
Summary Summer 2000

Volume 9, Number 3

CONTENTS

[Letter from the President](#)

Institute Research

Program: Distribution of Income and Wealth

- [Robert A. Margo, Project Report: History of Wage Inequality; Microeconomic Aspects of the Great Depression](#)
- [Edward N. Wolff, Recent Trends in Wealth Ownership, 1983-1998](#)
- [Michael J. Handel, Trends in Direct Measures of Job Skill Requirements](#)
- [Thomas Karier, Welfare College Students: Measuring the Impact of Welfare Reform](#)

Program: Financial Markets and Monetary Policy

- [The Tenth Annual Hyman P. Minsky Conference on Financial Structure, The Liberalization of Financial Markets: National and International Perspectives](#)
- [Marc-André Pigeon, "It" Happened, But Not Again: A Minskian Analysis Of Japan's Lost Decade](#)
- [L. Randall Wray, Can The Expansion Be Sustained? A Minskian View](#)
- [Ronnie J. Phillips, Braver Newer World? International Banking Regulation in the 21st Century](#)
- [Steve Keen, Toward a General Model of Debt Deflation](#)

Special Studies

- [James K. Galbraith, Is the New Economy Rewriting The Rules?](#)
- [Walter M. Cadette, Health Care Finance in Need of Rethinking](#)
- [S Jay Levy, Profits: The Views of Jerome Levy and Michal Kalecki](#)
- [Larry Stager, Phoenician Port Power: The Organization of Maritime Trade and Hinterland Production](#)

Institute News

- [Recent Events](#)
- [Upcoming Conference](#)

Publications and Presentations

- [Publications and Presentations by Levy Institute Scholars](#)

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

S Jay Levy, *Chairman*
Dimitri B. Papadimitriou, *President*

The *Summary* is a quarterly publication of The Jerome Levy Economics Institute of Bard College intended to keep the academic community informed about the Levy Institute's research. To accomplish this goal, it contains summaries of recent research publications and reports on other activities.

Editors: Karl Widerquist, Ajit Zacharias
Text Editor: Judith Kahn

Letter from the President

To our readers:

This issue of the *Summary* begins with the program on the distribution of income and wealth. It includes a project report and the summaries of two working papers and a policy note. Senior Scholar Robert A. Margo, of Vanderbilt University and the National Bureau of Economic Research, will be engaged in two research projects at the Institute during the forthcoming academic year. One project explores the history of wage inequality in the United States. The other, using data from the 1940 census, seeks to fill lacunae in our knowledge of the diversity of the Great Depression's effects on individuals and the diversity of their responses to this premier macroeconomic event of the century. In the first working paper, Senior Scholar Edward N. Wolff analyzes trends in wealth ownership over the last quarter century. In the second, Resident Scholar Michael J. Handel provides direct measures of job skill requirements using previously unexamined individual-level data. The policy note, by Research Associate Thomas Karier of Eastern Washington University, examines the effects of recent welfare reform on the incentives for higher education among low-income students.

In the program on financial markets and monetary policy, the Tenth Annual Hyman P. Minsky Conference on Financial Structure examined the problems and prospects of the liberalization of financial markets. There were also two publications and two seminars in the program. The working paper by Research Assistant Marc-André Pigeon analyzes the origins and dynamics of the Japanese financial crisis of the 1990s. The policy note by Visiting Senior Scholar L. Randall Wray analyzes from a Minskian perspective the sustainability of the current economic boom in the United States. A seminar led by Ronnie J. Phillips, of Colorado State University, discussed the history of international banking regulation and the turn regulation might take in the future. Steve Keen, of the University of Western Sydney, led a seminar on his dynamic model of debt deflation.

There are two policy notes and two seminars summarized under special studies. In the first policy note, Senior Scholar James K. Galbraith debunks the argument that the U.S. economy runs a danger of inflation driven by wage growth. In the second, Senior Scholar Walter M. Cadette discusses problems facing the health care financing system and possible solutions to them. A seminar led by Chairman S Jay Levy focused on the similarities and differences between the theories of profits propounded by Michal Kalecki and Jerome Levy. Larry Stager, of Harvard University, led a seminar on the role played by the control of seaports in the development of the Phoenician trading regime.

As always, I welcome your comments and suggestions.

Dimitri B. Papadimitriou
President

[Back to Contents](#)

Institute Research

Program: Distribution of Income and Wealth

Project Report: History of Wage Inequality; Microeconomic Aspects of the Great Depression

Robert A. Margo

Robert A. Margo, of Vanderbilt University and the National Bureau of Economic Research, will be a senior scholar at the Levy Institute this coming academic year. He will be engaged in two research projects, one a history of wage inequality in the United States and the other a microeconomic analysis of the Great Depression.

The first project is an extension of Margo's working paper for the Levy Institute, "The History of Wage Inequality in America, 1820 to 1970" (No. 286, November 1999), which was featured in a "charticle" by Peter Brimelow in *Forbes* (April 17). Wage inequality in the United States began to rise substantially in 1970, as evidenced by growing wage gaps between better- and less-educated workers, and between more- and less-experienced workers. Only recently (as of 1995), and perhaps temporarily, has this increase abated somewhat. Economists have argued about the possible causes of the rise, such as technological change, decline in unionization, and growth in international trade. Rarely, however, has anyone asked whether the changes in wage inequality are unusual in American history, either in magnitude or underlying causes.

In work that appeared in the *Quarterly Journal of Economics* in 1992, Margo and Claudia Goldin, of Harvard University, documented a substantial decline in wage inequality between 1940 and 1950--a phenomenon they dubbed the "Great Compression." The 1940s decline is attributed mainly to an increase in the relative demand for less-skilled workers during World War II and a conscious effort on the part of the federal government to narrow wage differentials. The Great Compression seems to be responsible for the perception that wage inequality has risen to "unprecedented levels," but compared with the level just prior to World War II, wage inequality today is not particularly high. Moreover, recent work by Goldin and Lawrence Katz, also of Harvard University, suggests that wage inequality declined between 1890 and 1940, primarily because of an increased relative supply of educated workers as a consequence of the so-called high school movement. However, Goldin and Katz do not consider whether the decline was a continuation of a longer-term trend or whether the nineteenth century, a period that encompasses the first "industrial revolution," witnessed rising wage inequality, as hypothesized some 40 years ago by Nobel Prize-winning economist Simon Kuznets.

In Wages and Labor Markets in the United States, 1820 to 1860 (University of Chicago Press, 2000), Margo examined wage inequality before the Civil War. He found no evidence of a growing wage differential between skilled blue-collar and unskilled ("common") labor, but did find a differential between white-collar and common labor, which he attributed to the effects of early industrialization on the demand for managerial skills.

In ongoing work with his Vanderbilt colleague Jeremy Atack and Fred Bateman, of the University of Georgia, Margo has documented a rise in wage inequality in manufacturing between 1850 and 1880 in what appears to be a mirror image of the post-1890 decline discussed by Goldin and Katz. Geographical factors appear to be partly responsible for the rise. The urban-rural wage gap grew as manufacturing became increasingly urban, and the North-South wage gap widened in the 1860s as a consequence of the Civil War. In addition, an organizational change in manufacturing played a role. In the early nineteenth century most manufacturing was

conducted in small shops in which highly skilled workers crafted articles for sale. As the century progressed, these "artisan shops" were displaced by factories, which economized on the use of skilled workers through division of labor. After the Civil War a new form of manufacturing organization began to emerge; "continuous process" firms were large, were capital-intensive, and made heavy use of inanimate sources of energy, such as steam power. This change progressed unevenly across industries, creating more variety in firm characteristics associated with the skill composition of manufacturing workforces--firm size, capital intensity, and energy use--and thus with more unequal wages.

While at the Levy Institute, Margo will be refining his research with Atack and Bateman and collecting additional wage data for the post-Civil War period, with the assistance of funding from the National Science Foundation. He intends to document further the changes in wage inequality that occurred after the Civil War and to explore the sources of these changes.

In addition to research on the history of wage inequality, Margo will be working on a new book, *From the Bottom Up: Microeconomic Aspects of Labor and Labor Markets during the Great Depression*. The Great Depression was the premier macroeconomic event of the century and a "defining moment" in the evolution of government policy. Yet the people who lived through it experienced it not as an abstract event but as an ongoing factor in their daily economic lives, that is, they experienced it in microeconomic terms. Economists have largely ignored the diversity of individual responses to the Great Depression. Margo believes that, aside from enriching our knowledge of economic history, analysis of the microeconomic evidence may help resolve certain macroeconomic controversies associated with the period.

Much of the book is based on the public use sample of the 1940 census, a landmark in American statistical history. The 1940 census was the first to collect information on income, educational attainment, and short-term migration, and it greatly refined the collection of information on unemployment and labor force participation. Because of certain unusual features of the census, it is possible to identify individuals who participated in the myriad of work relief programs (such as the Works Progress Administration). In previous work Margo used the census to study the relationship between work relief and labor force participation of married women and between work relief and duration of unemployment. He will update these studies and undertake studies of migration, schooling decisions, and race and gender differences in his analysis of the depression's impact.

[Back to Contents](#)

Recent Trends in Wealth Ownership, 1983-1998

Edward N. Wolff

[Working Paper No. 300](#), April 2000

Household wealth is an important indicator of well-being independent of the direct income it provides. Wealth can be converted into cash to meet consumption needs. In times of economic stress, such as a loss of income caused by unemployment, wealth can provide a personal safety net. Owner-occupied houses provide services to the owner. In a representative democracy such as the United States, the distribution of power is often related to the distribution of wealth. The current economic expansion, particularly the spectacular run-up in stock prices since 1995, has created the impression that all households are accumulating wealth equally. Therefore, an empirical examination of household wealth distribution is timely and important. Senior Scholar Edward N. Wolff undertakes this task, utilizing data from the Survey of Consumer Finances, published by the Federal Reserve Board in 1983, 1989, and 1998.

Patterns in the distribution of household wealth are examined using primarily net worth (current value of all marketable assets less current value of debts) as the definition of wealth. Time trends in net worth show that wealth has risen slowly for the average household. Median net worth (in 1998 dollars) rose by 7 percent between 1983 and 1989, but by only 4 percent between 1989 and 1998. The slow growth in median wealth was accompanied by a growing concentration of wealth. The richest 1 percent of families owned 34 percent of total household wealth in 1983, as compared to 38 percent in 1998; the share of the richest 20 percent went up from 81 percent to 84 percent during the same period. Most of the concentration appears to have occurred in the 1980s.

According to Wolff, the average American household is becoming increasingly indebted. The overall debt-equity ratio rose sharply from 0.15 in 1983 to 0.18 in 1998. The tendency toward indebtedness is especially strong for the middle class (the middle three quintiles of the wealth distribution), which has a debt-equity ratio of 0.51, and for the poorest households, as reflected in the fact that the proportion of households with negative or zero net worth rose from 15 percent to 18 percent during the same period. There are marked class differences in the composition of wealth: middle-class households tend to hold most of their wealth in the form of home equity (60 percent of total assets) and monetary savings and pension accounts. In contrast, rich households (the top quintile) hold most of their wealth in the form of real estate, business equity, corporate stocks, and financial securities.

Wolff examines wealth holdings by race and shows that African American and Hispanic households have made gains in net worth, financial wealth (defined as net worth less net home equity), and home ownership rates. Even so, the average wealth of black households in 1998 was only about 20 percent of the white average; for Hispanic households the wealth was about 25 percent of the white average. An examination of wealth by age revealed that between 1989 and 1998 households whose head was under the age of 55 and over the age of 75 experienced declines in average net worth and in financial wealth relative to the overall mean. However, married couples with children and female heads of household with children have improved their wealth status.

Wolff argues that there does not seem to be a clear-cut relationship between income classes and

growth in wealth, although there is a strong correlation between income and wealth levels. What does emerge clearly is that the financial wealth of the households (whose head was aged 25 to 54) in the bottom three quintiles is too meager to maintain their normal consumption or even consumption at 125 percent of the poverty level.

Overall, these results and the slow growth in real income for 80 percent of the population suggest that there has been no significant trickle down from economic growth to most Americans in the last two decades. According to Wolff, the fragile personal safety net along with the weakening of the social safety net has given rise to a growing sense of economic insecurity. Private as well as public measures are required for promoting asset ownership among the middle class and the poor. Wolff believes that savings accounts set aside by eligible low-income families and partially matched by public funds to finance schooling, home purchase, or business ventures is one possible public policy response. It could be enhanced by subsidized home ownership programs for the poor.

[Back to Contents](#)

Trends in Direct Measures of Job Skill Requirements

Michael J. Handel

[Working Paper No. 301](#), May 2000

It is commonly assumed that jobs in the United States require ever greater levels of skill and that this trend is accelerating as a result of the diffusion of information technology. Mainstream economists agree that the growth of earnings inequality in the 1980s and 1990s is due primarily to a technology-driven shift in the demand for skilled workers. Others question this hypothesis, but the debate over the importance of skill requirements suffers from a lack of direct measures of job skill requirements. Previous studies have used proxies, such as education, as indicators of shifting job skill requirements, but such studies are vulnerable to the criticism that a worker's educational attainment is not a direct measure of job content.

Resident Scholar Michael J. Handel attempts to rectify this measurement problem by using previously unexamined individual-level measures of job skill requirements to test for increase and acceleration of skill requirements over time. Specifically, he uses measures of the level of formal education needed for an individual's job and the time it would take the average person to learn the job. The data come from the Survey of Working Conditions (1969), Quality of Employment Surveys (1972, 1977), and the Panel Study of Income Dynamics (1976, 1985). He also uses these measures to validate occupation-level measures available from the *Dictionary of Occupational Titles* and to create a new set of occupation-level measures. The new set makes it possible to examine a longer time series of between-occupation skill shifts than is possible with the DOT measures alone.

Handel finds that direct measures of job skill requirements (based on individual-level data) do not suggest that the period of rapid growth in inequality in the early 1980s was a period of rapid growth in job skill requirements. He also finds little evidence that rates of undereducation grew or rates of overeducation declined rapidly in the more recent period, as would be expected if skill requirements rose especially rapidly and led to shortages. Similarly, between-occupation skill shifts, whether measured using mean occupational skill scores derived from microeconomic data or the more familiar DOT occupational scores, do not suggest discontinuities between the 1960s-1970s and the 1980s-1990s, except for a brief period of acceleration in job skill requirements corresponding to the early 1980s recession, when there was a dramatic loss of relatively low-skill but well-paid blue-collar manufacturing jobs. There is also no evidence of increasing inequality of job skill requirements between occupations.

Handel concludes the pattern is one of relatively steady growth in skill requirements over time, with little evidence of accelerating skill demands or increasing skills mismatch in the 1980s and 1990s. These results cast doubt on the notion that the recent growth in U.S. wage inequality is a result of a skills shortage.

[Back to Contents](#)

Welfare College Students: Measuring the Impact of Welfare Reform

Thomas Karier

[Policy Note 2000/3](#)

Changes in the rules governing welfare at the federal and state levels in the past few years were aimed at creating incentives for immediate employment. However, these changes have created disincentives for pursuing higher education as a means to achieve economic independence. The work standards required by federal law are difficult for full-time students to meet. Compliance by students who are also single parents (as many welfare recipients are) is made still more difficult by the fact that state and local governments deny them child care assistance.

Research Associate Thomas Karier, a professor of economics at Eastern Washington University, examines the effects of the welfare reform by studying students at the university who identified welfare receipts as a source of income between fall 1994 and fall 1998. The number of welfare students attending EWU was declining before the introduction of state-level welfare reform in 1997, but their number and their share in total student population declined much faster after the introduction. According to Karier, most of the reduction was due to the decline in the number of new welfare students (no new work plans that include a two- or four-year college program are being approved). A segment of the students who left the university were tracked in order to compare the wage distributions of graduates and dropouts. The median hourly wage for graduates was found to be \$11 (four quarters after graduation), while the median for dropouts

was \$9.06 (five quarters after graduation). The wage distribution for dropouts was skewed to the low end of the scale, while the distribution for graduates was more spread out, especially at the higher wage levels. Karier also found that the number of college years completed was positively related to wage rates; real economic benefits were associated with each year of college education, even when a degree was not obtained.

Karier makes some concrete recommendations to retain college as a feasible option for welfare recipients: provide child care and other appropriate benefits for recipients in college; make participation in college degree programs an approved category of work activity; count hours of college education, work study, and unpaid internships toward satisfying work requirements; and extend support beyond the usual time limits to recipients who make normal progress. Karier believes that his recommendations can be implemented through changes in the federal legislation or through state-level initiatives. College education is not a panacea for the problems of poverty and welfare, but for many people it is still the best strategy for achieving economic independence.

[Back to Contents](#)

Program: Financial Markets and Monetary Policy

The Tenth Annual Hyman P. Minsky Conference on Financial Structure, The Liberalization of Financial Markets: National and International Perspectives

As part of its research on financial markets, the Levy Institute organized a conference, held on April 27-28, to explore the ramifications of financial liberalization. Brief summaries of the speakers' remarks and the sessions are given here.

Wynne Godley

Wynne Godley, Levy Institute distinguished scholar, asserted that the prolonged expansion of the U.S. economy, with little inflation and low and falling unemployment, has been generated by an unusual, and eventually unsustainable, pattern in the major financial balances. In the first quarter of 2000, the general government balance (federal, state, and local governments) had a surplus equal to 1.1 percent of GDP, compared with a deficit of 6.1 percent in 1992. Over the same period the balance of payments moved from a deficit of 0.2 percent of GDP to a record 4.3 percent deficit. Thus, in stark contrast to any previous experience, the expansion has been taking place while the government and overseas sectors have been withdrawing large and growing amounts from the circular flow of income.

Godley stated that the economy could not have expanded against these tides had there not been

a large and unprecedented deficit in the private financial balance. In the first quarter of 2000 total private expenditure exceeded disposable income by 6.6 percent and the private sector's net saving (that is, total saving less investment) reached negative 5.4 percent of GDP. There has not been a private deficit of anything like this size in the United States in modern times, but there have been isolated cases in foreign countries, for instance, in Japan, the United Kingdom, and parts of Scandinavia about 10 years ago. The experience of these countries is worrying. In each case the private sector increased its net saving after a year or two and reestablished a surplus (sometimes overshooting so as to generate a surplus that was higher than normal), and in each case there was a severe recession as a consequence.

A rise in private expenditure relative to income high enough to drive the expansion is partly a consequence of the vast increase in stock market wealth, but it could not have taken place without an increase in net lending, which rose from 4.4 percent of disposable income in 1992 to about 15 percent at the beginning of 2000. The level of debt owed by the nonfinancial sector rose to a record 165 percent of disposable income.

According to the Congressional Budget Office, it is government policy to go on tightening the fiscal stance for several more years. This is the implication of their projections in which the budget surplus rises even as output growth slows down so much that unemployment starts to rise. At the same time some further deterioration in the balance of payments will probably occur if a reasonable growth rate is maintained and if the dollar remains relatively strong. Even if recovery in the rest of the world is sufficient to boost U.S. exports so that the balance of trade in goods and services does not deteriorate further, the negative foreign asset position of the United States is likely to generate a growing outflow of interest and other property income. This outflow will be exacerbated by recent and prospective increases in short-term interest rates.

With the government surplus and the overseas deficit both continuing to increase, it follows, by the laws of accounting logic, that the private deficit must continue to expand if growth is to continue--and this in turn implies a further rise in the flow of net lending, with the private debt-to-income ratio rising into ever higher record territory.

Godley's central contention is that the process of escalating private indebtedness is intrinsically unsustainable. Household balance sheets still look quite healthy (at least taken in the aggregate) because of the huge rise in asset values. However, a decisive constraint must arise at some stage because of the rising burden of interest payments and repayments of principal, which must be settled in cash, and the constraint will become binding more quickly if there is a significant further rise in interest rates. In addition, the high level of private indebtedness poses a potentially severe source of weakness should the stock market suffer a decline or income growth go into reverse.

Godley displayed some simulations of what might happen to output and unemployment in the United States if, with no change in macroeconomic policy, there were a recovery in private net saving to something like normal levels. The results of this exercise were dispiriting, indicating an

increase in unemployment to 8 or 9 percent over the next five years. Godley emphasized that a "hard landing" is not inevitable. However, preventing it would require the rehabilitation of active, expansionary fiscal policy. If the private sector deficit is to be replaced by a surplus, the public sector surplus will have to be replaced by a deficit.

Barney Frank

The Honorable Barney Frank, U.S. Representative from Massachusetts, discussed the pros and cons of globalization and the possibility of a balanced approach to free trade. Advocates of globalization argue that free mobility allows capital to find the best place and that benefits will trickle down to everyone; reality is not that simple. The precise argument for free trade is not that there will be no losers but that the beneficiaries will benefit more than the losers will lose. Trade is beneficial on balance, but it has costs and those costs tend to be borne unequally, with most of the benefits going to those who are already well off. It is morally unacceptable to help the rich get richer at the expense of the poor even if the rich are helped more than the poor are hurt.

According to Frank, in order to reap the benefits of globalization without imposing costs on the least well off, one must realize that pure free trade is not always the best policy. The free market gave us Y2K; the government gave us rural electrification. Free trade advocates said that increasing the minimum wage would increase unemployment, but after the last time the minimum wage was raised, unemployment continued to fall and there has been a labor shortage among low-wage workers. Some have said that the NAIRU would prevent the economy from achieving low unemployment without inflation, but unemployment has gone much lower than some thought it could without causing a spurt of inflation. A pure free market cannot protect the environment or stop global warming. There are times when the government must step in, but it can do so without eliminating the benefits of the market.

Frank stated that a center-left coalition may form that will support international mobility of capital in exchange for action to relieve the costs of trade liberalization. A better safety net must be established--for example, income support and health insurance for workers who lose their jobs; environmental and labor standards should be written into international trade agreements. Liberal democrats have been demonized as being against free trade, but they know that globalization is inevitable and desirable under the right circumstances. They are prepared to go along with it as long as its negative effects are recognized and something is done to counteract them.

H. Onno Ruding

H. Onno Ruding, vice chairman of Citibank, discussed the global and national consolidation of financial institutions. Mid-sized banks may want to consolidate into large banks in order to diversify, to create a larger buffer to absorb losses, to meet the needs of larger clients, and to create an image of strength and safety. A growing number of mid-sized banks are merging among themselves or being acquired by larger banks. What remains is a small number of large institutions and a large number of small, specialized institutions. Despite the apparent advantages

of large size, not all mergers are useful or successful. For example, larger institutions may develop management problems.

Ruding also addressed consolidation between banks and other financial institutions, such as insurance companies. Banks may desire cross-category consolidation to improve their ability to meet all of a customer's financial needs and to add to their diversification of risk. However, cross-category mergers are not always a good idea because expertise in one kind of financial service does not guarantee expertise in another. Managers who do not fully understand a new business may make mistakes.

Bank consolidation also takes place across borders. Many of the reasons for domestic mergers apply as well to cross-border mergers, but there are also some reasons specific to cross-border consolidation, for example, the creation of the Euro zone and the increase among banks' clients of multinational corporations that require services worldwide. Ruding stressed, however, that despite all the talk about globalization, there are still enormous handicaps for cross-border bank mergers: language and cultural differences, tax and regulatory complications, and the unwillingness of some national authorities to approve a cross-border merger because they see it as a threat to their sovereignty.

Ruding stated that consolidation would not be desirable if it reduced competition, but experience has proved the opposite. The remaining banks are stronger and increase competition. More open borders around the world are also helping to ensure increased competition. A theoretical danger is not a good reason to block the drive toward consolidation in countries where conditions warrant it. With the right restrictions, financial consolidation is a good development and an unavoidable part of the globalization of the world economy.

Henry Kaufman

Henry Kaufman, president of Henry Kaufman & Co., Inc., discussed several changes in financial markets over the last 20 years. The increased securitization of financial obligation has spurred globalization by providing the illusion of liquidity and allowing investors to believe that they can sell financial obligations at any time. Globalization has caused homogenization of thinking in financial markets around the world, which has increased the risk of contagion in future crises. Asset allocation is more difficult today because international markets rise and fall together most of the time. Securitization has also allowed participants to calculate instantaneously the value of financial assets and it has created pressure for investors to change their position if their assets are underperforming even in the very short term.

According to Kaufman, there are new risk takers in markets today. Derivatives push risk onto clients that used to be borne by intermediaries such as banks. The increased role of derivatives has contributed to the increased volatility of markets. Other new risk takers are middle managers. The massive consolidation of financial institutions has created a situation in which there are so many decisions to be made that affect the risk position of firms that all senior management can do is set goals for middle management. Consolidation may lower the cost of

operation, but it creates serious danger for policymakers as more and more institutions become too big to fail.

The role of government in finance has also changed in recent years. The growth of government debt has slowed, and it has actually been falling in the United States and Canada. However, this change in the government's debt position does not reduce the debt in society but simply shifts it to the private sector. No one will know how efficient these new creditors and borrowers are until the United States goes through a full business cycle with the new roles in place. There is also uncertainty about the government's role in financial oversight. Financial institutions want to be entrepreneurial, but they often forget their fiduciary role. In good times, participants say they want the government to leave it to the market. Kaufman believes that the government must strike a balance. It should not be too intrusive, but it should intervene in bad times, such as during the peso crisis or after the stock market crash of 1987.

David A. Levy

David A. Levy, vice chairman of the Levy Institute and director of its Forecasting Center, observed that many economists today seem to believe that rising productivity and the "new economy" are rewriting the rules so that the economy can keep expanding rapidly and the stock market can keep soaring. Levy argued that although productivity has accelerated recently, it is still not rising as fast as it was in the 1950s and 1960s. While it is true that the new economy has enormous potential to greatly change our lives over the next generation, there will be serious problems in the interim because of huge financial imbalances. Enthusiasm about new technology and rapid economic development in the 1920s eventually proved to be justified, but the new economy of the 1920s did not prevent the United States from going through the Great Depression because the financial health of the economy was poor.

According to Levy, the depression happened because fragility in financial markets was more dominant in the short run than rising productivity. The United States is once again in a position of financial fragility. Assets have grown faster than income and debt has grown faster than assets. Personal bankruptcy is now considered a practical option rather than a moral failing. There were four times as many bankruptcies in 1998 as in the recession year of 1982. Financial sector debt in 1953 was only 3 percent of GDP; by 1999 it had risen to 82 percent. Leverage in asset markets has increased volatility.

Levy believes that when a decline in asset prices occurs, it will have a major effect on profits that will reverberate throughout the economy. It is hard not to envision a downward spiral into recession, and a recession in the United States would have devastating effects for the world economy. The world economy is overextended, indebted, fragile, and dependent on the U.S. trade deficit to absorb its exports. But the U.S. economy is in one of the biggest asset bubbles in history. The chances of deflating asset prices and contracting debt without a major economic downturn in the next few years are slim. Referring to the current expansion, Levy concluded, "There may be a few good chapters to come, but I don't see a happy ending."

[Back to Contents](#)

Session 1. Stock Market Effects and the Macroeconomy

Byron R. Wien, managing director and chief investment strategist for the United States at Morgan Stanley Dean Witter & Co., stated that the stock market performance of the last 10 years has exceeded everyone's expectations as a result of the boom in technology stocks. Computer software and computer services business (including the Internet companies) does represent a technological revolution, but the valuation of many technology stocks is unsustainable. Estimates derived from a dividend discount model suggest that the S&P 500 may be as much as 40 percent overvalued. The upsurge in the stock market has been made possible by a combination of growing margin debt, rising personal income, and an expansionary monetary policy pursued by the Federal Reserve. However, the recent slowdown in the growth of the money supply, an increase in real interest rates, and an increase in the inflation rate threaten the boom. There is bound to be a correction in the market, but a prolonged bear market is unlikely because the prospects of a serious recession are rather dim.

According to **Robert J. Barbera**, executive vice president and chief economist at Hoenig & Co., the U.S. equity market bubble is close to bursting. During the last eight years market analysts' expectations of long-term growth in earnings have climbed steadily and are now around 16 percent per annum. However, such growth is incompatible with any reasonable macroeconomic scenario for the next few years because it implies an unrealistically low long-run unemployment rate and an unrealistically high current account deficit or an unrealistically high share of corporate profits in national income. In the more immediate future, as the Federal Reserve tightens monetary policy in response to the phenomenal growth in margin debt and the speculative binge in technology stocks, the excess liquidity in the stock market is bound to disappear. The technology sector, which has enjoyed the equity-financed boom, will be the hardest hit in the event of such a reversal.

David A. Levy, vice chairman of the Levy Institute and director of its Forecasting Center, and **Srinivas Thiruvadhanthai**, resident scholar at the Forecasting Center, examined the effect on the macroeconomy of the stock market via the household wealth effect. The stock market boom is producing an increase in aggregate household wealth, which has caused an exceptional rise in household spending. Since 1996 both consumer confidence and retail sales have been linked to stock market performance to an unprecedented degree. Estimates based on an econometric model of the household sector that allows for mutual interactions between consumption, wealth (including equity wealth), and income show a huge wealth effect in the 1990s. The estimates also show that the wealth effect is felt much more rapidly than generally believed and that the negative impact of a decline in wealth can be significantly greater than the positive impact of a rise in wealth.

According to **Frank A. J. Veneroso**, head of Veneroso Associates, and **Robert Parenteau**, director and economic strategist at Dresdner RCM Global Investors, insights from Minsky's

theory of financial fragility can be used to develop a coherent theoretical model of endogenous asset market bubbles. Rational behavior by three types of investors--the trend-following individual investor, the rational destabilizing hedge fund manager, and the relative performance money manager--can generate a situation in which stock buying begets more buying. The U.S. experience in the last few years is well explained by this model. Veneroso and Parenteau also argued that analysts' justification of the current valuation of technology stocks lacks credibility. Revenue growth in the personal computer and semiconductor industries has begun to stagnate over the last couple of years as a result of market saturation and limits on the share of national income these industries can command. The long-run future profit prospects for the majority of Internet companies are rather grim since the Internet cannot be privately monopolized to earn locational rents. Policy interventions can delay the bursting of the current bubble for some time, but they cannot postpone the day of reckoning indefinitely.

[Back to Contents](#)

Session 2. What Would Minsky Think?

According to **Martin Mayer**, guest scholar at the Brookings Institution, banks are not the major players in the economy they once were, and the Federal Reserve now should direct its attention more to equity markets than to banks. In the 1920s the Fed was perplexed by the question of what is a reasonable level for the stock market. There is still no answer today, and the question is even more important. Neoclassical economists assume that behavior based on rational expectations will stabilize markets, but this theory ignores momentum investing. People buy more, not less, when the price is going up because they believe it will continue to go up. Instead of assuming optimal markets, the Fed should be concerned about financial fragility and should evaluate the stabilizing or destabilizing effects of financial instruments.

Ronnie J. Phillips, professor of economics at Colorado State University, examined some of the lessons for dealing with financial crises that can be drawn from Minsky's work. The mainstream research generated by the Russian, Asian, and Brazilian crises does not offer a way to prevent the next crisis. Minsky pointed out that looking at problems of the past will not necessarily tell you how to deal with problems of the future. Market discipline will not prevent a crisis. The Asian countries did not have the expected signs of vulnerability, and the IMF's policies during the crisis do not instill one with the confidence that it will be able to forestall the next crisis. What is needed for stability is structural and macroeconomic reform. Debt deflations that occur in crises have considerable economic costs and contagious effects. A lender of last resort may help prevent contagion from developing.

L. Randall Wray, senior visiting scholar at the Levy Institute and professor of economics at the University of Missouri-Kansas City, believes that Minsky's insights into financial fragility, instability, and the relationships between profits, economic growth, and public and private financial balances are particularly relevant to today's conditions. There are signs of financial

fragility today, but people largely do not recognize them. High interest rates are increasing debt burdens and the number of defaults. Bankruptcy reform is making it more difficult to default, which will force indebted customers to cut back on other spending and will, therefore, make the next recession deeper. Private sector debt is continuing to rise; it is now over 5 percent of GDP. As debt service becomes an increasing proportion of income, consumers will cut back on borrowing, which will reduce the spending that is feeding the current expansion. Consumer spending could be stimulated through the government's ability to boost aggregate demand through public spending, but the current policy stance is biased toward surplus.

[*Editor's note: An expanded version of Professor Wray's remarks are available as Policy Note 2000/5.*]

[Back to Contents](#)

Session 3. The Financial Architecture in the Post-Gramm-Leach-Bliley Era

Ernest T. Patrikis, senior vice president and general counsel of American International Group, Inc., was disappointed that the Gramm-Leach-Bliley legislation did not go far enough toward deregulation. Most of it was devoted to distributing regulatory authority among agencies, which may mean more rather than less regulation. The legislation may be liberalizing for banking organizations, but it comes too late. It gives banks the power to invest more just as the economy is headed toward a downturn. According to Patrikis, the Fed is the best bank supervisor in the world, but there is a clear difference between supervision and regulation, and the Fed is not the best regulator in the world. Regulation is the laying down of rules that are often arbitrary and inflexible; supervision is qualitative and judgmental. The Fed could do a good job providing liquidity and acting as a supervisor of banks, and it probably could do these jobs better if it would leave regulation to other agencies.

Kenneth H. Thomas, independent consultant and lecturer at the Wharton School of Business, examined grade inflation in the bank ratings instituted in the Community Reinvestment Act (CRA) of 1977. These performance evaluations are the only bank and thrift examination findings disclosed by regulators. Inflation of CRA ratings has been alleged by community activists for two decades, but there has been no empirical investigation of it until now. Applying a unique grade inflation methodology to actual ratings and evaluation data for 1,407 small banks and thrifts under the revised CRA regulations, Thomas concluded that nearly half of all CRA ratings are inflated. He attributed these findings to what he calls the "friendly regulator hypothesis," which means that regulators have powerful incentives (such as the prospect of future private sector employment) to develop a close relationship with regulated institutions and to treat regulated institutions favorably.

Nancy A. Wentzler, director of Economic Analysis in the Office of International and

Economic Affairs at the Office of the Comptroller of the Currency, discussed new technologies that are being applied to financial instruments and are changing the financial markets. Technology has eroded the distinction between sectors of the financial market more than deregulation has, and the electronic marketplace will dominate financial transactions in the future. Banks will have to adapt to a world in which consumers have access to many alternatives. The interest rate margin for small banks has been declining for years and this decline is likely to continue. However, some small banks will survive and dominate niche service in local areas.

Session 4. Changes in the International Financial Structure

Robert Z. Aliber, professor in the Graduate School of Business at the University of Chicago, discussed aspects of the Asian financial crises of 1997 to 1998. Some analysts have suggested that the cause of the crises was too-hasty financial liberalization, but a closer examination reveals it was, instead, poorly managed domestic bank lending. The banks took unwarranted risks and engaged in Ponzi finance for several years, thus rendering the entire financial system vulnerable to shocks. Government controls that fixed the bank lending rate at a level lower than the market clearing equilibrium rate forced the more efficient firms to obtain capital from abroad. The slowdown in capital inflows before and during the crises led to monetary tightening and brought about sharp currency devaluations, thus contributing to the meltdown of these economies.

Philip F. Bartholomew, senior international adviser in the Economic Analysis Department of the Office of the Comptroller of the Currency, analyzed recent proposals to reform the two major international financial institutions--the International Monetary Fund and the World Bank. The effectiveness of these institutions is questionable. Their policies have been unsuccessful in achieving their desired objectives, and they appear to be highly inefficient bureaucracies. The institutions need greater transparency and better systems of reporting financial conditions. The IMF's attempts to solve problems of long-term economic development have largely been a failure and it should return to its original mission of short-term crisis relief. The recent reform proposals, by focusing on U.S. leverage in the international financial institutions, overlook the highly influential role of Japan, France, Germany, and other countries. The proposals also fail to address the actual mechanics of the reform process, leaving the institutions to reform themselves by some means, according to how they perceive people's preferences.

According to **Daniela Klingebiel**, financial economist in the Financial Sector Policy and Strategy Group of the World Bank, deregulation and information technology are bringing about fundamental changes in the global financial services industry and these changes have profound implications for public policy. Deregulation has led to reductions in trade barriers and dismantling of restrictions on investment and commercial banking. Information technology, especially the Internet, has helped reduce costs of operating businesses and starting new ones. It has also expanded the scope of the financial services industry by generating new products, several of which lead to a reduction in search costs for the consumer. The challenges for public policy in both developed and emerging market economies posed by the ongoing transformation of the industry are redesigning the safety net for the financial sector, including new ways to

assess risk; formulating competition policy that takes into account rapidly changing market definitions and new forms of market power; developing consumer protection policy with regard to privacy and information sharing; and finding ways to contain the international spread of the effects of domestic financial crises. The emerging market economies can benefit from the changes in the financial services industry only if they reform their institutions for regulation and supervision.

Jan A. Kregel, visiting senior scholar at the Levy Institute and international finance adviser at the United Nations Conference on Trade and Development, argued that the euro is bound to weaken against the dollar in the medium run. The weakness stems from the facts that the dollar is the international currency for financial intermediation and that the U.S. capital markets are deeper, broader, and more efficient than any others. The status of the United States as the dominant market for foreign investment also contributes to the strength of the dollar. The euro will appreciate against the dollar only if European capital markets can compete with dollar capital markets, but this is unlikely to happen in the medium term. The basic reason is that while the countries in the European Monetary Union have achieved convergence in terms of certain macroeconomic indicators, there still remains a substantial degree of heterogeneity at the national level. There are significant national differences in banking supervision and regulation, the competitive strategies of banks, credit ratings, and financial structure. As a result, the monetary policy of the European central bank generates different responses from the financial institutions of different countries within the EMU. The performance indicators of European banks are substantially below those of U.S. banks, which limits their capability to compete internationally and to pose a challenge to dollar capital markets.

Transcripts of the speakers' addresses and more detailed summaries of the sessions will be published in the conference proceedings. An audio webcast of the conference is available; see the [webcasts page](#) of the Levy Institute web site.

[Back to Contents](#)

"It" Happened, But Not Again: A Minskian Analysis of Japan's Lost Decade

Marc-André Pigeon

[Working Paper No. 303](#), June 2000

The financial crisis that hit Japan in 1990 inaugurated a period of slow economic growth that persists to this day. The vigorous application of fiscal, monetary, and institutional policies informed by orthodox economics did not succeed in reversing the financial and economic crisis. The policy stance pursued in Japan and the macroeconomic conditions prevailing there prior to the crisis are similar in certain respects to those now in the United States and Canada. Federal government surpluses are expanding, central banks are attempting monetary tightening to fight

inflation, and the regulatory (banking and environmental) and institutional structures (health care, and public and private unions) are being significantly dismantled. Research Assistant Marc-André Pigeon provides an institutional analysis of the Japanese financial crisis similar to the one Hyman P. Minsky applied to the post-World War II U.S. economy.

Pigeon argues that the popular perception of the pre-crisis Japanese economy as driven by a widespread bubble and speculative binge is unfounded. The bubble phenomenon was restricted to three areas of the economy: stocks, real estate, and banking. Firm-level data for 66 of Japan's largest companies and aggregate data for the industrial sector indicate that virtually all the performance indicators were better in 1990 than in 1985. However, Japanese firms were, on average, much more leveraged than their western counterparts. According to Pigeon, it was the institutional structure of the Japanese economy that allowed firms to prosper in spite of such high debt levels.

An institutional and policy environment that made rapid growth possible was developed during the 1950s and the 1960s. Corporations and investors could make decisions secure in the knowledge that the government would save a fragile bank, support a weak industry, reduce exchange rate volatility via capital controls, and assure a steady stream of cheap bank credit. The cheap credit resulted, over time, in a situation in which firms relied excessively on bank credit to finance investment and banks extended more credit than could be sustained by their asset base. The emerging weaknesses were concealed by rapid economic growth until three major shocks hit the economy in the 1970s: oil price increases, collapse of the Bretton Woods system, and trade tensions with the United States.

The government cushioned the impact of these shocks by subsidies and social spending, both financed by long-term government bonds with low yields which, by mandate, had to be absorbed by the banking system. Coupled with lower demand for loans from the largest companies, the banks began to experience a profit squeeze, which led to demands for deregulation. The deregulation process that began in the late 1970s gained momentum during the 1980s, and banks began to enter businesses that were risky and unfamiliar, principally the real estate sector. Nonbank financial companies, often financed indirectly by the banks, also entered the real estate business aggressively from the mid-1980s, thus leading to a deterioration in the quality of loans. The removal of capital controls and the opening up of the banking industry to more foreign competition, mainly under pressure from the United States, further strengthened the forces let loose by deregulation.

The growing fragility of the financial system was transformed into a financial crisis by changes in macroeconomic policy in the latter half of the 1980s. Monetary policy, as in several other OECD countries, began to focus solely on price stability; as a "preemptive strike," the discount rate was raised from 2.5 percent in May 1989 to 6 percent by the end of 1990. Fiscal restraint was pursued, as evident in the budget surpluses from 1987 and the tax hike in 1989. The inappropriate monetary and fiscal policies were the catalyst for the collapse of stock prices and real estate prices in 1990. The collapse of asset prices induced a liquidity preference on the part

of the banks and a serious cutback in loans. Given banks' paramount importance in financing investment, the financial and banking crises soon developed into a serious collapse of economic growth.

Pigeon believes that although the large-scale nonmarket institutions of the modern economy--the central bank and government--failed to ameliorate the Japanese crisis, this does not mean that these institutions are unable to play such a role. What is required is a vigorous and creative attempt by economists to design better institutions that can adapt quickly to constant changes. This task assumes even more urgency if one acknowledges the similarities between the pre-crisis situation in Japan and the current situation of the U.S. and Canadian economies.

[Back to Contents](#)

Can the Expansion Be Sustained? A Minskian View

L. Randall Wray

[Policy Note 2000/5](#)

Visiting Senior Scholar L. Randall Wray applies the insights of Minsky to analyze the future of the economic expansion. In the Keynesian model, investment is thought to be the driving force of the business cycle, but the early stages of the Reagan expansion can be explained by exploding government deficits and the Clinton-era expansion has been sustained primarily by increased household spending. According to Wynne Godley's analysis of the major financial balances, the United States has been running a trade deficit and the public sector has been running a surplus, both of which create a drag on the economy; this leaves only the private sector deficit as a source of stimulus. Consumers are now more willing and more able to borrow than at any time since the 1920s, and in the 1990s the private balance fell from a surplus of 4 percent of GDP to a deficit of 5.5 percent.

Adopting a Minskian perspective, in which government spending can act as an automatic stabilizer, Wray believes that the budget surplus is a serious danger to economic stability. The federal government has gone from a bias toward deficits at all stages of the business cycle to a bias toward surpluses in all but the most severe recessions. This bias could leave fiscal policy unable to stimulate the economy should a recession arise. Mainstream analysts hope that monetary policy will forestall any recession, but the experience of Japan shows otherwise. The Japanese government developed a similar bias toward surpluses by the late 1980s and continued in surplus for three years after the economy slid into recession in the early 1990s. Japan has remained in recession despite zero interest rates for nearly four years.

Wray sees several other Minskian danger signs for the U.S. economy. First, delinquency rates on loans and leases are not yet inordinately high, but they have been rising, which could indicate

problems to come. Second, the change in law making bankruptcy more difficult will force indebted consumers to cut back on other spending, which will make it harder to get out of recession. Third, Fed interest rate hikes will eventually increase the debt burden substantially among households. Fourth, weakness in the stock market will adversely affect consumer spending, if, as many believe, much of the increase in consumer spending has been stimulated by the wealth effect of the rising stock market. A continued wealth effect would require not only high but continually rising stock prices. Fifth, some areas of the economy slowed perceptibly in March. Sixth, there is a growing financing gap in the corporate sector. Seventh, business interest expense is rising sharply.

Economic theory does not support the notion that growing private sector deficits are any more sustainable than are growing public sector deficits and Minsky would have concluded that private sector deficits are far more risky. Wray believes Minsky would oppose any approach that relies on monetary policy alone to stabilize the economy and that limits fiscal policy to the maintenance of a surplus. Instead, the government should prepare to use fiscal policy to stimulate the economy should private sector spending falter, as already appears to be the case.

[Back to Contents](#)

Braver Newer World? International Banking Regulation in the 21st Century

Ronnie J. Phillips

Seminar, March 28

Ronnie J. Phillips, of Colorado State University, led a seminar on his work with Richard D. Johnson in which they examine the history of international banking regulation and its prospects for the future. Governments regulate domestic banks to protect depositors, to maintain monetary stability, and to ensure efficient and fair competition in the financial system. They regulate international banks for the additional purposes of creating a level playing field and guarding against systemic risk.

According to Phillips, international agreement on the regulation of global financial institutions is a relatively recent phenomenon. With the collapse of the Bretton Woods international monetary system in 1971, the increase in cross-border investments by multinationals, and the problem of recycling petrodollars, bank supervisory agencies in various countries began to recognize the need for greater cooperation to reduce the risks to the global financial system. However, it was not until the Basle Accord of 1988 that a major step was taken toward convergence of supervisory regulations governing the capital adequacy of international banks. The creation of the European Monetary Union promises to bring about changes in the structure and organization of banking in Europe and will undoubtedly affect global cooperation among banking agencies.

Phillips defined three possible approaches to international banking regulation in the future: a move toward greater reliance on the discipline of the market, the establishment of a supranational regulatory agency, and a continuation of the present system, which combines reliance on market discipline with an expandable role for international controls and supervisory cooperation. The third approach seems to be the one preferred by policymakers for the foreseeable future. It is likely that a cooperative effort for international banking regulation will progress gradually, with periodic accelerations caused by shocks to the financial system, such as payments crises and the collapse of one or several large financial institutions.

[Back to Contents](#)

Toward a General Model of Debt Deflation

Steve Keen

Seminar, May 23

Steve Keen, of the University of Western Sydney, demonstrated his dynamic model of financial instability. Static models focus on the levels of variables such as output, government spending, and demand. Dynamic models focus on rates of change in variables with respect to time and often the variables are expressed as ratios. For example, instead of using government spending as a variable, a dynamic model would use the rate of change in the ratio of government spending to output. The distinction between levels and ratios would be unimportant if dynamic processes converged to a static equilibrium and if static outcomes (those in which growth does not occur) were qualitatively indistinguishable from outcomes in which growth does occur. If these conditions do not hold, the difference between levels and ratios becomes extremely important.

According to Keen, dynamic tools are needed to analyze causal relationships because the economy is fundamentally dynamic and nonlinear. Dynamic tools include differential equations, systems engineering, and multi-agent simulations. A static linear model may capture a long-term convergence but it does not explain the cycles around an endogenously determined growth path. More important, it cannot show dynamic breakdown (the sudden reversal of a long-term trend), such as what happened to stock prices in 1929 to 1930. This type of systemic breakdown is what Hyman Minsky described in his financial instability hypothesis and what Keen has tried to model. To do so, Keen used an extension of Goodwin's predator-prey model in which wages, investment, unemployment, and output fluctuate around, rather than rest on, their equilibrium values. Near equilibrium, linear forces dominate, and since these are unstable in these models, values are pushed away from equilibrium levels; further away from equilibrium, nonlinear forces dominate, and values are pushed back toward equilibrium.

Keen extends Goodwin's model first by introducing debt, prices (using markup pricing), and a nonlinear investment function. Assuming a small government sector, the economy is locally

stable around equilibrium but globally unstable and thus it is vulnerable to systemic breakdowns via the accumulation of excessive private debt. Adding government as a potential countercyclical force converts the economy into one that is locally unstable around equilibrium but globally stable. Public debt counterbalances private debt and, although it does not eliminate cycles, it does prevent a debt-induced depression. Keen, therefore, sees a mixed economy as more systemically stable than a pure market economy.

[Back to Contents](#)

Special Studies

Is the New Economy Rewriting the Rules?

James K. Galbraith
[Policy Note 2000/2](#)

According to the "old rules," the expansion will not last. For decades economists have lived in fear of full employment, believing that wage inflation is sure to ensue and stifle a strong economic expansion. Today there is a new view that the "New Economy" has changed the rules, cutting costs and creating opportunities that never existed before and allowing the economy to generate more jobs before high employment sparks inflation. Senior Scholar James K. Galbraith, of the Levy Institute and the University of Texas at Austin, holds a third view, that the old rules were wrong all along.

According to Galbraith, in every year since 1993 unemployment has fallen and real growth has exceeded expected speed limits. In almost every year productivity has accelerated. Since unemployment fell below 6 percent, pay gaps have narrowed somewhat, demonstrating that rising pay inequality is not the price of progress. If there is a ceiling for growth or a floor for unemployment, no one knows where it is, and the Fed should not look for trouble in the imaginations of academics. There are dangers, but inflation is not one of them. The real dangers are high interest rates, stock market speculation, and excessive budget surpluses, which weaken private disposable income and act as a fiscal drag on the economy.

Galbraith asserts that the government can manage these dangers. It can offset household debt burdens by raising family income. It could raise the minimum wage, expand the earned income tax credit, support collective bargaining, expand public services, and consider modest tax relief. The Fed can help to contain a stock market bubble by controlling margin lending. This is a more targeted approach to stock market speculation than interest rate hikes and it would reduce the vulnerability of the stock market if a crash comes. The federal government can avoid excessive budget surpluses through appropriate taxation and spending policies. Galbraith believes that, with prudent policy, the good times could endure for another four or eight years.

[Back to Contents](#)

Health Care Finance in Need of Rethinking

Walter M. Cadette

[Policy Note 2000/4](#)

According to Senior Scholar Walter M. Cadette, several unfavorable trends have become entrenched in the health care system: a rising number of uninsured, relatively high out-of-pocket costs for many who are insured, loss of physician and patient autonomy with the ascendancy of managed care, and the unwillingness of third-party payers to pay for health care as generously as before. These trends require a comprehensive reevaluation of health care finance. Five major issues need to be addressed: the financial stress faced by the hospitals, Medicare's appropriate role in light of an aging population, a suitable model for financing long-term care, government's role in patient advocacy, and the status of the tax exemption of employer-based health benefits.

Hospitals are under severe financial stress primarily because of cutbacks in Medicare reimbursement under the Balanced Budget Act of 1997. The hardest hit are academic medical centers, which provide roughly 75 percent of uncompensated care and serve high-risk cases and low-income patients. Extremely low or zero operating margins for hospitals make it impossible for them to invest in emerging technologies. The economies the hospitals are forced to make as a result of financial stress will adversely affect the care received even by the well-insured.

The growing share of the elderly in the population will require an increasing proportion of the national income to be devoted to health care. Most of the expected increase will be provided through Medicare and this raises the question of how Medicare is to be financed. Cadette believes that higher Medicare tax rates and less reimbursement are undesirable options. The best alternative is to tie the benefits and premiums paid by beneficiaries under Medicare Part B to income so that the subsidies to the truly needy will be financed by the premiums paid by the better-off.

Long-term care is currently financed predominantly by Medicaid. The current welfare model has led to disparities in the quality of care received by people in different income groups and abuse by beneficiaries who can afford to pay and their heirs. The needs of all could be protected by pooling through insurance premiums, but a broad insurance market has not developed because of easy access to Medicaid.

The shift to managed care has restricted the freedom of patients to select care providers and of physicians to pursue a chosen course of treatment for a patient. HMOs should be made accountable for the consequences of denial or modalities of care, if such actions result from efforts to reduce costs.

Cadette believes that the tax exclusion of employment-based health benefits should be ended and the proceeds used to fund an income-scaled, refundable tax credit. A tax credit system, if accompanied by a requirement that everyone carry health insurance (as they must carry auto insurance), would achieve universal health care by overcoming portability problems and providing for low-wage employed, but uninsured Americans. It would restore health care decisions to individuals. It would also reduce moral hazard by pushing insurance toward catastrophic coverage.

According to Cadette, policymakers have to recognize that in the past cross subsidies from both government and employers provided health care for the poor and uninsured and support for hospitals. The government's fiscal restraint and the development of managed care have changed the situation starkly. The confluence of factors in the current system of financing will ultimately lead to a substantial deterioration in the quality of health care for all.

[Back to Contents](#)

Profits: The Views of Jerome Levy and Michal Kalecki

S Jay Levy
Seminar, April 20

Jerome Levy began his serious interest in economics and the derivation of the profits identity in 1908; unemployment was high in that recession year and no unemployment insurance or other public safety net was available for those who were out of work. Levy saw the profits equation as a tool to help address the scourge of unemployment. Michal Kalecki derived his version of the equation about 30 years later. He, too, was disturbed by unemployment and poverty. Chairman S Jay Levy led a seminar in which he compared the work of these two thinkers.

The Levy and Kalecki profits equations are essentially identical, but the processes of derivation were different. Although the two men would have understood and appreciated each other's work and probably would have broadly supported each other's point of view, they came from different cultural and theoretical places. Kalecki was a Pole who lived in a society of rigid classes: rich and poor and, to a great extent, rulers and ruled. He was dismayed by the inability of capitalism to provide full employment and by its lopsided distribution of wealth and power. Because he believed that unemployment was a feature of capitalism, he was attracted to Marxist ideas.

Jerome Levy, born in the small American town of Honesdale, Pennsylvania, was a member of a fluid society that lionized and rewarded able innovators. The Wright brothers, Irving Berlin, Henry Ford, George Eastman, David Sarnoff, Marcus Loew, George Pullman, and J. Walter

Thompson were just a few of Levy's more or less contemporaries who justified America's designation as the "land of opportunity."

Kalecki noted that capitalists' markup (the rate of profit on sales or revenue) determined the distribution of consumption between them and workers. He believed that capitalism tended to become increasingly monopolistic and that markups therefore tended to increase. Levy was not primarily concerned with the institutional form of an industry, that is, whether it was a monopoly in some sense or not. His primary interest was whether the rate of profit (the markup) was justified in terms of the productive risks of the industry.

Levy's premise was that profits are the sine qua non for private sector employment under capitalism, but not all profits induce desired production and employment. Kalecki would say that the current high and chronic unemployment in most of Europe supports his belief that such a situation is the natural outcome of capitalism. Levy would say that it is the result of abuses of the capitalist system, of the ways in which enterprises can "waste" profits. "Wasted profits" are those secured by enterprises that do not assume productive risks. Among these is the risk that the enterprise may not find a market for its products at prices that bring it a profit. To improve the standard of living of wage and salary earners and to assure full employment requires curtailing the waste of profits. Four-fifths of the jobs in the United States are in private, profit-seeking establishments. Profits are important and they should not be wasted.

[Back to Contents](#)

Phoenician Port Power: The Organization of Maritime Trade and Hinterland Production

Larry Stager
Seminar, May 3

Larry Stager, Dorot Professor of Archaeology of Israel at Harvard University, with funding support from Leon Levy, vice chairman of the Levy Institute, has been excavating the sites of two ancient Mediterranean seaports--Ashkelon and Tyre. In a seminar he discussed the role of "port power" in the development of the Phoenician trading empire.

The Phoenicians founded colonies throughout the Mediterranean from about 800 to 600 B.C.E. Although it seems that their major objective was to exploit the precious metals and other resources of the hinterlands, they limited their settlements mainly to the seacoasts. To explain this settlement pattern, Stager has constructed what he calls the "port power" model. The model describes a system in which the production centers of the interior were integrated, in a noncoercive manner, with the coastal colonies and overseas emporiums. Through their occupation of strategic nodes and control of key sectors of accumulation in this maritime network, import-export merchants could reap sizeable profits and wield more economic power

and influence than the harbor princes who protected them or the rulers of the interior, whose authority and power were largely circumscribed by territorial limits.

In the course of examining these maritime networks, Stager discovered through deep-sea reconnaissance two ships lying on the sea floor at a depth of 400 meters in the eastern Mediterranean. Stager believes that the two ships set sail from the Phoenician homeland (modern Lebanon) about 2,700 years ago and sank in a storm on their way to Egypt or the fledgling colony of Carthage. The ships and their cargoes, along with other evidence found in the excavations of Ashkelon and Tyre, support the idea of a large, complex trading system and suggest the power the port cities could derive from their control of the system.

[Back to Contents](#)

Institute News

Recent Events

Conference on Saving, Intergenerational Transfers, and the Distribution of Wealth

June 7-9, 2000

An international group of researchers gathered at Blithewood to present their recent work on the accumulation and distribution of wealth. The conference was organized by Edward N. Wolff, a senior scholar at the Levy Institute and a professor of economics at New York University.

In the first session, on wealth trends in the United States in the 1990s, **Arthur B. Kennickell**, of the Board of Governors of the Federal Reserve System, examined changes in the distribution of household wealth using data from the Survey of Consumer Finances. **Barry Johnson**, of the Internal Revenue Service, analyzed trends in the distribution of personal wealth using data from tax returns filed with the Internal Revenue Service.

Wealth extremes in the United States was the topic of the second session. **William Shay**, of Harvard University's Center for Basic Research in the Social Sciences, discussed sectoral sources of wealth accumulation by the wealthiest families (as reported in Forbes magazine) from 1982 to 1999. **Conchita D'ambrosio**, of Bocconi University, and **Edward N. Wolff** presented

a method to quantify the degree of polarization in wealth distribution and the estimates of polarization obtained from that method.

The third session focused on intergenerational transfers in the United States. **Frank Stafford**, of the Institute of Social Research, University of Michigan, and **Ngina Chiteji**, of Skidmore College, examined the relationship between actual asset ownership rates and family-based exposure to assets. **Paul Schervish**, of Boston College, projected the charitable giving by wealth holders over the next half century using a simulation model.

In the fourth session, on trends in home ownership, **Dalton Conley**, of New York University, discussed the relationship between income inequality, home ownership rates, social spending, and political behavior. **Erik Hurst**, of the University of Chicago, analyzed the causes of racial differences in home ownership rates and their consequences.

Wealth inequality and saving behavior in Europe and Japan was the topic of the fifth and sixth sessions. **Mariacristina Rossi** and **Anthony Shorrocks**, of the University of Essex, examined the differences in the patterns of wealth distribution in Britain that emerged from two different data sources. **Axel Börsch-Supan**, of the University of Mannheim, analyzed the factors behind German household saving decisions, especially the influence of pension policy. **Luc Arrondel**, of DELTA-CNRS, discussed how saving behavior by French households has changed in the recent years as a result of increasing economic uncertainties. **Charles Yuji Horioka**, of Osaka University, examined the nature of the bequest motive and its impact on the economic behavior of parents and children in Japan.

In the seventh session, racial divisions in wealth accumulation and distribution in the United States, **Maury Gittleman**, of the Bureau of Labor Statistics, U.S. Department of Commerce, and **Edward N. Wolff** examined racial differences in sources of wealth accumulation. **Lisa Keister**, of Ohio State University, examined racial differences in family structure and their impact on wealth accumulation patterns.

Wealth taxation was the focus of the eighth session. **John Laitner**, of the University of Michigan, discussed the effects of eliminating the federal gift and estate tax on wealth distribution using a long-run simulation model of saving behavior. **Pierre Pestieau**, of the University of Liège, presented a theoretical model of direct and indirect taxation that incorporates inherited wealth as an explicit variable.

The final session discussed the sources, inter vivos transfers, and psychological aspects of wealth accumulation. **F. Thomas Juster** and **Joseph Lutton**, of the Institute for Social Research, University of Michigan, examined the changing structure of saving and wealth in the United States over the last four decades using both aggregate and household-level data. **Stefan Hochguertel**, of European University, and **Henry Ohlsson**, of Göteborg University, presented an empirical study of intergenerational transfers in the United States. **Jay L. Zagorsky**, of Ohio State University, discussed differences in the perceptions of husbands and wives about household income and wealth and their impact on data generated from surveys.

In a speech, **James K. Galbraith**, of the Levy Institute and University of Texas at Austin, discussed the relationship between income inequality and wealth inequality, and the relationship between inequality and growth in the United States and Europe.

The fall issue of the *Summary* will contain synopses of the speech by Galbraith, the papers presented at the conference, and comments by the discussants. Extended summaries of the sessions will be published in the conference proceedings. The entire conference is also available from the audio webcast archives on our [web site](#).

Workshop on Earnings Inequality

June 6, 2000

Researchers gathered at Blithewood on June 6 to discuss their recent work on earnings inequality. The workshop was organized by Michael J. Handel, resident scholar at the Levy Institute.

Session 1. Earnings Mobility

Martina Morris, of Pennsylvania State University, compared hourly wage growth for two cohorts of young workers who were surveyed over 16 years, one cohort in the 1960s and 1970s and the other in the 1980s and 1990s. She finds that real wages for the more recent cohort were consistently lower than for the earlier cohort, grew more slowly, and grew more unequal over time. **Peter Gottschalk**, of Boston College, compared earnings mobility in the United States and Germany in terms of level of inequality over time, degree to which ranks reverse over time, and degree to which future income is dependent on current income. He finds that permanent income is more unequal in the United States than in Germany, but future income is less dependent on current income.

Session 2. Technology and Skills I

In a study of U.S. manufacturing plants, **Kenneth Troske**, of the University of Missouri-Columbia, finds that much of the total wage dispersion is between plants. Changes in between-plant wage inequality are related to changes in between-plant productivity differences and both are related to differences in levels of computer investment and capital intensity. In a case study of a plant that relocated, modernized production technology, and introduced greater employee involvement in quality control, **Roberto M. Fernandez**, of Stanford University, finds that skill requirements and wage inequality rose significantly among blue-collar workers.

Session 3. Technology and Skills II

Eli Berman, of Boston University, reported trends in the education premium. He finds that the premium rose dramatically in the 1980s, remained flat for most of the 1990s, and then resumed significant growth after 1997. **Michael J. Handel's** research challenges the attribution of inequality growth to technologically induced shifts in the demand for skill. He finds that most of the increase in inequality in the last two decades occurred during the recession in the early

1980s, before widespread computerization; that computer use is not related to educational upgrading within occupations; and that computer use does not appear to be related to shifts in the occupational structure.

Session 4. The Big Picture: Effects of the 1990s Expansion

In a study on changing levels of inequality across U.S. counties, **James K. Galbraith**, of the Levy Institute and the University of Texas at Austin, finds that from the late 1970s through the late 1990s there was a steady increase in inequality within states but that a small number of counties, especially those in large urban areas, account for most of this growth. **John Schmitt**, of the Economic Policy Institute, reported on trends in differentials between workers in the 90th, 50th, and 10th percentiles of the wage distribution from 1973 to 1999. The relatively small change in the gap between the 90th and the 10th percentiles in the 1990s masks growth in the differential between the 90th and the 50th percentiles and decline in the differential between the 50th and the 10th, as the bottom of the wage distribution recovered from some of the dramatic declines in the 1980s.

See the fall issue of the Summary for extended synopses of the workshop participants' papers.

[Back to Contents](#)

Upcoming Conference

Multiraciality: How Will the New Census Data Be Used?

September 22-23, 2000

Census 2000 introduces far-reaching but not well-understood changes in the way information about race is collected. Senior Scholar Joel Perlmann and Mary Waters, a professor of sociology at Harvard University, have organized a conference to consider these changes.

The arguments about how to ask "the race question" on the census form are over. In past censuses, each respondent had to choose one race; in the new census, the respondent may list more than one racial origin. The Census Bureau (and other government data collectors) now face the problem of how to count responses that mention multiple racial origins.

Race counts are used in many domains of American life: in education, economic, and health surveys; in legislative and judicial actions involving civil rights (such as workplace discrimination cases) and voting rights; and, of course, in predicting the future racial composition of the population. Officials in the private and public sectors, as well as researchers across the social sciences, use this information. But how will racial combinations be aggregated for their use? For example, when a respondent lists an Asian category and white, will that person be counted as the listed minority or as white? Who will decide?

The Census Bureau may not be obliged to answer these questions immediately. It can sidestep the issue by simply presenting detailed tabulations down to the smallest geographical unit. Nevertheless, the bureau will eventually be obliged to aggregate these counts into meaningful larger racial categories in its published volumes and to relate the figures to race trends presented in years past. Moreover, other government agencies will need definitions of racial groups that can be used to institute and operate policies that depend on race counts.

Because racial intermarriage is less common among some racial groups and more common among others, the impact of the new methods of racial counting will vary across racial groups. Also, responses to the race question and to the question about Hispanic origin are so often used together that the new formulation of the race question is bound to affect counts of the Hispanic population as well as those of racial groups.

Complicating the problem is that there is more than one reasonable way to aggregate the counts and to define racial groups. In its pilot work, the bureau experimented with different ways of tabulating and aggregating multiple responses to the race question. Any method of classification or definition that an agency elects to use and any governmental ruling relying on racial data will be a candidate for challenge.

The conference will be loosely organized around five themes:

- Anticipated responses to the new race question in Census 2000
- Presentational issues for the Census Bureau and other agencies
- How and whether to make projections of shares of different races in the population
- A historical and comparative perspective on government classification and counts
- Implications of multiracial categories for ethno-racial preference programs

Invited participants include federal officials and university scholars: Kenneth Prewitt, John Thompson, and Jorge H. delPinal, Census Bureau; Katherine Wallman, Office of Management and Budget; Clyde Tucker, Bureau of Labor Statistics; Jennifer Madans, Centers for Disease Control and Prevention; sociologists Reynolds Farley, Josh Goldstein, Charles Hirschman, and Matthew Snipp; political scientists Jennifer Hochschild and Peter Skerry; and historians Hugh D. Graham and Matthew Jacobson.

The conference will be held at Blithewood. The registration fee is \$100. Program information will be posted on the [Events page](#) in the What's New section of the Levy Institute web site as it becomes available.

[Back to Contents](#)

Publications and Presentations by Levy Institute Scholars

Philip Arestis Visiting Senior Scholar

Publications: "OECD Unemployment: Structural Breaks and Stationarity" (with Iris Biefang-Frisancho Mariscal), *Applied Economics*, March 2000; "History Warns Against Ditching the Pond at this Level" (with Malcolm Sawyer), *The Guardian*, April 3.

Presentations: "The Economics of New Labour" (with Malcolm Sawyer), Conference on Economics of the Third Way, University of East London, May 26; "Financial Sector Reforms in Developing Countries with Special Reference to Egypt," The Economic Policy Initiative Consortium Conference on Financial Development and Competition in Egypt, Cairo, May 30-31; "The Relevance of Kalecki's 'Political Aspects of Full Employment' to the 21st Century" (with Frank Skuse) and "Economics of New Labour: An Assessment" (with Malcolm Sawyer), Post Keynesian International Workshop, Knoxville, Tennessee, June 23-28.

Walter M. Cadette Senior Scholar

Publication: "Financing Long-Term Care," *Sanders Research Associates' Quarterly Commentary*, First Quarter 2000.

Presentations: "Financing Health Care: Problems and Prospects," Eastern Economic Association, Crystal City, Virginia, March 24-26, 2000; "Financing Long-Term Care," Institute for SocioEconomic Studies and Manhattanville College, Purchase, New York, April 24.

Steven M. Fazzari Senior Scholar

Publication: "Investment-Cash Flow Sensitivities Are Useful: A Comment on Kaplan and Zingales" (with R. Glenn Hubbard and Bruce Petersen), *Quarterly Journal of Economics*, May.

Presentation: "How Responsive is Business Capital Formation to Its User Cost? An Exploration with Micro Data," CIDE, Mexico City, May 26.

Mathew Forstater Research Associate

Publications: "Adolph Lowe on Freedom, Education, and Socialization," *Review of Social Economy*, June 2000; "Savings-Recycling Public Employment: An Assets-Based Approach to Full Employment and Price Stability," *Journal of Post Keynesian Economics*, Spring, 2000; editor (with Aaron Warner and Sumner Rosen), *Commitment to Full Employment: The Macroeconomics and Public Policy of William S. Vickrey* (M. E. Sharpe, 2000).

Presentations: "Sraffa, Lowe, and the Revival of Classical Political Economy," History of Economics Society, Vancouver, June 2000; "'You Know My Method!': Analysis and Synthesis in Lowe, Peirce, and Polya (and Sherlock Holmes!)," International Network for Economic Methodology, Vancouver, June 2000; "Full Employment Policies Must Consider Effective Demand and Structural and Technological Change," Post Keynesian Workshop, Knoxville, June 2000; "Working Backwards: Instrumental Analysis as a Policy Discovery Procedure" and "Freedom, Education, and Socialization," Western Social Science Association, San Diego, April 2000; "Full Employment and Multicultural Democracy," Conference on Public Service Employment Assurance, University of Missouri-Kansas City, March 2000.

James K. Galbraith Senior Scholar

Presentations: "Is the New Economy Changing the Rules?" White House Conference on the New Economy, First Plenary Panel, April 5; "Inequality, Unemployment, and Growth: Was Kuznets Right After All?" Florence Davis Dean Lecture, University of Vermont, Burlington, April 20; "Issues in the 2000 Campaign," The Century Foundation Panel Discussion, National Press Club, Washington D.C., April 28; "Sustainable Development and the Open Door Policy in China" (with Lu Jiaqing), Workshop on Sustainable Development, Council on Foreign Relations, New York, May 5; "Inequality, Unemployment, and Economic Growth," University of California at Riverside, May 17; "The Evolution of Wage and Earnings Inequality in the World Economy," University of California at Santa Barbara, May 18; "What Can be Done About Unemployment?" Learning2000 Conference, Lisbon, Portugal, May 28.

Wynne Godley Distinguished Scholar

Publication: "Is Goldilocks Doomed?" (with L. Randall Wray), *Journal of Economic Issues*, March 2000.

Oren M. Levin-Waldman Resident Scholar

Publication: "The Minimum Wage Can Be Raised: Lessons from the 1999 Levy Institute Survey of Small Business," *Challenge*, March-April; "The Rhetorical Evolution of the Minimum Wage," *Rhetoric & Public Affairs*, June.

Presentations: "Welfare Reform: Theory and Practice," Eastern Economic Association, Crystal City, Virginia, March 24-26.

Media: Interview, National Public Radio, May 1.

Jamee K. Moudud Resident Scholar

Presentations: "Macroeconomics of Social Policy" (with Resident Research Associate Ajit Zacharias) and "A Classical Determination of the Loan Rate of Interest" (with Anwar M. Shaikh of New School University), Eastern Economic Association, Crystal City, Virginia, March 24-26, 2000.

Dimitri B. Papadimitriou President

Publications: "Minsky, Hyman P.," a biographical entry in R. J. Barry Jones (ed.), *Routledge Encyclopaedia of International Political Economy* (Routledge, 2000); "Minsky's Analysis of Financial Capitalism" (with L. Randall Wray), in Ricardo Bellofiore and Piero Ferri (eds.), *The Legacy of Hyman P. Minsky* (Elgar, 2000).

Presentations: "The Budget Surplus and the State of the U.S. Economy," Eastern Economic Association, Crystal City, Virginia, March 24-26; "The State of the U.S. Economy" and "Full Employment Policy and the Benefits of Public Investment," St. Petersburg State University, Russia, April 4-6; "Prospects for Full Employment: Theory and Evidence" and "Can Social Security Be Saved," Western Economic Association's International Conference, Vancouver, June 30.

Malcolm Sawyer Visiting Senior Scholar

Publications: "The Theory of Industrial Policy," in Wolfram Elsner and John Groenewegen

(eds.), *New Challenges to Industrial Policy* (Kluwer Academic Publishers, 2000); "History Warns Against Ditching the Pond at This Level" (with Philip Arestis), *The Guardian*, April 3. **Presentations:** "The Economics of New Labour" and "Endogenous Money and Economic Policy," University of the Basque Country, Bilbao, Spain, April 13-14; "Britain and the Single Currency," UNISON and National Union of Teachers, London, May 19; "The Economics of the New Labour" (with Philip Arestis), Conference on Economics of the Third Way, University of East London, May 26; "Kalecki on Money and Finance," "The Economics of the Third Way," and "Economics of New Labour: An Assessment" (with Philip Arestis), Post Keynesian International Workshop, Knoxville, Tennessee, June 23-28.

Willem Thorbecke Research Associate

Publications: "Monetary Policy, Time-Varying Risk, and the Bond Market Debacle of 1994," *Journal of Macroeconomics*, Vol. 22, no. 1; "A Public Choice Perspective on the Globalizing of America," in Thomas L. Brewer and Gavin Boyd (eds.), *Globalizing America* (Elgar, 2000).

Presentations: "Budget Deficits, Inflation Risk, and Asset Prices," Washington Area Finance Association Conference, April 28; "European Macroeconomic Policy Interdependencies," Rutgers University Law School, June 9.

Karl Widerquist Resident Research Associate

Presentations: "Public Choice Problems Among Altruists and Moral Idealists," Eastern Economic Association, Crystal City, Virginia, March 24-26, 2000; "The Public Commodities Problem," Public Choice Society, Charleston, South Carolina, March 10-12, 2000.

Edward N. Wolff Senior Scholar

Publications: "Technology and the Demand for Skills," in Lex Borhans and Andres de Grip (eds.), *The Overeducated Worker?* (Elgar, 2000); "How Persistent is Industry Specialization Over Time in Industrialized Countries?" *International Journal of Technology Management*, Vol. 19, nos. 1 and 2.

Presentation: "U.S. Income Distribution," Economics Club, New York University, April 18.

Media: Interview, Brazil's Globostate television, April 13; Interview, Harold Channer's *Conversations* television program, April 17; Interview, IDEA-TV, April 19; Interview, Public Broadcasting Station program *After the Gold Rush*, April 20; Interview, Harold Channer's *Conversations* television program, May 15.

L. Randall Wray Visiting Senior Scholar

Publication: "Is Goldilocks Doomed?" (with Wynne Godley), *Journal of Economic Issues*, March 2000.

Presentations: "The Surplus Threatens Goldilocks," Boston Economics Club, Federal Reserve Bank, April 19; "The Tale of the Surplus that Devoured Goldilocks," Bradley Institute of Belmont Abbey College, Charlotte, North Carolina, April 25.

Ajit Zacharias Resident Research Scholar

Presentation: "Macroeconomics of Social Policy" (with Resident Scholar Jamee K. Moudud), Eastern Economic Association, Crystal City, Virginia, March 24-26, 2000.

[Back to Contents](#)
