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Replacing the Dollar

Changing the reserve currency will do little to alter a pattern of intensifying financial instability. A far better approach to global and domestic swings lies closer to home.

by Margaret L. Greene

Although the United States is at present still in a class of its own economically and perhaps even militarily it cannot avoid confronting the two great tests which challenge the longevity of every major power that occupies the "number one" position in world affairs: whether, in the military/strategical realm, it can preserve a reasonable balance between the nation's perceived defence requirements and the means it possesses to maintain those commitments; and whether, as an intimately related point, it can preserve the technological and economic bases of its power from relative erosion in the face of the ever-shifting patterns of global production. The test of American abilities will be the greater because it, like imperial Spain around 1600 or the British Empire around 1900, is the inheritor of a vast array of strategical commitments which had been made decades earlier, when the nation's political, economic, and military capacity to influence world affairs seemed so much more assured. In consequence, the United States now runs the risk, so familiar to historians of the rise and fall of previous Great Powers, of what might roughly be called "imperial overstretch": that is to say, decision-makers in Washington must face the awkward and enduring fact that the sum total of the United States' global interest and obligations is nowadays far larger than the country's power to defend them all simultaneously.

—Paul Kennedy, "The United States: the Problem of Number One in Relative Decline"

The United States still has much to contribute as all of our countries navigate these uncertain times.

Kennedy's comments about the United States relates to trends that occur over the long sweep of history. It is obvious that all of the glorious civilizations of the past have been replaced, with the passage of time, by something else. Even if something similar were happening to the United States now, it might be difficult to discern, given the need to distinguish the normal ups and downs of a country's performance from the developments that are important enough to establish a fundamentally new trend.

Moreover, a question of leadership depends not only on what happens within what Kennedy calls the Number One country, but what is also happening elsewhere. The turmoil in the Middle East and the tragic events in Japan currently reflect and will ultimately result in further changes. And just as some of these events would have been unimaginable a few weeks ago, so too it is nearly impossible to gauge the enormity of the changes and challenges that may be ahead.

As an American, I believe that the United States still has much to contribute as all of our countries navigate these uncertain times.

I also believe that an open society with a market-based economy and a representative government is best situated to adjust to change and to benefit from any new opportunities that these changes might present. In fact, it can be the synergies from this process that unlock creative solutions and provide new leadership potential. So I am not prepared to accept the proposition that any particular outcome is inevitable for the foreseeable future.

I would note that Kennedy wrote

Author **Margaret L. Greene** served as senior vice-president of the Foreign Exchange and Research Departments and secretary of the Foreign Exchange Committee of the Federal Reserve Bank of New York. This article is adapted for publication from a March 23, 2011, presentation in Zurich at the Progress Foundation's 32nd Economic Conference.

that piece in the mid 1970s, a very difficult time for the United States. We were still living in the shadow of the Viet Nam war. We had disappointing economic growth together with record rates of inflation. Our currency was under siege in the exchange markets. The efforts to deal with the dollar led to a spreading of our inflation to other countries through foreign exchange market intervention. I can understand how someone might have had serious doubts about the continuance of United States' leadership at that time.

In the end, we turned the situation around. We tackled our inflation problem. Together with other central banks, we moved to inflation targeting for guidance on monetary policy and relaxed the exchange-rate restraint so that countries had the option to conduct monetary policy more clearly toward their own internal objectives. The United States was fortunate to have a courageous chairman at the Federal Reserve and inspired leadership from a president who brought us back to our core values, helped us regain our self confidence, and could faithfully project our values to the rest of the world.

I would admit that, once again, the United States is going through what the British would call a "rough patch." Some of the challenges are monetary or financial. Some are more political. It is too early to tell whether we will be able to turn the situation around again this time.

All I can tell you is that it is impossible to watch television or read the newspapers in the United States without being impressed that people are really engaged in trying, and these efforts are taking place at all levels of government.

Individuals with no previous interest in political activity are working within the system to demonstrate, run for office, or find other ways to be involved. For me, that is more a strength than a weakness.

Nonetheless, there is now, as there was in the late 1970s, a growing desire to find a solution to reverse an intensifying financial instability.

In this paper, I consider whether changing the reserve-currency mechanism we now have could be a solution. I conclude the answer is no.

There is no alternative but to address the fundamental source of this instability globally—and that source may be our own behavior. I will end by making some suggestions about what more I would like to see the United States do either to reduce instability or, if we cannot do that, find ways to limit the damage.

Financial instability is not new. The 2005 book, *Manias, Panics, and Crashes* by Charles P. Kindleberger and Robert Aliber, chronicles financial crises for almost four centuries, from 1618 to 1998. It is clear that no country is exempt from financial turmoil. The crises examined in this book occurred all around the globe and involved countries with every conceivable type of financial structure. The authors suggest there was a relatively quiescent period between the end of World War II and the late 1960s.

Is there another country with a currency that meets these requirements and has a better long-term record?

But, in the latest edition, Kindleberger and Aliber assert many times and many ways that the subsequent 30 years were the most turbulent of all. They describe the years since the late 1960s as "unprecedented" in terms of number, scope and severity and infer that the lessons of history were either forgotten or slighted. The authors wrote that description before the events of the latter part of this decade. Imagine how they might have described them.

If the authors' description of the period since 1968 is correct, and if the latest episode is even more extreme, it is understandable that there is a yearning for some change in the system to curb the instability. Proposals for a "new" reserve currency or an "international lender of last resort" reflect a real concern.

But would a change in the reserve currency structure improve the chances for financial stability?

What currency or currencies could be expected to serve in the capacity of a reserve currency?

A reserve currency must meet the minimum requirements of a medium of exchange and store of value. To be a medium of exchange, the currency would have to be freely convertible and already widely used in international transactions. To be a store of value for both central banks and the private sector, the country of issue of the currency would have to have a well developed financial structure and an internationally acceptable record of economic and financial performance.

Now, I am one of those who is disappointed with the United States' recent record. But is there another country with a currency that meets these requirements and has a better long-term record?

These criteria already limit the number of currencies available currently. If the objective is to increase financial stability, I would suggest that we need to add to that list characteristics about the reserve-currency country or, in the case of a group of countries, the reserve-currency zone.

The country/zone, for example, should have a large enough and diverse enough economy to be able to absorb different kinds of economic shocks. It probably should be large enough geographically to be able to resist various climatic, natural, or environmental shocks. And certainly, it should have an open and reliable decision-making capability with a proven record of orderly transfers of power to reduce the probability of political shocks emanating from the reserve-currency center.

It is, of course, possible that over time currencies other than the dollar will emerge that fulfill all of these requirements. I can see how that might happen in an evolutionary way. It is harder for me to imagine it coming about another way—except perhaps in the face of some cataclysmic disaster in much the same way that the Bretton Woods institutions were created out of the destruction of World War II.

In any event, the financial system would have to adjust to changes in the reserve currency structure. How would that adjustment take place? The historical record is not promising.

In most cases, the existence of multiple reserve currencies has added to, not reduced, financial instability because it opens up the possibility for shifts of preferences among the currencies at the center of the system. Even the replacement of one reserve currency (sterling) with another (the dollar) was a major source of financial instability for decades after the replacement had been, effectively, completed.

These concerns have led some to suggest a multilateral solution, perhaps building on the International Monetary Fund (IMF) as an institution and the Special Drawing Rights (SDR's) as a currency.

The fact of the matter is that the SDR has not been used as extensively as had been hoped when first created. That is because limits on the issuance and transferability of SDR's together with a cumbersome decision-making procedure within the IMF for managing SDR's make the SDR an unattractive asset to central banks. Even the managing director of the IMF has recently acknowledged "technical hurdles" involving the use of SDR's as a replacement for dollars.

There are undoubtedly ways that the IMF could play a larger role going forward. "Technical" changes probably could be made to make SDR's more attractive assets for central banks.

There probably could be ways to enhance the IMF's General Agreements to Borrow and the central bank swap networks to provide more backstop financing during a crisis. The IMF might even be able to set up a "substitution account" whereby central banks that wished to divest themselves of dollar assets could exchange dollars for SDR's on the IMF's books.

There also may be ways that the IMF can draw on its extensive understanding of its member countries' economies and financial systems to shore up the overall macro-prudential effort.

Still, the underlying limitations of an asset created on the books of a multilateral institution are unlikely to change easily or soon. Sovereign countries give up responsibility for their national currencies and financial systems most reluctantly. Moreover, decision making within multilateral institutions is usually not quick enough, nimble enough, nor sufficiently removed from national political pressures to address issues of monetary and financial stability.

To get at the source of the instability, we need to understand how manias develop.

So, at least for now, there are no ready alternatives to the dollar as the reserve currency of the system. I would go further and assert that the problem is not one of structure of the monetary system. We need to look elsewhere to find the source of our instability.

That brings me back to Kindleberger's and Aliber's thesis: that the major financial crises all seem to follow a similar pattern of mania, panic, and crash. What differentiates a boom-bust experience from the normal vicissitudes of the business cycle is the development of a mania. Asset bubbles are a manifestation of a mania.

So, to get at the source of the instability, we need to understand how manias develop. Kindleberger and Aliber suggest two types of mechanisms that trigger a mania by opening up previously unexpected opportunities for investment or trading profits.

One is some sort of exogenous shock to expectations such as war, supply shocks, or technological revolution.

The second is some sort of endogenous process at work that helps to tip the balance towards mania as the expansion matures. Kindleberger and Aliber explicitly mention two: "maladroit" monetary management and financial deregulation.

The world has had a good share of such events during the past 40 years. In the United States alone during this last episode, we had many of these characteristics. Monetary expansion was too much for too long. We had financial deregulation that left some elements outside of the regulatory rubric.

We also had a new technology, financial modeling, that market participants and regulators alike used to define capital requirements, to price complex instruments, and to identify systemic risk.

In the end, the models used proved to be inadequate. But by that time, the modeling had allowed financial institutions to feel more comfortable than they should have felt with separating the origination function from the processing and resolution elements of financial transactions. It also allowed them to accept a huge increase in proprietary trading. Together, these developments became reflected in skewed compensation schemes.

When you consider the positive feedback effects within this scenario, one can understand, unfortunately after the fact, how the mania developed and intensified.

Should we be trying to prevent manias like these? I hope, here, the answer is yes, we should be trying to avoid manias for several reasons. They cause a misalignment of resources during the manic phase. They almost always come to a most unpleasant end. And they can be followed by a period of stagnation—sometimes a long period of stagnation—as the economy struggles to return to a more balanced orientation.

In this most recent episode, the overexpansion in many industries, the loss of production in others, and the concentration of talent in the financial sector that the United States experienced several years ago are all symptoms of an imbalance that will take time to unwind in even the best of circumstances.

Though there always will be fluctuation in the rate of growth of our economies, the large swings that are caused by manias, panics and crashes have to be costly and have a negative effect on our long-term growth potential. Moreover, having these cycles occur as frequently as in the recent past leads to a loss of confidence by the public in their governments and financial institutions. That is undesirable for all sorts of reasons.

I am concerned others may not agree that avoiding manias is a desirable policy objective. Sometimes I think manias have come to be viewed as acceptable or inevitable to ensure a growing global economy. How else are we to understand Federal Reserve Chairman Bernanke's *Washington Post* op-ed last November where he explained the mechanism whereby his quantitative easing policy will affect the economy? He wrote:

> Lower mortgage rates will make housing more affordable and allow more homeowners to refinance. Lower corporate bond rates will encourage investment. And higher stock prices will boost consumer wealth and help increase confidence, which can also spur spending.

It could be worse. We could have become a society that think manias or asset price bubbles are actually desirable. As the global economy has grown, wealth has been created so that, for example, middle class Americans are more likely to have portfolios of real and financial assets.

In fact, personal income receipts on assets, which for the United States as a whole was negligible in 1960, started rising in the early 1970s and then took off in the late 1970s. Today, individuals can trade foreign exchange, trade the securities in their 401K accounts, or refinance their mortgage by just using their computer in their own home.

An underlying behavioral fundamental might help to explain the increase in financial instability.

Has this increase in individual holdings of assets changed societal behavior so that we are more accepting of, maybe even becoming addicted to, asset bubbles? Politically, are asset bubbles seen as the way of throwing out the old power structure and creating new wealth?

Let us not forget that the problems surrounding Fannie Mae and Freddie Mac in the United States were not addressed because the problems were unknown, thanks to the investigative reporting of *The Wall Street Journal's* editorial page. It was because the political overseers of these institutions found it inconvenient to address them.

The problem with accepting a little bit of an asset bubble is that the record shows that manias are difficult to detect in the early stages and even harder to stop.

An essential element of a mania is that the velocity of money becomes unstable, as credit and near-money substitutes are developed to satisfy the speculative appetites. Under these circumstances, the conventional tools of monetary policy, even if applied, may not yield the customary results.

What could the authorities do? They might issue some kind of warning of events to come or take some unexpectedly strong action. But the timing would have to be nearly perfect—after the risk of a mania had become plausible, but before the dynamics of the mania had fully set in. Even then, the relevant authorities would face unpleasant outcomes. Either their actions would go unheeded, blown away by the momentum of the speculative pressures of the time. Or their actions would be effective and probably would trigger the denouement of the mania.

Even if the denouement were to be less severe than the alternative, who wants to be blamed for such an outcome? How often can we expect individuals that we put in positions of authority to have the intuition, the conviction of their intuitions, and the courage to take such risks?

Kindleberger and Aliber may have identified the proximate sources of mania as exogenous shocks to expectations or endogenous disturbances caused by monetary mismanagement or financial deregulation. And the increase in instability during the past four decades or so may reflect an increase in such events. But in addition there is an underlying fundamental that is behavioral that might help to explain the increase in financial instability during the past several decades.

As wealth has grown and a larger percentage of the population has shared in that increase in wealth, the monetary and regulatory authorities are under more pressure on the margin to deliver opportunities for trading gains and capital appreciation at the expense of securing income growth and investment in plant and equipment. During the inflation fight of the 1970s, it was the middle class of the United States that came to realize their financial future and societal stability were threatened by the inflation and supported the Fed's efforts to combat it even though the process was painful.

If this source of political support is becoming less secure, then to have any hope of restoring more financial stability to the global economic system we are going to have to find ways increasingly to insulate the monetary authorities from the political pressures coming from the asset-bubble cheerleaders.

Is this development unique to the United States? Probably not. But the United States should be held to a high standard of monetary management.

As long as the dollar remains the major reserve currency of the international monetary system, monetary and financial conditions in the United States have a major impact on other countries. Responding to the events of the last several years, Congress and the authorities have taken a number of actions and are working on others.

I do not intend to give a comprehensive critique of all of these actions. Instead, I will just make one general comment and then mention a few ideas that I think warrant further consideration.

The general comment is this. Effective monetary and macroprudential management requires the participation of market participants, the existence of an apolitical monetary/supervisory authority, and a mechanism for political accountability of the monetary/supervisory authority. The relationships among the "bankers," the "central bank," and the "politicians" will always be uneasy, as any one will imagine that the other two are ganging up against him.

This tension is constructive; it is what keeps each group from overstepping their respective boundaries. The process of these three groups working together is like a three-legged stool. For it to stand on its own, the legs have to be in balance. Developments in the United States, including the recent passage of the Frank-Dodd legislation on financial regulation, have had the effect of extending the leg of the politicians at the expense of the other two.

Now for a few suggestions. First, the authorities should tell the public the truth about what caused this latest crisis.

It is probably too much to ask for an objective and serious review of all the elements that combined to create the crisis we experienced. It is so much easier and convenient for our political leaders to lay the blame on others.

Authorities proved unable to keep abreast of the evolving vulnerabilities of the financial system.

This diverts public attention on the role policy choices and political institutions might have played. It saps support for the actions that might be appropriate to reduce the probability of a repeat performance. And it leaves a false impression that everything has been put to right so that a new bubble need not be feared. The public deserves better. It needs to know what really happened.

The two biggest culprits being presented to the public are bankers and foreign countries with large current-account surpluses.

The bankers are blamed for being greedy, reckless, and devious about the way they got the public rating agencies to give *Good Housekeeping* seals of approval for the securities they were asked to evaluate. By putting the bankers in front of the public as enemy #1, the politicians portray themselves as innocent bystanders at the time of the crisis and the source of protection from any reoccurrence afterwards.

Now, we all know that blaming the bankers in time of financial distress is nothing new. Certainly in this instance bankers were far from blameless. They took undue risks, had inadequate measures of the risks they were taking, and leveraged their institutions excessively.

But the bankers were operating in an environment in which government authorities are supposed to establish the rules of the game. As it turned out, these same authorities proved unable to keep abreast of the evolving vulnerabilities of the financial system.

The United States government was exerting pressure on the banking system to provide adequate financing to fulfill the nonmonetary policy objective of increasing home ownership. And these same government authorities were accepting of well-known breakdowns in lending practices.

Now let's turn to the foreign countries. Some are accused of hijacking the international monetary system by managing their exchange rates so as to run chronic current-account surpluses. In this way, they steal American jobs and flood the United States with too much credit.

It is a separate issue whether another country is pursuing an appropriate policy objective for itself. Even if it is not, the monetary system has to be elastic enough to accommodate individual countries' preferences for reserve assets.

In this case, it was the United States that was unable to find a way to channel the capital inflows effectively to finance productive investment. Instead, the United States was content to accept excessive spending on housing and consumption. In doing so, it squandered the opportunity to use the inflows to build up the productive capacity the country is going to need to pay off these increased liabilities.

To the extent these capital inflows occurred, they bolstered the dollar in the exchange market. As a result, whatever the actual trend or movements there were for the dollar's exchange rate, the dollar was stronger than it otherwise would have been.

A corollary of this observation is that domestic inflation would appear less virulent than otherwise would be the case. Import price inflation would be lower to the extent that the dollar was stronger than justified, and domestic producers of close import substitutes would find it difficult to pass on to their customers rising input prices. This result would become important to the extent that the central bank was making monetary policy decisions based at least in part on observed measures of domestic inflation.

That brings me to the second point. The Federal Reserve should accept a more cautious approach to monetary policy and broaden the scope of what it looks for in assessing a developing situation. To the extent that it is willing to risk an asset bubble to expand the economy, the Fed will have to speed up the detection of an impending problem as well as the decision making about how to respond.

Put another way, if there is a history of fast driving and if we are not confident that we can keep the traffic safely on the roadway, we need to have a strong braking system.

The Fed's record the last time around is not reassuring. The pressures then building up were not reflected in the target variable the Fed has been using—the Consumer Price Index less food and energy prices—but in other ways.

Did the Fed become too complacent with its relative success previously in keeping the inflation rate within bounds that it did not see what was happening elsewhere? Or, did the Fed see what was happening clearly enough but was unable to resist the political pressure and/or popular addiction for the positive wealth effects that rising asset prices were producing?

Either way, was the concentration on one signal variable a disservice in this instance?

A 2010 study published by Robert Pavasuthipaisit in the *International Journal of Central Banking* suggests that it was. He writes that taking account of asset-price movements can improve monetary policy decisions and that it would have been optimal for the Federal Reserve to have increased the weight of asset prices in its rate-setting decisions prior to and during the subprime mortgage crisis of 2007.

In any case, we should broaden the horizons of what policy makers must be held accountable for in order to forestall future economic and financial instability.

We should broaden the horizons of what policy makers must be held accountable for to forestall future instability.

Are we going to miss the signals of stress and fail to respond appropriately again? Just as an exercise while working on this paper, I took a look at the headlines for one day (February 28) in the *Wall Street Journal* and *New York Times* to see if there was evidence of a bubble brewing. And what did I find? A superabundance of cash and credit, a supply shock, unexpectedly high values for "hot" deals, labor market pressures in "hot" sectors (even at a time of generally high unemployment), and a new synthetic derivative product.

If these news items do not suggest a bubble brewing, they sure ought to be seen as a warning. With the amount of high-powered money still in the system from the panic of 2009, it is going to take timely and effective action to keep things under control.

My third suggestion is for stronger capital requirements. The greater the tendency for fast driving, the stronger capital requirements must be to protect the public from such recklessness.

The most recent episode demonstrated that when the financial system is under stress, the only capital that matters is equity capital. There does now appear to be more recognition that capital requirements need to be higher, higher still for systemically important firms, and composed importantly of equity capital.

There are other components also being discussed. The difficulty is that it takes time to craft such a program, especially if it is to be a program that can be expected to be fairly applied across jurisdictions and extend to non-banks that potentially pose systemic risks.

Some of the proposed requirements appear quite complicated, an attribute which hinders both compliance and enforcement. Moreover, delays in implementation could be lengthy. My concern is the longer we wait to implement new capital requirements, the greater the risk that it not be done at all or that the process gets subverted once again so that the program loses much of its potential effectiveness.

Fourth, we need to insert enough of a sense of risk for the institutions that might be too big to fail or too interconnected to fail. We don't appear to have done so. The big institutions are even bigger now than before. And we just witnessed the spectacle of having the head of the Federal Deposit Insurance Commission (FDIC) warning the banks that she would be tougher next time.

One possibility would be to set up *by statute* the requirement that any institution receiving a future bailout would be broken up into several parts and, once stabilized, sold as separate parcels not to be recombined by the buyers. Such a provision would increase the disincentive to be bailed out. For those institutions that need government assistance, it would change the character of the institution in a way to reduce the possibility that it would pose systemic risks if it were not bailed out during a subsequent crisis.

Finally, reform of the Federal Reserve System should go further in at least two respects. My suggestions reflect concern about one of the outstanding trends in the Federal Reserve during the past decades: the growing concentration of power of the board of governors in Washington at the expense of the 12 regional Federal Reserve Banks.

Part of the impetus for this trend was the need to achieve efficiencies, avoid duplication, and reduce costs in the provision of central banking services.

But the result of pursuing these operational objectives is to reduce the effectiveness and importance on the policy side of the regional strength that had been a hallmark of this institution.

The regional banks, with their boards of directors and the boards of directors of their individual branches form a network of communication that informs the policy deliberations and helps to garner support for sometimes unpopular policy decisions.

A number of the regional banks have in their research departments their own unique analytical approaches for evaluating economic and monetary conditions and policy options. This diversity helps to reduce the chance that the central bank gets unduly influenced by any one model or interpretation of the policy issues under consideration.

Having the 12 Federal Reserve Bank presidents be in a position to challenge the five board members in the Federal Open Market Committee (FOMC) not only helps preserve the interests and points of view of different parts of the country. It also helps counter the intense political pressure that is ever present in the nation's capital city. A couple of reforms come to mind.

First, impose a term limit for the chairman of the Federal Reserve and for the newly created post of vice chairman for supervision who would also be a member of the board of governors appointed by the president.

Second, include all 12 Federal Reserve Bank presidents on the new Financial Stability Oversight Council in much the same way that they now serve on the FOMC. This move would enhance the position of a Fed president while greatly strengthening the macro-prudential process.

Changes are more apt to occur over time in response to changing economic and political circumstances.

As Alan S. Blinder forcefully argues in a recent essay, when a systemic problem erupts or threatens, the lender of last resort will be crucial to the solution. Beefing up the representation of Federal Reserve practitioners is essential both to the process of identifying a potential problem and to dealing with any immediate rescue.

The Reserve Bank presidents bring a dimension to the table that is different from what the members of the board can contribute. The presidents are the ones that deal with the financial institutions involved and are knowledgeable about the "internal plumbing" of the financial system. That they are not on the Financial Stability Oversight Council is, to me, unconscionable.

The search for a fundamental reform of the international monetary system reflects anxieties about the soundness of the system, anxieties that are justified by recent events.

But real changes in the monetary system are unlikely to come easily or soon. Such changes are more apt to occur over time in response to changing economic and political circumstances and, in reality, have to take a form consistent with those realities.

Financial instability may be more intense now than in previous eras. But instability has occurred in so many different financial structures that it is hard to imagine that it would not continue to be a threat no matter what changes are made institutionally to the monetary system.

International institutions can help. But there is no substitute for individual countries maintaining a vigilant watch for signs of approaching instability and having the tools in place and the willingness to use them in a timely fashion.

This responsibility is the greater for countries that are the center of the international monetary system, and I have made some specific suggestions for further actions that could be taken in the United States to keep alive the hopes that we can do a better job in the future.

But in a world where political pressures are increasing to provide more opportunity for trading profits and asset-price appreciation, the risks of a policy error also increases. As we have experienced, the consequences can quickly spread around the world.

Every country has to be on the alert for developing financial instability. This responsibility requires a continuous process of adjusting to constantly changing economic, financial and market conditions.

There simply is not a magical one-time fix that will make the world safe from the ravages of future manias and asset-price bubbles.

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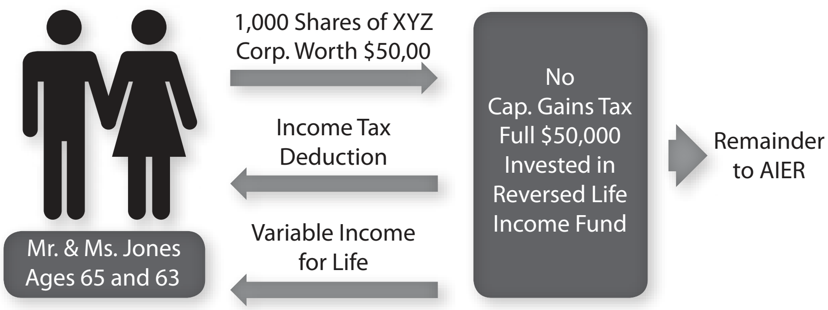

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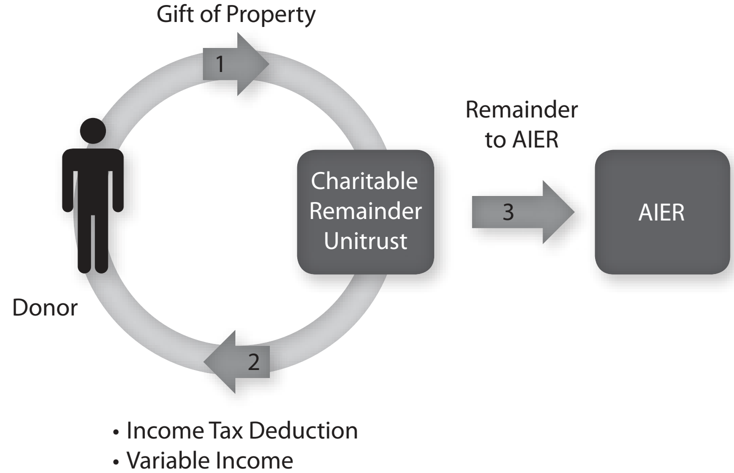

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