Scholars met at the Levy Institute on October 18 and 19 to discuss their latest findings on economic mobility. The conference, organized by Senior Scholar Edward Wolff of New York University, encompassed sessions on a range of issues, from the effect of education on intergenerational mobility to the persistence of hardship over the life cycle.

The participants included international experts from government, the nonprofit sector, and academia. Audio of the conference can be accessed from the Webcast Archive page of the What’s New section of the Institute’s website.

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The Levy Economics Institute of Bard College, founded in 1986, is a nonprofit, nonpartisan research organization devoted to public service. Through scholarship and economic research it generates viable, effective public policy responses to important economic problems that profoundly affect the quality of life in the United States and abroad.

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Session 1. Mobility in Economic Well-Being

The session was chaired by Levy Institute President DIMITRI B. PAPADIMITRIOU. Presenting papers were JONATHAN D. FISHER of the Bureau of Labor Statistics (BLS), CONCHITA D’AMBROSIO of Università Bocconi, Milano, and DIW Berlin, and JOACHIM R. FRICK, DIW Berlin. The discussants were LARS OSBERG of Dalhousie University and THESIA GARNER of the BLS.

Fisher pointed out that the ability of individuals to move between income classes might be less important than their mobility between different levels of consumption. Economists believe that patterns of consumption may be different from those of income, primarily because economic theory suggests that consumers tend to maintain a relatively steady level of expenditures, even as their incomes vary. Measuring mobility using estimates of consumption, instead of income, is thus an interesting exercise. There is no data set that follows the consumption expenditures of specific individuals over time, however. Fisher and his coauthor, David S. Johnson of the BLS, were able to surmount this obstacle by constructing estimates of consumption for the participants in the Panel Study of Income Dynamics, which did follow respondents over a number of years. Their method was to measure certain variables that are correlated with total consumption, such as home ownership. Fisher and Johnson then estimated the probabilities of consumption increasing or decreasing over time. For example, an individual whose consumption expenditures were in the lowest fifth of the population in 1984 had approximately a fifty-fifty chance of leaving that group by 1999.

Many observers have attributed the recent economic slowdown in Germany to the costs of unification. D’Ambrosio and Frick looked at how the same events shaped mobility within German society. On average, incomes gradually converged in the two parts of Germany from the time of unification until about 1997. After that, the gap between the two regions increased, and a wide disparity remains. The process of economic mobility within eastern Germany had the effect of reducing overall inequality among former East Germans. In the western part of the country, mobility had less of an equalizing effect and may have even increased the skew in the income distribution. (This indicates that in the west, those near the top improved their lot at the expense of their poorer compatriots.) D’Ambrosio and Frick also examined self-reported satisfaction, and their results suggested that eastern Germans grew happier, not just richer, during the period after unification.

Responding to Fisher and Johnson, discussant Osberg pointed out several difficulties in accurately inferring consumption expenditures from data on income. He remarked that although the authors defined mobility as movement relative to the rest of the population, such movement could also be interpreted as a form of risk. Garner, discussant for the presentation by D’Ambrosio and Frick, described the historical precursors to the current practice of measuring well-being subjectively and the trend toward such measurement in studies of labor markets. She suggested attempting to break down total measures of mobility into components related to particular demographic changes.

Session 2. Mobility in the Labor Market

Senior Scholar EDWARD N. WOLFF chaired the session. ROBERT HAVEMAN of the La Follette School of Public Affairs, University of Wisconsin—Madison and BRUNO CONTINI of the Centre for Employment Studies IZA and the University of Torino gave presentations on recent work. HEIDI HARTMANN of the Institute for Women’s Policy Research acted as the discussant for both papers.

How have young workers coped with declines in their economic opportunities? Clearly, two options are to remain at home or to live alone. Haveman and coauthor Brian
Knight, of the Federal Reserve System Board of Governors, studied this issue by comparing labor market and living arrangement data for youth during two different time periods: the “good” job market years of the late 1960s to mid 1970s and the “bad” years of the mid 1980s to around 1990. Haveman presented evidence that as job opportunities for young men deteriorated in the 1980s, the men adjusted by marrying later or not at all, or, if married, by not having children, which protected them somewhat from the punishing effects of the poor labor market. Low-skilled men were the most affected by unfavorable economic conditions during the period, and, of all men, they were the ones who adjusted their living arrangements and family commitments the most. This disparity suggests a cause-and-effect relationship between economic opportunity and lifestyle choices.

Women, on the other hand, increased their earnings, an improvement that allowed growing numbers to live alone or raise children on their own. This rising tide, however, did not lift all boats; the disparities between wages for high-skilled and less-skilled women increased over time.

Whether people can move easily between classes is a question related to a theory known in the economics literature as labor market segmentation. As described by Contini, the theory posits that two different tiers exist in the labor market: a “secondary” one characterized by low pay and few ladders to a higher level, and a primary one, with relatively good pay, more contractual protections, and plenty of opportunities to advance. Contini presented evidence that U.S. labor markets are among the most segmented of a large group of Western economies. This result is based on the fact that workers who earn the least have a relatively low chance of moving into a higher income bracket, while higher earners are more mobile. When the ratio of employed workers to total population for each country was plotted in a graph as a function of the degree of labor market segmentation, a U-shaped pattern appeared. Contini suggested that this apparent relationship between segmentation and employment was due to two separate links: (1) countries with a stronger welfare state tended to have less segmented markets, and (2) labor market participation was highest in two groups of countries: those with the smallest welfare state and those with the largest. What could be the rationale for the second link? Countries with a relatively large welfare state, such as those in Scandinavia, provide ample child care and other services that allow people to work. On the other hand, where the welfare state is weakest—in Great Britain and the United States—the state provides few safety nets for those who do not work, leaving citizens no choice but to accept any available job.

Hartmann offered a more positive interpretation of the changes in women’s living arrangements described by Haveman. Declining rates of marriage may not be due to a decline in the economic fortunes of potential husbands, she said, but may instead reflect women’s increased withholding to support a family independently. She agreed with Contini that the Scandinavian countries’ extensive system of publicly provided social services (such as child care) may account for the fact that labor market participation in those nations rivals that of Anglo-Saxon countries. Hartmann also pointed out that Contini’s results suggested an intriguing difference: European women who earn low wages were more likely than those in the United States to escape the low-earnings category as they aged.

Session 3. Poverty over the Life Cycle

Research Scholar AJIT ZACHARIAS was the chair of the session. THOMAS HUNGERFORD of the Social Security Administration and PANOS TSAKLOGLOU of Athens University of Economics and Business presented papers. (Hungerford will be joining the Institute early next year as research director and senior scholar). SANDERS KORENMAN of Baruch College was the discussant.

Economic well-being involves more than income. It is important to know if other forms of hardship tend to persist throughout a lifetime. Hungerford described a study of a typical group of Americans born between 1924 and 1931. The study utilized data on several different indicators of what might be considered social or economic hardship, including receipt of welfare benefits, poverty, being unmarried, being a tenant, and living in overcrowded housing. The most important finding of the study is that most of these forms of hardship tended to be linked across the life span. For example, those who were unmarried in their 40s had a 27 percent chance of being poor or nearly poor at age 65, while only 7 percent of those who were married during their 40s were poor or nearly poor when they reached old age. Middle-aged poverty raised the probability of poverty in old age.
age by 30 percentage points. These differences were moderated, but not eliminated, after other differences between individuals such as race, gender, and education were taken into account. In many cases, the measures of persistence were particularly large for African Americans and women.

Tsakloglou presented a view of economic mobility in western Europe during the 1990s, concentrating on mobility in and out of poverty. A person was considered poor if his or her income was less than a certain percentage of the income of the typical citizen. Using new data from the European Union, Tsakloglou showed that although there was a great deal of movement in and out of poverty over time, a large proportion of citizens in each country, ranging from 58 to 78 percent, stayed out of poverty during all five years of the study. Moreover, in many countries, such as Denmark, most of those who fell into poverty were able to escape within a year’s time. On the other hand, in each of the countries, at least 14 percent of those who were poor at any given point in time were impoverished over the entire time span of the data set.

What events were likely to lead to a spell of poverty? Changes in family or living arrangement status, such as divorce, were less important in this regard than declines in income. Similarly, a rise in income was most likely to lift an individual out of poverty. The most important type of change in income for poverty exit and entry was losing or obtaining a job. Another finding of Tsakloglou’s study was the existence of a kind of poverty “trap”: individuals who were in poverty tended to stay there, even if their other characteristics (such as race) did not make them especially prone to poverty spells.

Korenman, as the discussant for this session, pointed out that Hungerford used a five-year measure of hardship in middle age, while his gauge of hardship in old age was based on a one-year “snapshot.” Fewer individuals experience hardship over an extended period of time than in any one given year. Korenman emphasized the connection between the persistence of hardship and the equalizing effects of government benefits for the aged. In discussing Tsakloglou’s presentation, Korenman pointed out the difficulty of distinguishing between two hypotheses: first, that the longer a particular individual stays in poverty, the harder it is to get out; or second, that those in poverty a long time tend to have unobserved characteristics, such as a lack of job skills, that predispose them to stay in poverty.

Session 4. Intergenerational Income Inequality

DAPHNE GREENWOOD of the University of Colorado at Colorado Springs was chair for the session. JO BLANDEN of the Centre for Economic Performance at the London School of Economics presented a paper she had written with Stephen Machin of University College London and the Centre for Economic Performance. BARBARA WOLFE of the University of Wisconsin—Madison was the discussant.

Blanden presented evidence on mobility from studies that followed the same individuals over a number of years. She focused on the picture in the United States and the United Kingdom. In the United States, mobility, as measured by the relationship between parental and child income, stayed roughly the same between the cohorts that turned 30 around 1987 and 1998. In the United Kingdom, mobility fell sharply over a roughly similar time period. Blanden examined whether changes in the affordability of education were behind the reduction in mobility in the United Kingdom. She presented evidence that parental income has indeed been a factor of increasing importance there in determining whether a child receives a college degree. Moreover, much of the decline in mobility in the United Kingdom can be attributed to increasing disparities in educational attainment.

Wolfe argued that differences in college attendance rates between the United Kingdom and the United States or from one time period to another might be due to differences in the economic rewards for completing a degree, rather than differences in the generosity of financial aid programs. She called attention to the complexity in the relationship between college attendance and a parent’s earnings; for
example, a parent may increase his or her work effort specifically to pay for a child’s education.

**Session 5. Wealth Mobility**

MARIKO CHANG of Harvard University chaired this session. RICHARD H. STECKEL of Ohio State University presented a paper he had written with Jayanthi Krishnan of Temple University. FLORENCIA TORCHE and SEYMOUR SPIELERMAN of the Center for the Study of Wealth and Inequality at Columbia University then presented their joint paper. JAY L. ZAGORSKY of Ohio State University gave the third presentation. These were followed by the remarks of discussants NGINA CHITEJI of Skidmore College and ROBERT MARGO of Vanderbilt University.

Steckel began by making some general observations on the work presented so far. He pointed out that data on how individuals’ wealth evolves over time are affected by historical context. For example, the period from the mid 1960s to the mid 1970s was characterized by declining income and wealth inequality, so that individuals may have been more mobile in that period than, say, during the 1980s or 1990s. In this case, economic mobility would merely reflect historical circumstances, rather than any general tendency to move from one part of the income or wealth distribution to another. Steckel also emphasized the importance of the difficulty in comparing studies that measure wealth in different ways or that look at two different age groups. Steckel’s own study, a joint piece with Jayanthi Krishnan, used data from the National Longitudinal Study for a time period from the mid 1960s to the mid 1970s. Steckel and Krishnan found that there was significant movement during their sample period from one decile of the wealth distribution to another, a phenomenon that mitigated the inequality found when the distribution at any one point in time was examined. Another important finding of the study is that mobility differed by demographic characteristics, such as race, marital status, occupation, years of schooling, and region of the country.

Torche and Spilerman examined the effects of Chileans’ wealth and income on their children’s economic well-being. Torche showed that resources are distributed more unequally in Chile than in the United States. Parental resources can affect children’s economic prospects in several ways. First, parents’ wealth can be transferred directly to children. Second, wealthy parents can invest in their children’s education, thus bestowing wealth indirectly. Torche dealt with these issues using a survey of several thousand male heads of household in Chile. The data support the view that parents’ economic resources, whether measured in terms of wealth or occupation, have a strong impact on how much education their children receive. Moreover, parental resources affect children’s ownership of various consumer goods, such as computers and automobiles. The two effects are closely
related: the benefit to consumption levels of having wealthy parents operates primarily through access to education. On the other hand, the children of wealthy parents tend to be more likely to have more substantial assets, such as stocks, certificates of deposit, or real estate primarily for a different reason: because they were able to pay for those assets with money from their parents.

Zagorsky presented evidence on how an individual’s race was likely to affect his or her ability to accumulate assets over time. Data show that in 2000, the mean net worth of white, young baby boomers was $213,000, while the corresponding figures for African Americans and Hispanics were $48,000 and $87,000, respectively. Using data that tracked specific individuals from 1985 to 2000, Zagorsky found that there is a great deal of mobility between levels of net worth. For example, about half of all white baby boomers who were in the lowest 10th of the wealth distribution at the beginning of the sample period had moved into the top half by 2000. African Americans in the lowest 10th did not succeed as well in escaping the lower end of the distribution, however, and those in the middle of the distribution tended to be pulled downward over time. Wealth mobility is strongly influenced by nonracial characteristics such as home ownership, but even holding those factors constant, African Americans are less likely to become richer over time.

Chiteji was interested in Steckel’s finding that race played an important role in mobility. Determining the reason for this relationship was important, she said: was it due to the fact that on average, whites received larger inheritances than African Americans? Did entrepreneurship account for some of the difference? Chiteji also pointed out some apparent inconsistencies in the effects of adjusting the data for age differences on Steckel’s results. Margo noted that Torche and Spilerman as well as Zagorsky based their analyses merely on associations between various characteristics and economic outcomes and did not establish any causal relationships. He said also that it might be worthwhile to compare economic mobility in Chile now with mobility before the recent liberalization of the economy. With regard to Zagorsky’s findings on the mobility of African Americans, Margo argued that this group’s over-representation in the lowest wealth category increased their chances of apparent upward movement (as they could not possibly move downward). These movements tended to obscure African Americans’ true lack of mobility.

**Session 6. Earnings Mobility**
The final session was chaired byHEATHER BOUSHEY of the Economic Policy Institute and included talks by STEVEN J. ROSE of ORC Macro International and JEFFREY S. ZAX of the University of Colorado at Boulder. MAURY GITTLEMAN of the BLS, as discussant, commented on both papers.

Rose began by making some observations on the difficulties of drawing inferences from data on how individuals’ earnings change over time. Many studies compare the percentile of a person’s total earnings at the beginning of a certain period with that at the end, but observations of earnings in a given year depend on an element of chance, not just on permanent increases in earnings capacity. The importance of chance events that temporarily boost or decrease income can by seen by observing the earnings paths of individual workers, which often form a saw-toothed pattern. Thus, someone who happened to be unlucky in the first year of a study would be likely to have higher earnings by the final year, but this would not reflect a steady growth of earnings that would lift a worker into a higher income class for an extended time. In his paper, Rose attempted to avoid this kind of fallacious reasoning by categorizing workers according to their average earnings over a 15-year period. He found that many people did not experience a rising earnings level over his sample period (1981–1995), and that a large proportion lost ground. Low-wage workers and those who left the labor market for part of the period fared badly. A comparison to workers of an earlier generation showed that their earnings in the 1950s and 1960s more likely followed a rising path.

Whether we should be concerned about the trend in much of the world toward increased inequality depends in part on whether the trend is mitigated by economic mobility. Zax posited three possible stylized patterns of mobility. First, in the most inequitable scenario, individuals would remain in the same percentile of earnings throughout their working lives. A second possibility would slightly alter the first one to allow for all individuals to rise steadily throughout their lifetimes relative to the workforce as a whole. Finally, earnings could be simply random, with no persistence in relative position from one year to the next. Zax assessed these theories using data from the unemployment insurance system of the State of Colorado. These data allowed him to trace the path of workers’ earnings over a number of years. A person’s position in a “ranking” of annual earnings tended to
increase over time, suggesting that there may be some truth to the second hypothesis. However, this result did not apply to workers earning more than the median income, who often failed to hold on to their relative position. This result was inconsistent with all three stylized models.

Gittleman pointed out that Rose’s results could be related to the broad decline in older men’s participation in the labor force. Zax’s study, he said, was hampered by the lack of data on demographic characteristics, such as age and gender, and more elaborate hypotheses about economic mobility than those entertained in Zax’s paper should be considered. According to Gittleman, one problem evident in both presentations was an inability to distinguish between changes in wage levels and changes in the number of hours worked in a given time period.

New Working Papers

Polish and Italian Schooling Then, Mexican Schooling Now? U.S. Ethnic School Attainments across the Generations of the 20th Century
Joel Perlmann
Working Paper No. 350
www.levy.org/docs/wrkpap/papers/350.html

An important and sometimes overlooked part of globalization is the recent great wave of immigration into the United States. Many experts are now pondering whether the new immigrants and their children, particularly those with low levels of education, can assimilate economically into the United States as completely and quickly as those who came here during the last great immigration, in the late 19th and early 20th century.

In a new working paper, Senior Scholar Joel Perlmann of Bard College begins by assessing the economic prospects of the new generation of Mexican Americans—the children of immigrants. He compares their achievements in education and labor markets “now” to those of second-generation Poles and Italians whose parents were among the large numbers of eastern and southern Europeans who came here around a century ago (“then”). Perlmann finds that Mexican males “now” face a greater disadvantage relative to native whites with native parents in terms of years of schooling completed than did the Poles and Italians “then.” Mexican females “now,” on the other hand, have less of a disadvantage than the corresponding Polish and Italian women who were born between 1896 and 1905, a sign of the improved status of women. The current gap between second-generation Mexicans and native whites is fairly small—only a little over a year’s difference in total schooling—but this disparity is larger than the one between African Americans and native whites.

In the labor market, however, second-generation Mexican immigrants have been relatively successful in several respects. Among male high school dropouts, a greater percentage of Mexicans than native whites or blacks are working full-time. Among men with a high school diploma or less, Mexicans earn an average of 18 percent more than African Americans. All of these statistics lead one to believe that the children of Mexican immigrants may assimilate into the mainstream of the U.S. economy fairly quickly, belying the gloomy predictions of many economists and sociologists.

Race, Ethnicity, and the Gender-Poverty Gap
Yuval Elmelech and Hsien-Hen Lu
Working Paper No. 351
www.levy.org/docs/wrkpap/papers/351.html

In the late 1970s, poverty researchers began to notice a trend that became known as the “feminization of poverty.” Some speculated that this phenomenon could be due to the major changes in family structure that were occurring around the same time. The issue has continued to garner attention, since the gender gap in poverty rates has persisted in the last 10 years, even as the absolute level of female poverty has subsided.

This new working paper addresses several issues sometimes neglected in this discussion. First, does the magnitude of the male-female poverty gap differ between the major ethnic groups? Second, what are the factors leading to this gap, and do these factors differ between racial and ethnic groups? For example, do gender differences in labor force participation contribute significantly to the gender gap? If so, do these differences matter more for some racial and ethnic groups than for others?
Women in some minority groups have higher poverty rates than either white women or men of their own group. One of the more disturbing findings of this paper is that Puerto Rican and African American women face a “double disadvantage”: the gender gap in poverty rates is greater for these groups than for non-Hispanic whites. Moreover, the “penalty” for being black or Puerto Rican is greater for women than for men. Elmelech and Lu find that differences in marital status partly explain this double effect of gender on the one hand and race and ethnicity on the other. Mitigating the interactive effect of the two factors is the lower gender inequality in labor market participation among black Americans compared to whites.

More generally, differences in family structure contribute to the gender gap, even after differences in race and ethnicity are accounted for. Disparities in labor force participation and educational attainment are also partly to blame. One of the notable features of this paper is that it examines the role of being an immigrant. Perhaps surprisingly, immigrant status tends to be associated with a lower level of male-female inequality, offsetting some of the gender gap among Asian and Latin American populations.

Critical Realism and the Political Economy of the Euro
Philip Arestis, Andrew Brown, and Malcolm Sawyer
Working Paper No. 352
www.levy.org/docs/wrkpap/papers/352.html

Mainstream modern economics, known as neoclassicism, is characterized in part by its pervasive use of mathematical methods, such as econometrics and models. In recent years, a new theory of the ways in which economists can come to know things has emerged and challenged long-held preconceptions about the validity of these mathematical methods.

Critical realism, as the new theory is called, proposes discarding econometrics and mathematical models in favor of retroduction. Retroduction involves identifying complex social structures by examining premises such as unexplained or surprising events. In this new working paper, Institute Professor Philip Arestis, along with Andrew Brown and Senior Scholar Malcolm Sawyer, both of the University of Leeds, scrutinize this approach to economics, using The Euro: Evolution and Prospects, their study of the eurozone, as an example.

The authors find their eurozone study consistent with the theory of critical realism in that their study largely concerned a surprising phenomenon—the recent fall in value of the euro relative to the dollar. Also parallel to the critical realist approach was the authors’ effort to unearth the structures underlying their puzzling observation.

Arestis, Brown, and Sawyer conclude, however, that critical realism ultimately fails as an account of their analysis of the euro. The euro study did not hypothesize heretofore unknown structures—a daunting task to say the least—but, rather, used well-known concepts such as wages and exchange rates. Much more important than the mere existence of these structures was the discovery of the relationships and connections between them. This task involved the use of the very abstract theories so anathema to the critical realists, such as the works of Keynes, Kalecki, and Marx, which emphasize the tendency of capitalist economies to experience crises due to a lack of aggregate demand. The critique offered in the working paper—inspired in part by a recent article that Brown and two other economists published in the November 2002 issue of the Cambridge Journal of Economics—shows that economists still have a long way to go before they fully understand what their science is, and should be, doing.

Managed Care, Physician Incentives, and Norms of Medical Practice: Racing to the Bottom or Pulling to the Top?
David J. Cooper and James B. Rebitzer
Working Paper No. 353
www.levy.org/docs/wrkpap/papers/353.html

With the costs of medical care on the rise and the ranks of the uninsured swelling, the health care system in the United States is once again under media and Congressional scrutiny. HMOs and other providers of “managed care” are at the center of the controversy. While these organizations are credited by many with controlling the costs of health care, they have also been accused of doing so at the expense of their members’ well-being. In this new working paper,
Research Associate James B. Rebitzer and David J. Cooper, both of Case Western University, examine the merits of the claim that the cost-control incentives used by managed care organizations result in a lower quality of care.

Cooper and Rebitzer use a model to determine how doctors and HMOs would rationally behave under a simplified version of their current incentive structure. This structure includes fixed per-patient payments to doctors that are reduced by a proportion of the costs they generate, a feature criticized by many observers on the grounds that it may discourage doctors from ordering necessary, but expensive, tests and treatments. In the model, doctors are interested not only in their monetary compensation but also in the quality of care they provide. Patients, being unable to determine the adequacy of their treatment, are forced to make their choice of an HMO based on the number of doctors affiliated with each one. HMOs thus face a trade-off: If they give doctors a stiff penalty for using costly treatments, they will have difficulty recruiting and retaining physicians, because of doctors’ desire to provide good care. Patients will tend to leave shrinking HMOs, a development that will reduce the revenues of the affected organizations. Thus, in considering what kind of compensation plan to use for physicians in their networks, HMOs must consider the indirect adverse effect that penalizing doctors for expensive care would have on the demand for their own product.

This model offers several insights into the medical care policy issues now being discussed in policy circles. Contrary to the expectations of many of the current system’s critics, there is no tendency for HMOs to provide a minimal level of care in order to control costs. Two possible measures to improve the quality of treatment—limiting the use of incentives for providers and making HMOs liable in malpractice lawsuits—are found to increase the number of uninsured people by raising costs. Rebitzer and Cooper argue that policymakers should consider these adverse consequences of the “cure” for poor care.

**Should Banks Be Narrowed?**

Biagio Bossone

Working Paper No. 354

www.levy.org/docs/wrkpap/papers/354.html

Narrow banking would in essence require banks to back their liabilities with safe assets, such as short-term government securities. The various forms of lending now handled by banks would be taken over by mutual fund–like organizations that would not be backed by deposit insurance or any other form of government safety net. In a new working paper, Biagio Bossone of the IMF and Banca d’Italia examines the pros and cons of narrow banking from the perspective of modern theories of financial intermediation.

Narrow banking, Bossone concedes, has many advantages to recommend it. In a conventional insured system, banks are tempted to invest their funds in risky loans. Depositors have little incentive to monitor such activities, because their deposits are not at risk. The resulting mismatch between guaranteed, liquid liabilities on the one hand, and long-term, difficult-to-monitor assets on the other, leaves the system vulnerable to crises such as bank runs. Proponents say that narrow banks, on the other hand, would be unlikely to fail, because of the strength of their assets. Preventing bank illiquidity and insolvency would relieve the costs associated with government bailouts and would protect the integrity of the payments system.

Nevertheless, Bossone believes that the disadvantages of narrow banking outweigh these advantages. Modern banking theories demonstrate that the existing banking system serves a number of important purposes. Banks have more information than their depositors about the creditworthiness of potential borrowers and can screen out those that are likely to default. Bank accounts also act as a kind of insurance against their depositors’ sudden needs for cash. Other types of investment lack such flexibility.

If narrow banking proposals were implemented, the appeal of traditional bank services would not disappear. A strong demand would emerge for the reestablishment of normal, bank-like institutions in the unregulated side of the financial sector. Political demands for federal safety nets would then be extended to these new institutions, leading to the reemergence of the original problem. On the other hand, to the extent that narrow banking legislation was
successful in suppressing new quasi banks, it would diminish the availability of credit to the private sector.

Other problems that might be generated by narrow banking would include a lack of appropriate securities in which banks could invest and the loss of various synergies generated by the combination of loan and deposit activities. Bossone concludes that narrow banking would only partially eliminate the problems with the existing system, while dissipating its important advantages.

Can Monetary Policy Affect the Real Economy?
Philip Arestis and Malcolm Sawyer
Working Paper No. 355
www.levy.org/docs/wrkpap/papers/355.html

Those who are aware of the U.S. recessions of 1980 and 1981–82 and of Japan’s long-standing economic malaise have probably thought about the impact of monetary policy on the economy. Economists are particularly concerned about two related issues: First, how does monetary policy affect GDP and inflation? And second, how large is this effect? Many different theories have been produced in an effort to answer these questions, but economists are no closer to complete agreement on the effects of money. Nevertheless, among central bankers in the developed world and many mainstream economists, there is a consensus on the broad outlines of money’s role in the economy. This new working paper by Institute Professor Philip Arestis and Senior Scholar Malcolm Sawyer of the University of Leeds details the consensus view and confronts it with an array of empirical evidence.

The consensus theory is complex but can be hinted at with a few of its main contentions. First, it posits that the actual level of economic activity is not affected in the long run by nominal interest rates and monetary stocks. Nevertheless, these monetary variables do govern the rate of inflation, and monetary policy works best when central banks use an inflation target as a guide to their policy decisions. Targeting inflation, as opposed to targeting the money supply or aggregate output, for example, is effective in part because it has the properties of “credibility” and “transparency,” meaning roughly that people in the private sector can easily be assured that the central bank will fight inflation vigorously.

Before assessing the plausibility of the new monetary beliefs, Arestis and Sawyer describe the many “channels” through which money is said to affect the level of economic activity. These range from the interest rate channel, which works by changing the cost of financing new capital goods, to the exchange rate channel, which operates through the effects of a country’s interest rates on flows of foreign capital.

The empirical evidence cited by Arestis and Sawyer casts doubt upon many of the elements of the consensus position that monetary policy can and should be used to combat inflation. Interest rate hikes have only a small effect on inflation and meanwhile reduce output significantly. A large portion of the “cost” of dealing with inflation in this way comes in the form of a reduction in the rate of investment in new factories, buildings, and other capital goods. The reduction in investment can permanently affect the output capacity of the economy, decreasing GDP and raising unemployment in subsequent years. If we are to measure the new theory by the empirical evidence for its policy nostrums, the consensus view on money should be rejected in favor of a Keynesian alternative.

Asset Poverty in the United States, 1984–1999:
Evidence from the Panel Study of Income Dynamics
Asena Caner and Edward N. Wolff
Working Paper No. 356
www.levy.org/docs/wrkpap/papers/356.html

After falling for a number of consecutive years, U.S. poverty rates increased in 2001, largely due to that year’s recession. Data examined by Research Associate Asena Caner and Senior Scholar Edward N. Wolff show that when poverty is measured in terms of wealth rather than income, the nation made no significant progress even during the expansion and asset bubble of the late 1990s. This is just one of many surprising and often disturbing findings in this new working paper.

Caner and Wolff make a strong case that wealth ownership is just as important to the well-being of households as earnings and other ongoing flows of income. Assets can help people weather economic setbacks, such as unemployment. Therefore, in order to measure poverty, economists and
policymakers must take assets, and not just income, into consideration.

The authors use two measures of the prevalence of asset poverty. The first is a “head count” of those whose assets are below a certain threshold. The second is a measure of the “poverty gap,” or the amount of additional wealth hypothetically needed to raise everyone’s asset holdings to the threshold. One finding in the paper is that poverty in assets is much more common than poverty in income and is concentrated in certain segments of the population, such as racial and ethnic minorities. The authors also use statistical techniques to determine the effect of various household characteristics on the prevalence of asset poverty, with other factors held constant. They find that certain factors increase the chances of being asset-poor: low levels of educational attainment, minority status, and being a tenant.

Caner and Wolff analyze data from the Panel Study of Income Dynamics, a survey that followed the same respondents over a period of many years. This enables them to determine the persistence of poverty, or the probability that an individual who was poor in a given survey was again (or still) poor in the next survey, five years later; Caner and Wolff estimate that chance at about 60 percent. Caner and Wolff also take advantage of their data set to find out how various major life events, such as marriage and home purchase, can change the likelihood that a person will escape from, or fall into, asset poverty. They find that marrying increases significantly one’s chances of leaving asset poverty, while people become more likely to enter poverty when their marriages end. Interestingly, the impact of marriage on the probability of entering or exiting poverty has increased over time. As might be expected, acquiring a house or receiving an inheritance often allows people to rise out of poverty.

**The Euro, Public Expenditure, and Taxation**

Philip Arestis and Malcolm Sawyer

Working Paper No. 357

www.levy.org/docs/wrkpap/papers/357.html

In a new working paper, Institute Professor Philip Arestis joins Senior Scholar Malcolm Sawyer of the University of Leeds in examining what effect entering the eurozone would have on Britain’s fiscal policies. They begin by recounting how first the Maastricht Treaty and then the Stability and Growth Pact—the eurozone’s agreements on harmonizing economic policies—have restricted the member nations’ freedom to adopt expansionary fiscal and monetary policies.

The authors believe that the Maastricht agreement accounts in part for the slow growth of many European economies in the 1990s. They suggest that the Stability and Growth Pact would have a similar impact on Britain, should it join the eurozone. They are especially concerned about a provision that forbids governments from running a deficit of more than 3 percent of GDP in any given year. The lack of a stimulative fiscal policy would leave the burden of maintaining economic growth to the European Central Bank, but that institution has failed to respond adequately to the problems already facing the eurozone and it seems unlikely to do so in the future, as it is “independent” of elected governments and is constitutionally required to focus on inflation control, to the neglect of growth and employment.

The authors contrast this gloomy scenario with the policies that are likely to be followed if U.K. economic policy continues to originate in London. Tony Blair’s government, while not strongly pursuing Keynesian policies, is set to maintain a relatively lax fiscal stance under its “golden rule” of public finance. Though that rule would require the government to balance, on average, current expenditures with revenues, it would allow excess spending that took the form of “investment” rather than consumption. The authors estimate that Labor’s policies would allow deficits of about 2 percent of GDP. Moreover, there would be no strict ceiling on the size of the deficit during recessions. If stabilizing and maintaining growth are a priority, then Britain may be better off outside the eurozone.

**Threshold Effects in the U.S. Budget Deficit**

Philip Arestis, Andrea Cipollini, and Bassam Fattouh

Working Paper No. 358

www.levy.org/docs/wrkpap/papers/358.html

After several years of running fiscal surpluses, the U.S. government budget is once again in the red. Economists disagree about the implications of this shift in fiscal stance. For example, several Levy Institute scholars, including Wynne Godley and Dimitri B. Papadimitriou, have argued...
that large deficits are needed as a corrective for the looming effects of the recent massive accumulation of corporate and consumer debt. Other economists argue that deficits must be kept small, at least over the long term, in order to maintain low interest rates and keep inflation under control. In a new working paper, Institute Professor Philip Arestis, Andrea Cipollini of Queen Mary and Westfield College, and Bassam Fattouh of the School of Oriental and African Studies at the University of London investigate an issue closely related to these debates: whether U.S. fiscal policy has been sustainable during the postwar period, over parts of that period, or not at all.

Arestis, Cipollini, and Fattouh define an unsustainable fiscal policy as one that entails ever-increasing deficits and requires governments to use escalating amounts of borrowed money to pay off maturing bonds. A glance at the history of the U.S. budget balance reveals that from the late 1970s to the mid 1990s, the federal government appeared to be adding to the debt almost every year, giving an impression that policy was unsustainable. At other times, however, the government did not consistently run deficits. This suggests that budget policy has veered between stimulative—and perhaps unsustainable—stances and more restrictive postures, a hypothesis that has been the conclusion of a number of earlier studies. In this working paper, the authors attempt to test statistically one hypothesis about when and why these switches in policy “regimes” have occurred: that the government changes from a lax to a tight fiscal stance when deficit increases exceed some “speed limit,” presumably because concern about fiscal shortfalls reaches some critical point.

The authors confirm earlier findings that no one regime characterizes the entire postwar record and verify their hypothesis about the timing of regime changes. They identify two distinct regimes and 14 switches from one to the other. Most of the changes follow, after a significant time delay, well-known events, such as wars, oil shocks, recessions, and the Reagan tax cuts. Perhaps most important, when the overall record for the postwar period is considered, policy has been sustainable. It appears that despite the many hazards of the current budget-writing process, policymakers have always intervened before the debt has careered out of control.

Is There a Trade-Off between Inflation Variability and Output-Gap Variability in the EMU Countries?

Philip Arestis and Kostas Mouratidis
Working Paper No. 359
www.levy.org/docs/wrkpap/papers/359.html

Inflation targeting has become fashionable in recent years among central bankers. This method of conducting monetary policy is distinct from the interest rate targeting of the immediate postwar period in the United States, and the monetary targeting favored by Milton Friedman and his supporters. Inflation targeters, such as the European Central Bank, manipulate the short-term interest rate so as to try to hit a (usually very low) target rate of inflation. Critics, citing the case of the Bundesbank, say that inflation targeting neglects important economic goals other than inflation control, such as stabilizing and stimulating economic output.

The use of inflation targeting during the period between 1979 and 1998 by some countries of the European Monetary Union (EMU) raises several questions. Did some EMU central banks concentrate their efforts on inflation control more than others? Did some European economies respond differently to monetary policy than others? Did the Maastricht Treaty lead to an increased focus on controlling inflation among the central banks of member nations? Did this shift in priorities lead to a sacrifice in the form of higher GDP volatility? In this new working paper, Institute Professor Philip Arestis and Kostas Mouratidis of the National Institute of Economic and Social Research use data from the EMU countries to investigate these questions.

When a supply shock, such as an increase in the price of oil, hits an economy, its central bank has a range of options. On the one extreme, the bank can “accommodate” the shock fully, allowing the rate of inflation to rise but maintaining full employment. At the other extreme, monetary authorities can hold inflation in check, taking their medicine in the form of a recession. Most central banks have policies that fall somewhere in between the two extremes. The “preferences” of a country’s central bank as to policy goals can be measured by observing the bank’s position on this spectrum of policies, as Arestis and Mouratidis do in this paper.

In one set of statistical tests, they find that the Maastricht Treaty caused five countries—Finland, France, Germany,
Ireland, and Spain—to allow output volatility to increase in order to fight inflation variability. The other EMU countries did the opposite. (All of the results reflect in part differences in the other characteristics of the countries.) For the countries as a group, the authors find strong evidence that the treaty brought about a shift in priorities from output stabilization to price stabilization. Another set of statistical tests, this time encompassing the entire period from 1979 to 1998, reveal that the Bundesbank emphasized inflation control more strongly than did the other EMU nations. Austria and Ireland were at the opposite extreme, with the other nations falling somewhere in between.

Financial Globalization: Some Conceptual Problems
Philip Arestis and Santonu Basu
Working Paper No. 360
www.levy.org/docs/wrkpap/papers/360.html

For many, the term financial globalism is synonymous with financial liberalization. In a new working paper, Institute Professor Philip Arestis and Santonu Basu of South Bank University, London, argue that globalization entails much more than capital mobility, the elimination of restrictions on interest and exchange rates, and the other policy prescriptions of neoliberal economists.

The period of roughly 1870 to 1913, the first era of financial globalization, was characterized by instability and frequent crises. By contrast, in the period immediately after World War II, most countries—both developing and wealthy—tightly regulated their financial markets. As a result, capital flows were impeded, but governments had some success in channeling funds to productive uses in the private sector, and the global financial system was relatively stable. In the past 30 years or so, most countries have once again deregulated their financial systems.

However, even now that capital markets have been deregulated, many barriers remain to the free flow of credit and finance to developing countries. In view of the fact that lenders have only imperfect information about potential borrowers, appropriate collateral is crucial to credit access. And if the loans are denominated in foreign currency, as they are for most borrowers in emerging markets, the needed collateral must be in a form that is readily convertible into reserves. Such assets are generally in short supply in economies that lack a fully developed export sector. Countries that earn a great deal of foreign currency are still vulnerable to the vicissitudes of their export markets. Thus, even in a liberalized system, developing nations have a disadvantage in raising capital, and international capital markets are often disrupted by crises. The present system would best be described as “fractured,” rather than globalized. True financial globalization would require a leveling of the playing field.

How could this be achieved? The introduction of an international currency, regulated by a global central bank, might ease the problem. Such a currency should not be moored to gold or to any national currency. This system could accommodate adequate growth, reduce the risk of crises, and permit a more equitable distribution of credit.

Credibility of EMS Interest Rate Policies: A Markov Regime-Switching Approach
Philip Arestis and Kostas Mouratidis
Working Paper No. 361
www.levy.org/docs/wrkpap/papers/361.html

In many models of the policymaking decision of the central bank, the credibility of the monetary authorities is an important consideration. In these models, a central bank is assumed to have preferences regarding the mix of inflation and unemployment. The central bank sets the interest rate based on its preferences and on the expected costs and benefits of maintaining a specific combination of unemployment and inflation.

This is where the role of credibility becomes important. A credible monetary authority is one that is expected to fight inflation, even when it might be possible to achieve greater economic growth by allowing inflation to increase. Credibility can be difficult to achieve, because the central bank has no way of persuading the public that it will not allow inflation at some point in the future. Without credibility, however, the costs of reducing the inflation rate in terms of lost economic growth are high. Certain events can cause a central bank to deviate from a credible policy. For example, a shock to the price of oil may present a dilemma: the central bank
can induce a recession in an effort to prevent a jump in inflation, or it must accept a rise in inflation, a response that tends to reduce credibility. Thus, the costs of achieving credibility increase. As the costs and benefits of this choice evolve over time, monetary policy will periodically change from credible regimes to noncredible.

In a new working paper, Institute Professor Philip Arestis and Kostas Mouratidis of the National Institute of Economic and Social Research use statistical techniques (essentially the Markov regime-switching technique) to study how the credibility of several European central banks evolved during the years of the European Monetary System (EMS). The countries included in the study are Austria, Belgium, the Netherlands, France, and Italy. In this instance, a credible policy was defined as one that shadowed that of the German Bundesbank. The results of the study show that all of the countries pursued credible policies from 1979 to 1998 in the sense that their interest rates converged over time with those of Germany. The results also indicate that when the inflation rate was high, the central banks of these countries were more likely to switch from a high- to a low-credibility policy regime, which confirms that in setting policy, central banks take into account the costs and benefits of maintaining credibility. The reverse was not true, however: low inflation did not increase the probability of moving from a low-credibility policy to a high-credibility one. The statistical model developed by the authors thus accounts for the history of policy changes in the EMS.

New Policy Notes

The Brazilian Swindle and the Larger International Monetary Problem
James K. Galbraith
Policy Note 2002/2
www.levy.org/docs/pn/02-2.html

When the world seriously considers the ideas of economist John Maynard Keynes, it usually does so because it is confronted with a crisis that seems to resist any other resolution. Senior Scholar James K. Galbraith argues here that we should be taking lessons from Keynes’s work now.

The immediate focus of Galbraith’s argument is the current Brazilian economic crisis. Once thought to be on a different track than its neighbor, Argentina, Brazil now finds itself caught up in its own spiral of debt and devaluation. These dramatic events can be seen as part of an ongoing trend that began with the third-world debt crisis of the 1980s.

After two decades of increasing inequality and stagnant growth, many Brazilians and others throughout the developing world are questioning more than ever the wisdom of the “Washington Consensus” on deflationary macroeconomic policies, privatization of industry, and liberalization of financial markets. In this atmosphere, Brazil has now elected a leftist government. How should the new government, and the rest of the world, deal with the economic crisis in the setting of the global economy?

Up to this point, Washington and the IMF responded to crises such as the current one in Brazil by demanding more of the same measures—reductions in social spending, sales of public assets at bargain prices, and ongoing loans that do little to relieve the burden of debt or finance new investment. The advocates of this approach argue that countries adopting “sound finance” will eventually reap benefits in the form of a stable currency and the capital inflows it brings. Brazil, however, is already running both trade and government budget surpluses, once interest payments are excluded. More “soundness” would further weaken the economy, without relieving the heavy burden of debt.

The best alternative is one that Keynes offered as the postwar economic system was being forged. Adjustment would be achieved by changes on the part of the creditors, rather than by self-defeating policies designed to improve the current account balance by crippling aggregate demand. In the absence of such a cooperative effort, the “second-best” alternative suggested by Galbraith has several parts. Countries in crisis should reduce or stop payment on their loans. This action would bring an end to IMF involvement, an outcome that seems less painful once one realizes that those loans are used primarily as a replacement for existing debt to private entities and to forestall further devaluation. A massive outflow of capital might ensue, but the hemorrhage might be stanched by the use of capital controls, as demonstrated by Malaysia during an earlier crisis. In any event, policymakers, creditors, and ordinary citizens will soon have to recognize the need to change course.
The complete economic integration of Europe remains a goal much sought after, yet just out of reach. In a new policy note, Institute Professor Philip Arestis and Senior Scholar Malcolm Sawyer of the University of Leeds analyze the legal framework of the monetary union (EMU) and the economic ideas behind the new institutional structures that have been put into place. They argue that the Maastricht Treaty, which set the terms for entry into the EMU, and the Stability and Growth Pact, which accompanied the introduction of the euro, unduly emphasize the goal of price stability, to the detriment of economic growth, employment, and investment.

The agreements’ numerical limits on government deficits prevent national governments from using fiscal policy aggressively to fight recessions; meanwhile, the ECB makes its decisions without input from member states and with the sole objective of suppressing inflation. The division of responsibilities between the ECB and the national governments makes difficult the coordination of fiscal and monetary policy. This arrangement also imposes a one-size-fits-all macroeconomic policy on a diverse group of economies that range from the wealthy Hamburg region of Germany, which boasts a per capita GDP of 40,353 euros, to Ipiros, Greece, where the average annual income barely reaches 6,500 euros. The various strictures on economic policy are surely one reason why growth averaged only 1.7 percent per annum in the eurozone from 1992 to 1999. The ECB shows little inclination to respond aggressively to the current slowdown, insisting instead on “reforms” such as labor market deregulation.

Arestis and Sawyer trace the philosophical roots of current policies to a new neoliberal view of the economy that includes many elements of monetarism while it discards others. This consensus rejects democratic input as an impediment to judicious policymaking. Though it downplays monetarism’s emphasis on controlling monetary aggregates, it retains that school’s belief that in the long run policy can affect only the rate of inflation. This belief runs counter to an array of empirical evidence demonstrating that moderately tight monetary policies have only a modest effect on inflation and do in fact diminish economic growth and employment.
he was a research professor and head of the Department of Applied Economics at the University of East London, and head of the Economics Division at Greenwich University.


Arestis holds three degrees in economics: a B.A. from the Athens Graduate School of Economics and Business Studies, an M.Sc. from the London School of Economics, and a Ph.D. from the University of Surrey.

**Levy Institute–Shanghai Academy of Social Sciences Research and Scholar Exchange**

In October, President Dimitri B. Papadimitriou visited the Shanghai Academy of Social Sciences in the People’s Republic of China as a Distinguished Scholar. He gave a lecture, “The Revival of Keynesian Economics,” and led two seminars, “Reconstituting the Financial Structure” and “Community Development Banking.” He also finalized an agreement between the Levy Economics Institute and the Shanghai Academy of Social Sciences for joint research and a scholar exchange.

**New Research Staff**

Research Scholar Asena Caner is currently working with Senior Scholar Edward N. Wolff and Research Scholar Ajit Zacharias on designing the Levy Institute Index of Economic Well-Being. The index, which will describe the level and distribution of quality of life in the United States, incorporates the multidimensional concept of well-being and will be used as a tool to monitor the improvements (or lack of) in the quality of life. Caner’s research interests include the role of household wealth in poverty and inequality, wealth distribution, the relationship between entrepreneurship and household wealth accumulation, and the measurement of income flows from household assets. She received a B.S. in industrial engineering from the Middle East Technical University in Ankara, Turkey, and a master’s degree in economics from North Carolina State University. She is a Ph.D. candidate in economics at New York University.

Research Scholar Claudio dos Santos is working with a team of Institute scholars on the Levy macroeconomic models, originally developed for the Institute under the direction of Distinguished Scholar Wynne Godley. Dos Santos’s broad areas of research interest are in the fields of macroeconomics and macroeconometrics. He received B.A. and M.Sc. degrees in economics from Rio de Janeiro’s Federal University (UFRJ). He is a Ph.D. candidate in economics at the Graduate School of Political and Social Science, New School University; his thesis is entitled “Three Essays on Stock-Flow Consistent Macroeconomic Modeling.”

Greg Hannsgen, editor of the Levy Institute *Report*, has joined the Institute as a resident research associate. He is studying the effects of monetary policy and the determinants of the supply of money. Previously, he was involved in research on Supplemental Security Income, an interest stemming from four years’ work at the Social Security Administration. Hannsgen received a Ph.D. in economics from Notre Dame. He previously earned an M.A. in public affairs from the University of Minnesota in Minneapolis and a B.A. in economics from Swarthmore College.

Research Scholar Gennaro Zezza is a researcher at the University of Naples, Italy. He will be working with a team of scholars on the Levy macroeconomic models, originally developed for the Institute under the direction of Distinguished Scholar Wynne Godley. Zezza has long worked on macroeconomic models, with Godley in the United Kingdom, in Denmark, and at the Institute, as well as at Confindustria in Italy. His other research interests are economic growth, innovation, and regional convergence. He is also involved in projects on distance learning and has taught economics at the University of Cassino. Among his most recent publications is “The Dynamics of International Competitiveness” (with Paolo Guerrieri Paleotti and Paola Maggiolini), *Labour* 12:2, 1998. He holds a degree in economics from the University of Naples.
Publications and Presentations by Levy Institute Scholars

INSTITUTE PROFESSOR
PHILIP ARESTIS
Presentations: “Can Monetary Policy Affect the Real Economy?” (with Malcolm Sawyer), International Conference on Monetary Policy, University of Bourgogne, Dijon, France, November 14; “New Keynesianism and the Economics of the Third Way” (with Malcolm Sawyer), Sixth International Workshop on “Neukeynesianismus—Der Neue Wirtschaftspolitische Mainstream?” Berlin, October.

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