should be higher." "The fact is" says Dunkelberg, "that housing accounts for over 30% of the consumer price index. Now, you may conclude that because there has been a boom in the housing sector, this part of the consumer price index has been bubbling. On the contrary, the opposite is true: as professional economists know, the government calculates inflation in real estate following the dynamics of rents. The problem, now, is that rental vacancy rates are at record levels on account of high ownership rates, and in turn this keeps rents low, stabilizing the reported cost of life."

Dunkelberg continues, "You can judge for yourself. If you believe that dwellings' values have been rising dramatically and you call that inflation, then the dynamics of prices is faster than the official figures." Dunkelberg says that, according to his calculations, core inflation, namely inflation excluding energy and food, is as high as 3-3.5% compared to 2-2.3%, which is the accredited number.

"However," he adds "the Federal Reserve has already tightened enough to slow the economy down and mitigate price pressures. Therefore, perhaps another rate hike in June is all we need."

Let's go back to the US current account deficit and the dollar. Do you have an opinion on the prospects of the greenback?

"A natural thing would be a decline. I hope it will happen in a gradual way."

Do you fear a currency crisis?

"It is a possibility, although not the most likely one. Foreigners have been big buyers of dollar assets. But if the tide turns, for instance, because European or Asian investors perceive that the currency risk is high, holders of dollar assets might respond by dumping their liquid investments. Do not forget that foreigners hold huge amounts of US government securities, which are very easy to dump."

You mentioned it is not a likely scenario...

"Yes, because, the dollar exerts a crucial role in the international economy. This leads me to favour a gradual adjustment. However, there's an imbalance, no question. Savings are part of the problem. We Americans don't save. It's an incredible situation that China is a net investor in the United States."

Your studies have dwelt on the links between risk and security markets. What are your feelings on the many boom-bust sequences that investors, savers, and families have been experiencing in the last few years?

"To be frank, I have mixed feelings. I thought that the early expansion of the markets would distribute risks more efficiently. You can see this in the securitization of mortgages, which has advanced people's ability to buy houses. No doubt, however, that the fluctuations we have been witnessing have been greater than the fluctuations in the underlying realities and that is bad."

Several commentators, also in this magazine, have asserted there may be a

bubble in real estate...

"It is my contention that the considerable increase in housing prices has to stop pretty soon. What the pessimists fear is that when the upward pressure abates, a correction could easily turn into a rout, engendering a collapse, like in Japan. My diagnosis is that circumstances are not so vulnerable. I expect a classical correction where house prices remain stable while general prices and salaries recover."

My final question: do you share the view that the US is outperforming continental Europe because continental Europe is suffering from over-intrusion by its governments?

"Well, the expression over-intrusion is too generic. It is the specific forms of intrusions that count. It seems to me that your welfare states function remarkably well and are not at all unbearable. The labour laws are rather a problem. There is evidence that they do amplify unemployment, especially among young people. It is also striking that in Europe, few people work compared to the rest of the world."

Not bad for us...

"Productivity per hour in Europe is high, but persons at work are simply fewer. In fact, as you seem to imply, part of the story is a choice: long vacations, short weeks. Plus, involuntary unemployment. Finally, the tax structure discourages hard work and retards the growth of Europe."

Professor Arrow, thank you for your time

V.S.

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