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The Jerome Levy Economics Institute of Bard College

# Summary

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*Summer 1996*

*Volume 5, Number 3*

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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.

The Summary is a quarterly publication of The Jerome Levy Economics Institute of Bard College and is produced by the Bard Publications Office.

Editor: Frances M. Spring

Text editor: Judith Kahn

The Jerome Levy Economics Institute of Bard College  
Blithewood

Annandale-on-Hudson, New York 12504-5000

914-758-7700, 202-737-5389 (in Washington, D.C.)

E-mail: [info@levy.org](mailto:info@levy.org)

Web site: <http://www.levy.org>

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## Letter from the Executive Director

To our readers,

This issue of the Summary includes activities in three research programs and miscellaneous research topics. Events relating to the employment and labor market structure program were our annual employment conference, a series of forums on immigration and ethnicity, and three seminars. The synopsis of the conference, "The Employment Act of 1946: 50 Years Later," includes summaries of the remarks of featured speakers, which included Katharine Abraham, Bureau of Labor Statistics; George Becker, United Steelworkers of America; Richard E. Cavanagh, Conference Board, Inc.; S Jay Levy, Levy Institute; and Alicia H. Munnell, Council of Economic Advisers, and a session in which the panelists were all former members of the Council of Economic Advisers: George C. Eads, William Niskanen, James Tobin, and Murray Weidenbaum. The forums were organized as part of the research initiative, "Ethnicity and Economy in America-Past and Present." The first forum featured Roger Waldinger, professor of sociology at the University of California at Los Angeles. The second was entitled "Immigration, Racial Identity, and Work: Past and Present" and the third "Immigration, Economy, and Policy in America." In the seminars, Alan Krueger of Princeton University discussed the legacy of separate and unequal schooling, Robert Frank of Cornell University spoke about the increasing reward to the top earners within occupational groups, and Richard J. Murnane of Harvard University School of Education talked about the new level of skills required in the workplace.

In the financial sector restructuring program three new working papers are summarized. In the first, Distinguished Scholar Hyman P. Minsky explores the economic uncertainty arising from the current form of capitalism. In the second, Executive Director Dimitri B. Papadimitriou and Research Associate L. Randall Wray examine problems in using the CPI as a monetary policy target because of biases in the index and because the typical transmission mechanisms of monetary policy might not work through the components of the CPI. In the third working paper, Minsky and Visiting Scholar Charles J. Whalen search for reasons to account for the split in post-World War II economic performance before and after 1966. The summary of our sixth annual financial structure conference, "Recent Developments in the Financial System," includes synopses of remarks by the conference's featured speakers: J. Kenneth Blackwell, treasurer of the State of Ohio; Neil Levin, New York State Banking Department; Eugene A. Ludwig, Comptroller of the Currency; Roberto G. Mendoza, J. P. Morgan & Co.; Ernest T. Patrikis, Federal Reserve Bank of New York; Jay N. Woodworth, Woodworth Holdings, Ltd.; and Janet L. Yellen, Board of Governors of the Federal Reserve System.

In the international trade and competitiveness program there are six new working papers. John Williamson evaluates proposals to create a new short-term financing facility; Louis Kasekende, Damoni Kitabire, and Matthew Martin analyze capital flows to sub-Saharan Africa; Claudio E. V. Borio and Robert N. McCauley analyze the volatility in the major bond markets in 1994; E. V. K. FitzGerald investigates roles that the International Monetary Fund might play given its mandate and current worldwide economic instabilities; Andrew Cornford and Jan Kregel examine the failure of policies of the postwar period to produce economic stability and explore policies based on economic fundamentals that might reduce these instabilities; Guillermo Le Fort and Carlos Budnevich assess the macroeconomic and financial results of Chilean and Colombian policies regarding external capital accounts; and Yung Chul Park and Chi-Young Song analyze the experiences of Korea, Thailand, Malaysia, and Indonesia in managing rapid capital inflows. These papers were presented at a symposium, "Global Capital Flows in Economic Development," jointly sponsored by the Levy Institute and the United Nations Conference on Trade and Development (UNCTAD). Included here is a synopsis of the symposium's policy roundtable.

The work summarized under miscellaneous research topics is a working paper by Resident Scholar Oren M. Levin-Waldman in which he argues that the 1994 election did not represent a political realignment.

As always, I invite your comments on the Summary.

Dimitri B. Papadimitriou  
Executive Director

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## **Program Summary: Employment and Labor Market Structure**

### **Conference**

#### **The Employment Act of 1946: 50 Years Later**

On April 25 and 26 the Levy Institute held its annual conference on employment issues, "The Employment Act of 1946: 50 Years Later." The conference focused on the status of the goals stated and institutions established in the 1946 act. Featured speakers were Katharine Abraham, commissioner of the Bureau of Labor Statistics; George Becker, president of the United Steelworkers of America; Richard E. Cavanagh, president of the Conference Board, Inc.; S Jay Levy, chairman of the Levy Institute; and Alicia H. Munnell, member of the Council of Economic Advisers. Conference sessions were entitled "The Links among Technological Change, Corporate Restructuring, and Stable Employment," "The Economic and Labor Market Effects of Immigration," "Options for Low Inflation and Long-Term Employment," "Marketplace Dynamics and Less-Skilled/Low-Wage Workers," "The Employment Act of 1946: A Perspective from the Council of Economic Advisers," and "Employment Policy in a Changing Marketplace." The speakers' remarks and the Council of Economic Advisers' session are summarized below.

#### **Katharine Abraham**

Katharine Abraham's address, "The State of Our Economic Intelligence: Where We've Been and Where We're Going," focused on the evolution of economic data collection since the Employment Act of 1946. She noted that although the act made no mention of the statistical agencies of the federal government, it is clear that sound economic data are critical to the role that the act envisioned for those charged with the development and execution of macroeconomic policy. A surprising amount of information was available prior to the passage of the act, including data on employer payrolls and employment, average weekly hours and earnings, labor force

participation and unemployment, wholesalesale and consumer prices, and gross national product. At that time, however, there was no model for how data would be collected. Initially, Bureau of Labor Statistics (BLS) reports were perceived as advocacy pieces rather than objective analyses. In order to counter this perception, the BLS and other data-collecting institutions adopted professional standards of objective analysis that continue today.

Since 1946 improvements in the production of core economic measures have been made by sharpening concepts, expanding the scope of coverage, announcing all publication dates in advance, and limiting access to data prior to their release. Abraham noted that there is a natural tension between wanting to improve the data and wanting to keep measurements constant in order to have a consistent series. Most improvements were suggested by expert panels, such as the 1962 Gordon committee, the 1979 Levitan commission (on employment data), the 1961 Stigler committee, and the current Boskin commission (on consumer prices). These panels were convened in response to perceptions that there were serious problems with certain data. For example, the Boskin commission stemmed from congressional testimony about the consumer price index (CPI) by Alan Greenspan in which he stated that research at the Fed indicated that there was a significant (1.0 to 1.5 percentage point) upward bias in the measure. Since a more slowly rising CPI would slow the growth of federal spending, increase the flow of tax revenues, and reduce the federal budget deficit, it is not surprising that in the current climate of austerity this issue has received a lot of attention.

Abraham judged that economic data are substantially better today than in 1946 and that, contrary to some news analyses, "our statistical system is second to none in the world." She offered three possible explanations for why the data are perceived as unreliable. First, demands are now placed on the data that were not envisioned when the data were designed; these demands result from the "pocketbook implications" of the data, such as their effects on stock market prices, federal spending levels, and federal tax brackets. We should remember, noted Abraham, that these data were designed as economic indicators to be used for description and analysis, not necessarily for the purposes for which they are used today. Second, the data do not cover aspects of economic questions that have arisen since the data were designed. For example, employment statistics were designed at a time when most people worked full-time and on site. The present diversity of employment arrangements leaves some questions unanswerable with the available data. Third, budgetary constraints prevent the BLS from producing much more than the data it is legally required to produce. In real terms the BLS appropriation is the same now as it was in 1978.

## **George Becker**

George Becker prefaced his remarks saying that for him work and economics are a real-life experience. As a noneconomist he may not always understand all of the economic models presented to him, but he does know, based on his experience, what works and what does not and what is good for American workers.

During the period from 1979 to the early 1990s the federal government encouraged imports and, through its antiinflation policies, "gave away" an estimated 9 to 11 million American jobs in industries such as steel, auto, electronics, textiles, and shoes. The steel industry was virtually dismantled and the steelworkers' union lost over a half a million members. The jobs lost were "family-supportive jobs," that is, jobs that had allowed workers to make enough money to participate in the American dream: to raise a family, buy a house and a car, and educate their children. Communities were and remain affected by these job losses: water systems were shut down, schools and hospitals closed, and police and fire services curtailed.

During this time the steelworkers' union worked with the surviving mills, forcing some companies to stay open and becoming experts in newly devised plans to keep companies afloat, such as employee stock ownership plans (ESOPs) and concession bargaining. In concession bargaining the union insisted that companies reinvest in the mills at the first opportunity. In many cases the union took over the mills and instituted new work practices. Many mills reached partnership agreements with the union. The surviving U.S. steel industry is the most competitive in the world.

The world of work, however, changed forever. Family-supportive jobs were eliminated and new ones have not been created. The incomes of two working spouses do not equal the income from one family-supportive job

during the 1970s. It is the exception when a young worker can get a job with health care benefits, and job security is not even a dream for most. In spite of soaring U.S. productivity levels, living standards are declining.

What went wrong with the so-called American dream? Becker vehemently disagreed with those who assert that no one has any idea of what is causing wage stagnation or how wages could be raised. Quite the contrary, we learned what is necessary from the Great Depression: Workers need to be allowed to organize, to bargain collectively with their employers, and to share in the wealth they create. During the last 20 years, however, employers have rejected this contract and have made every effort, at times in collusion with the government, to negate it.

Becker stated that government policy should be directed toward encouraging and assisting in the creation of family-supportive jobs. It is his belief that Federal Reserve policies are a part of the problem, not a solution. Controlling inflation by raising interest rates generates a tremendous transfer of wealth from working people to Wall Street and causes economic stagnation. The 5.5 percent of workers who are unemployed as a result are prohibited from participating in the American Dream. Becker asserted that any system that requires for its success a large reservoir of unemployed people to keep wage rates and the economy depressed is fundamentally flawed.

### **Richard E. Cavanagh**

Richard E. Cavanagh asserted that articles published in the popular and academic presses often lead to the impression that large-scale enterprise accounts for an increasingly smaller percentage of total employment, that downsizing among large firms is the principal factor in total job loss, and that downsizing has been undertaken to satisfy the interests of Wall Street. It is easy to understand how people might draw such conclusions from the fact that the ten largest companies that announced downsizing since 1993 displaced a total of 279,000 workers. But, according to Cavanagh, that impression is inaccurate. He examined data from a recent issue of Fortune magazine on the 390 firms among the 500 largest industrial and service corporations headquartered in the United States in business today that also were in the Fortune 500 in 1991. (Among the remaining 110 corporations, some had merged, such as CBS and Westinghouse; some had split into separate entities, such as Sears Roebuck; and others had possibly changed their name.) He found that employment among the 390 totaled about 20 million workers in 1995, or 17 percent of total U.S. employment, a figure consistent with past employment shares (17.0 percent in 1960, 17.6 percent in 1980, and 17.4 percent in 1990). These same firms created 500,000 net new jobs since 1991, a figure representing about 5 percent of the total employment increase during the period. Cavanagh reasoned that the employment and job creation figures imply that these firms are neither the principal destroyers nor the principal creators of jobs. In addition, Cavanagh observed that some firms (61 percent) experienced rapid (greater than 10 percent) employment growth, while others (26 percent) experienced employment declines.

Cavanagh also found that the 13,000 companies publicly traded on a stock exchange (including the Fortune 500) accounted for approximately 45 million jobs. Their job growth was characterized by Cavanagh as modest and stable. During the past three years the number of publicly held firms increased by 8,000 from a base of 5,000 in 1993. There is no comparative data for 1991 and 1995 for about two-thirds of the current firms; however, the 4,600 firms for which there are common data for 1991 and 1995 accounted for 1.2 million new jobs, or 12 percent of U.S. job growth for the period.

Cavanagh asserted that employment growth among these firms was driven by revenue growth, profitability, and return to shareholders. Of the top 25 firms in revenue growth, 16 were among the top 25 in terms of employment growth, and, surprisingly, 30 of the 53 industry groupings grew in employment, including textiles, apparel, and food, which all posted greater-than-average employment growth. Among the 390 Fortune 500 firms, those companies having high (over 20 percent) returns to shareholders over the past 10 years also had high (7 percent) employment growth; those experiencing declines in shareholder returns (averaging 10 percent or more) posted a 9 percent decrease in employment. Moreover, firms that had declining returns to investment cut employment, while those that posted a high return to investment share increased employment.

Cavanagh observed that the performance of individual companies was more important than the sector in which a company did business. For example, some of the largest employment increases were experienced by high-technology firms (Microsoft, Dell, Compaq, and Quantum), but some of the largest employment losses were posted by firms in the same industry (DEC, Wang, and IBM). Employment growth was also recorded in some of the so-called mature industries, in which we would not expect such growth to occur (State Farm Insurance, up 38 percent; Nike, up 27 percent; Mattel, up 19 percent); these firms also registered large gains in revenues and profits.

Cavanagh concluded that employment trends are likely to change somewhat in the near future and that some firms will experience tightening in their labor markets. Conference Board polls indicate that (1) in contrast to only three years ago, big business in the United States "is increasingly focused on the top line of revenue growth rather than the bottom line of return to shareholders"; (2) most people believe that downsizing and restructuring will continue, but that their limits have more or less been reached; and (3) the chief human resource officers from 50 of the 100 largest corporations in the United States predicted that within 12 to 18 months we will experience labor scarcity, particularly in high-quality, high-skill jobs. Cavanagh noted that a third of Conference Board members report that they currently have shortages in entry-level and senior-level technical and managerial personnel.

## **S Jay Levy**

S Jay Levy discussed his concern that job insecurity, as distinct from unemployment, is rapidly spreading and intensifying. Levy, recalling the recent chess match between world champion Gary Kasparov and the IBM computer, Deep Blue, noted that computers now appear to have analytic capabilities that put many administrative and technical jobs at risk, jobs never before threatened by scientific advances. Technological change may also partly explain why formerly paternalistic corporations at the leading edge of applied technology, firms noted for employee security and good benefits, have in many ways turned their backs on their workers.

Levy voiced little doubt in the ability of the U.S. economy to create full employment at a level not truncated or guided by concepts such as a "natural" or nonaccelerating inflation rate of unemployment (NAIRU). If the nation maintained policies that stress growth and ignore a NAIRU, the U.S. economy would have full employment by almost any definition. However, the uneasiness arising from technological advances would hardly be alleviated by a boost in the rate of employment.

Technological advances will result in increased productivity in many industries, and labor costs are likely to fall. Although greater use of computers and related machines will tend to limit price increases, something unique is happening today; technology is causing job losses that would occur regardless of policies that might result in cyclical unemployment. Skilled occupations are being displaced as a result of computerization. So although the economy is able to create a great many jobs, technology-driven displacement of well-paying jobs is occurring at an increasing rate.

Is technology no longer serving human beings? If so, what should we do? If technological advances are a major contributor to the present widespread sense of economic insecurity, we must address the ethical implications of a system that puts masses of people in an uncomfortable, if not unhappy, condition. We cannot stop the march of technology, and it is one of the gifts of the twentieth century. The trouble is that neither economic theory nor the wisdom developed by other disciplines has experience with the problems that arise from it.

## **Alicia H. Munnell**

Alicia H. Munnell spoke about macroeconomic issues related to the Employment Act and the recent report on the quality of new jobs issued by the Council of Economic Advisers (CEA). Munnell voiced her satisfaction that the Employment Act instructs "the federal government to use all practicable means to promote maximum employment, production, and purchasing power." The legislation represented a fundamental change in thinking about the magnitude of economic fluctuations we are willing to tolerate.



According to Munnell, the costs of allowing the economy to operate at less than maximum employment are significant. Even with unemployment insurance and income support programs, unemployment results in a loss of income, a reduction in future earnings potential, and devastating psychological effects. These consequences are particularly painful for the most disadvantaged members of society and aggravate existing trends of decreasing earnings and increasing income disparities. Although the situation of the poor and the low-skilled improved during the 1960s, it stagnated in the 1970s and worsened in the 1980s, especially during the 1980-81 recession. During the recovery of 1983 to 1989 the incidence of poverty remained high and earnings for families headed by people with less than a high school degree fell. Maximum employment remains a necessary, although not sufficient, condition for improving the well-being of the disadvantaged.

Munnell noted that economic improvements during the past three years, especially improvements in the federal budget deficit, have allowed the economy to operate at full employment in an environment of low and stable inflation. The current unemployment rate is 5.6 percent as compared to 7.3 percent in 1993. Moreover, a recent CEA study reports that the quality of the new jobs is good. According to BLS data, the percentage of the workforce with more than one job was 5.2 percent in 1970 and has since fluctuated between 4.0 percent and 6.2 percent; the figure stood at 5.8 percent in 1994 and 6.2 percent in 1995. These data imply that there has been no spurt in the number of people holding multiple jobs. In addition, the BLS household survey indicates that there has been no dramatic change in the percentage of people employed part-time, either involuntarily or voluntarily. Voluntary part-time employment has hovered around 14 percent and involuntary part-time employment around 3.5 percent.

In order to see whether new jobs are low paying and low skill, the CEA examined 1994 earnings data (the most recent data available for comparative purposes) across occupational and industry groupings. It extrapolated 1994 median weekly earnings (about \$480) according to 1996 occupational and industry groupings and found that 68 percent of the increase in employment consisted of jobs that paid wages above the median wage. (Munnell noted that the CEA could not be sure that the jobs that paid wages above the median in 1994 would necessarily pay wages above the median in 1996. However, she felt that the occupational definitions were narrow enough to provide useful information on this question.) Munnell contended that the CEA's findings, based on very detailed job classifications, showed that the number of low-skill and low-wage jobs declined in 1994 and 1995. Why then, hasn't wage growth improved? Munnell responded that "what happens to the people in the labor force is much more important in determining what happens to averages than the characteristics of the new jobs."

The CEA also examined possible explanations for the growing economic anxiety. It attempted to determine if the probability of getting laid off had increased in recent years, but had difficulty measuring that probability. First, the most recent period for which BLS data on displaced workers are available is 1991 through 1993. Second, interpreting the difference in displacement rates in 1981-82 from those in 1991-92 is difficult even though the proportions of displaced workers in the workforce were roughly the same. For example, questions arose as to the appropriate method of correcting for differences in the business cycle, with each method yielding different conclusions about relative displacement. Two pieces of evidence, however, suggest that conditions have improved and displacement has declined. First, data on the number of people who have received unemployment benefits for five weeks (not on temporary layoff and seeking work) have followed the BLS data fairly well and suggest that the upcoming 1996 BLS survey on displaced workers could show some improvement. Second, some private (and somewhat controversial) surveys examining the number of announced layoffs also have suggested a reduction in displacement levels.

Munnell hypothesized that if anxiety does not stem from a greater chance of being laid off, it could arise as a result of highly publicized announcements of large layoffs and the changing nature of the people experiencing job loss, namely, older, white-collar, and more-educated workers who previously were not at risk. Other factors addressed in the CEA report-slow compensation growth, an increasing portion of total compensation paid as benefits, increased variability of wages-could contribute to rising anxiety.

How should the federal government respond to the problems associated with unemployment? Munnell noted the importance of three types of policies: encouraging basic education, training, and retraining; fostering benefit portability; and using the unemployment system to provide job search and counseling services to promote

reemployment.

**Session: The Employment Act of 1946: A Perspective from the Council of Economic Advisers**

Among the provisions of the Employment Act of 1946 was the establishment of the Council of Economic Advisers (CEA) and the Joint Economic Council (JEC). Steve Pearlstein, financial news writer at the Washington Post, moderated a session in which each of the panelists was a former member of the CEA: James Tobin, Sterling Professor of Economics Emeritus at Yale University, was a member under President Kennedy; George C. Eads, vice president of Charles River Associates, Inc., was a member under President Carter; and Murray Weidenbaum, Mallinckrodt Distinguished University Professor and chairman of the Center for the Study of American Business at Washington University in St. Louis, and William A. Niskanen, chairman of the Cato Institute, were members under President Reagan. Some also served as staff for the JEC.

**Steve Pearlstein** suggested that the 1946 act seems anachronistic now in that it assumed that the U.S. economy was a national economy. The economy has increasingly become a borderless one, with markets, not governments, dictating economic outcomes. Moreover, economic policy currently is highly partisan and polarized. Pearlstein asked the panelists how, in light of these suggestions, they would rewrite the act of 1946 or write a new employment act for 1996.

**Murray Weidenbaum** recounted that the CEA's first chairman, Edwin Nourse, viewed the council as a nonpartisan group that was not to be an advocate for particular policies. Subsequent chairs and councils acted otherwise, but under Arthur Burns the council avoided public controversy, and ensuing councils, while performing a more public role, have attempted to avoid being labeled as either advocate or oracle. Overall, the council acts as "the economics profession's key window into Washington. Far more important, it is a source of professional advice to a president from a group that has no special interest baggage. It can serve as a proxy for the public interest." He noted that it is "a tribute to the power of mainstream economics that on so many issues the work of Democratic and Republican councils is interchangeable. I could have taken Charlie Schultz's memos and just updated them and you couldn't, I think, tell the difference between his and our own on issues such as subsidies."

According to Weidenbaum, the JEC has never had any authority to report out legislation and, therefore, does not have the power of a legislative committee. However, the committee has gradually expanded its purview to hold hearings and to commission studies on a variety of issues. Some of its hearings, committee reports, and compendia have been influential in monetary and fiscal policy, international economics, defense procurement, taxation, and budget issues. In part because of its nonpartisan status and the establishment of separate budget committees in each house of Congress, the committee's influence has diminished. Nevertheless, the JEC remains the only institution in Congress that focuses on economics and one of the few in which members of both houses can interact regularly.

Views on the effectiveness of fiscal versus monetary policy have, however, changed. The Federal Reserve is now seen as the primary mechanism for achieving short-term stability, while tax and budget policies are seen as means to longer-term structural changes in investment, economic growth, and income distribution. "The reference in the Employment Act to purchasing power has been redefined to be the basis for the government's concerning itself with controlling inflation. . . . The original emphasis on maximum employment has taken a back seat," and current council reports contain chapters on micro issues, typically focusing on regulation.

In Weidenbaum's opinion, this change in focus provides a new opportunity to raise the subject of employment in the spirit of the act. He would accomplish this by having the council's annual report contain a section linking maximum employment and improvements to economic efficiency. Specifically, attention should be paid to "the discouraged employer," that is, aspects of regulation that discourage employers from adding to their payrolls.

Weidenbaum concluded that the 1946 act should not be revised. He criticized his "fellow conservatives" by stating that there is "no need to modify the statement of policy in the [19]46 act with regard to the Fed. The Fed should focus its effort on controlling inflation. . . . However, the Fed does not ignore growth and employment nor should it."

**James Tobin** argued against those who feel that the economy is limited in the rate at which it can safely grow. He noted that a gap between potential and actual GDP indicates that the economy can sustain a period of fast growth because the economy is "catching up" by using up excess capacity. Some economists argue that if such growth continues long enough, excess capacity declines and GDP grows at its potential rate of growth.

Tobin argued against calls by supply-siders for additional tax cuts such as those enacted during the 1980s, when growth averaged about 4 percent. He noted that when the cuts were implemented, growth of actual GDP represented a high unemployment rate (10 percent or higher), which allowed high growth for a relatively long period of time before reaching capacity. Moreover, such policies did not change the growth rate of potential output; rather the recovery that took place was due to a combination of demand-side policies and the pragmatic course of action taken by the Federal Reserve.

Tobin stated his belief that the Federal Reserve does not have the tools to increase the growth rate of potential output. However, a more relevant question is whether the way the Federal Reserve is acting implies that it believes the growth trend of potential GDP is greater than most other economists believe it might be. Since no one really knows the rate of the trend line, shouldn't the Federal Reserve follow a path of more balanced risk? A growth rate of 3.2 percent would add \$75 billion per year to GDP.<sup>2</sup> Moreover, if such a growth rate represented an unemployment rate that is beyond the barrier of growth with sustainable, low inflation, while there would be some costs (in terms of inflation), such costs are not irreversible; there would be an opportunity for policy correction.

Tobin then noted that when the economy is experiencing structural problems, the Beveridge curve, which shows the (generally negative) relationship between job vacancies and the unemployment rate, will shift to the right because of the simultaneous rise in vacancies and the number of unemployed people who, for one reason or another, are not connecting with the vacancies.<sup>3</sup> During the 1950s and 1960s the desirable noninflationary unemployment target was thought to be 4 percent; the rate rose during the 1970s and 1980s and the curve shifted outward, signifying that for a given number of vacancies, the sustainable unemployment rate was higher than during the 1950s and 1960s. Since then, however, it appears that the curve is shifting back, indicating a reasonable possibility for a sustainable unemployment rate close to that of the 1950s and 1960s. Tobin did stipulate that if the standard 6 percent estimate of a NAIRU is still correct, taking a risk and increasing the growth rate of actual GDP might result in considerably more inflation for a time until the situation can be corrected. However, pretending that the rate is in the high 5 to 6 percent range, when it in fact is lower, means that we are losing some output and employment. Those who say, then, that there is no Phillips curve trade-off are not quite correct; there is a trade-off in terms of the uncertainty associated with balancing one risk against the other.

**William A. Niskanen** stated that the expected role of the CEA today is dramatically different from its expected role in 1946 and for many years thereafter. At the time the act was written, the major economic problem was inadequate demand, and fiscal policy was perceived as the primary tool to be used to avoid this problem. Starting in the late 1960s, and especially during the Reagan administration, the focus shifted to supply conditions. With an aggregate demand focus, the council was primarily concerned with changes in budget totals; with an aggregate supply focus, the council must address a range of policies, including spending, taxes, and regulation.

Niskanen gave two reasons for the change in focus. The first reason was a developing recognition that the institutions of the federal government made it difficult to use the budget on a discretionary basis. This was due to the difficulty of forecasting turning points in the economy and getting Congress to take action on aggregate fiscal policy as a problem develops. As a result, fiscal policy actions were almost always taken too late. The second of Niskanen's reasons for the change in focus was the breakdown in the mid 1960s (and the near-disappearance by the early 1980s) of consensus on the Keynesian perspective. Replacing this perspective was a developing consensus that after controlling monetary policy, budget totals have little effect on aggregate demand.<sup>4</sup> The consequence of the change in focus is that the council now attempts to answer the question of how to increase potential output via supply-side changes to the tax code, budget, regulations, trade, and antitrust laws rather than via demand-side measures.

Niskanen argued that there was no need to change the Employment Act because "we haven't been bound by it

in any meaningful way" for some time, although, conceptually, it might be helpful to add a concern about inflation and general productivity growth to reflect the shift away from an exclusive concern with aggregate demand. Niskanen did assert that the Humphrey-Hawkins Act should be abolished because it represents unrealistic expectations and offers inconsistent guidance and therefore has not had any effect.

He noted that "there is a case for clearer congressional guidance to the Fed." He proposed that congressional guidance take the form of an arrangement in which Congress and the Fed agree on a relevant nominal aggregate target (such as nominal domestic final sales) that would reflect a combination of output and price effects consistent with zero expected inflation. A demand target of this type would circumvent adverse behavior by the Fed in the case of a supply shock. This is not true of price level guidance, such as the arrangement proposed by Connie Mack. Price level guidance results in adverse monetary policy reactions to supply shocks. It would be preferable for the effects of supply shocks—either adverse, such as from an oil shock, or beneficial, such as from a rise in productivity—to be passed through as a one-time change in the price level and for the Fed to do nothing to change demand conditions. Unfortunately, observed Niskanen, it is not clear, given the political world in which we live, that Congress would give the Fed the kind of guidance that would lead to better outcomes than the Fed has achieved without such guidance. Although the performance of the past two Fed chairmen has been superb, a law cannot be written based on an expectation that a certain person will be at the helm; rather, we should be writing laws or developing traditions based on the institutional biases of the institutions involved.

**George C. Eads** spoke about the importance of the council's microeconomic activities. One of the council's main microeconomic functions is to disentangle the effects of various proposed programs to assess whether markets are working or are failing to produce the results desired by program advocates. In areas where markets do not work, such as in the presence of significant externality effects, the council acts as an advocate for the use of marketlike mechanisms.

An area provoking much interest at the time Eads was on the council was policy aimed at protecting the auto industry. A task force examining the state of the auto industry and the effects of trade restrictions on Japanese entry to the U.S. market reached much the same findings as those reached by other economists. However, most economists did not sufficiently appreciate the nature of the change taking place in the world auto industry, especially with respect to the production process, the role of individuals in that process, and the role of the production systems and skills. Economists generally do not realize how much turmoil is created when an industry paradigm is erased, particularly when that industry appears, from all external observations, to be doing well. When an industry is conspicuously failing and nobody denies that change is needed, change can be implemented relatively easily; such was the case with Chrysler and Ford. General Motors, on the other hand, had a long-term alternative that allowed it to continue operating according to the old paradigm longer than it should.

Eads stated that a deeper understanding within the economics profession of how markets work would be a way to increase understanding about how government intervention and general periods of turmoil affect economic factors, such as productivity. Eads voiced concern about the degree to which many in the current debates seem to be looking backward, trying to recapture a "golden age of productivity" and the relationships that seem to have worked in the past. If we look forward, we can see mutually beneficial changes within the context of new kinds of relationships between labor and management with an enormous potential for productivity gains.

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## Notes

1. Tobin defined potential GDP as being a function of full employment.
2. Tobin noted that the amplitude of the synchronized fluctuation between unemployment and the GDP gap has declined from an estimated 3.0 percentage points (Okun's law) in 1961 to 2.0 to 2.5 percentage points today. His figures were based on current estimates.
3. Tobin stated that this phenomenon could be regarded as frictional unemployment, but in an extreme form, it also could be regarded as structural unemployment.
4. Niskanen based his conclusion about the change in the perspective of the profession on the fact that "there has been very little Keynesian rhetoric in the reports of the Council of Economic Advisers for 15 years,

including reports by the Clinton council."

[The speakers' remarks and summaries of the session discussions are to be published in the conference proceedings. To request a copy call 914-758-7700 or 202-737-5389 (in Washington, D.C.), fax 914-758-1149, e-mail [info@levy.org](mailto:info@levy.org), or write The Jerome Levy Economics Institute of Bard College, Blithewood, Annandale-on-Hudson, NY 12504-5000.]

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## Forums

### Immigration and Ethnicity

As part of its research initiative "Ethnicity and Economy in America-Past and Present," guided by Senior Scholar Joel Perlmann, the Levy Institute organized a series of three forums on immigration and ethnicity.

#### Immigration and Ethnic Change in Los Angeles

The first session featured **Roger Waldinger**, professor of sociology at the University of California at Los Angeles and author of the forthcoming *Still the Promised City? New Immigrants and African-Americans in Post-Industrial New York*. Waldinger emphasized the ability of immigrant groups to create and capitalize on job niches and their use of networks to facilitate employment for newly arriving immigrants, particularly in blue-collar labor markets. Personal contacts and networks have led to an overrepresentation of immigrants in certain occupations and industries. Korean-owned grocery stores and Indian-owned newsstands are commonly cited examples, but Waldinger has found that the concentration of immigrants extends also to the industrial sector. He states that in 1990 in Los Angeles Mexican immigrants were "heavily overrepresented" in 53 of the 82 largest manufacturing industries.

Among the consequences of this self-perpetuating network process is its effect on poor African Americans in metropolitan areas with a heavy concentration of immigrants. Recruitment through immigrant networks in effect limits open competition by African Americans for jobs. Waldinger cites as a result the relatively small share of African Americans in the manufacturing sector; for instance, only 3 percent of workers in New York's garment industry are African American.

Waldinger was not optimistic about the possibilities for successful competition by African Americans against immigrants in the job market. Few observers anticipate a decline in the number of new immigrants who will be competing for entry-level jobs. Moreover, the new immigrants typically choose to live in cities with existing employer-immigrant networks. This effect is amplified by the perception, false as it may be, among many employers that immigrants work harder and are more productive than African Americans.

However, Waldinger is reluctant to endorse policies that would place strict limits on the flow of immigrants to the United States. Rather, as he has said, "alleviating the economic distress of low-skilled blacks requires attacking two problems: the unwillingness of employers to hire them and the lack of meaningful training" (*New York Times*, April 11, 1996).

### Immigration, Racial Identity, and Work:

#### Past and Present

The second forum included two sessions. Noel Ignatiev, lecturer in history and literature at Harvard University, discussed his new book *How the Irish Became White*, and Mary C. Waters, professor of sociology at Harvard University, gave an address entitled "West Indian Immigrants and Their Children: Identity Choices and Socioeconomic Outcomes."

**Noel Ignatiev** focused on assimilation of Irish immigrants to the United States into the political and social mainstream. The efforts of the Irish—a low-status group "situated between blacks and native whites" upon their arrival in America—to distance themselves from African Americans took the form of establishing an institutional and ideological framework that emphasized their "whiteness." The Irish increasingly recognized the social, economic, and political liabilities of being relegated to the social stratum of African Americans and thus undertook to displace African Americans from their niches in marginal economic arenas.

According to Ignatiev, the assimilation of the Irish was aided by organized labor and the Democratic Party, both institutions that were anxious to elevate the Irish from their low status—at the expense of African Americans—in order to consolidate Irish political support. In essence, assimilation was facilitated by racism and the deliberate construction of a social chasm between the Irish and African Americans. Ignatiev challenged the conventional wisdom that racism is a historical aberration in American society; instead, he views racism as an essential feature in the evolution of America's contemporary socioeconomic structure.

**Mary Waters** presented findings that suggest a link between the identity choices among first- and second-generation West Indians in the United States and their level of economic success. Using survey data, she also explored white, African American, and West Indian cultural images of other identity groups and the mode and degree of assimilation among these groups.

The complexity of race relations in the United States is an obstacle in measuring the level of assimilation for second-generation West Indians. However, Waters indicated that first-generation West Indians tend to agree with the perceptions, however false, that some whites have of African American communities. West Indian immigrants reveal negative impressions of the work ethic and cultural values observable in African American communities. West Indians also indicate that many African Americans are hypersensitive about race; in actual cases of racial bias West Indian immigrants are vigilant in acknowledging and redressing the injustice, but they accuse African Americans of often falsely infusing race into issues. Newly arrived West Indian immigrants take deliberate steps to differentiate themselves from African Americans because of the stigma (that is, the lack of work ethic and criminal propensity) and cost (such as fewer employment opportunities and lower earnings) associated with the "African American" label. Interestingly, however, 10 to 15 years after emigrating to the United States, West Indians more frequently cite the existence of institutional racial biases, which they did not initially acknowledge.

Many employers demonstrate a clear preference for hiring West Indian immigrants over African Americans on the basis of their perceptions of the two groups' work ethic and value structure. As a result of this labor market advantage, first-generation West Indians often outperform African Americans in measures of employment and earnings. However, because Waters's findings are less robust for second-generation West Indians, she suggests that the findings indicate that race and identity are so structurally embedded in the American social fabric that even as the socioeconomic gap between African Americans and West Indians may sometimes close, the gulf between white and African American communities is unmitigated.

## **Immigration, Economy, and Policy in America**

The first session of the third forum, entitled "Economic Effects of Immigration: Past and Present," consisted of presentations by David Card, Theodore A. Wells Professor of Economics at Princeton University, and Stanley Engerman, professor of economics and history at the University of Rochester. Participating in the second session, entitled "The Present Moment in Immigration Reform," were T. Alexander Aleinikoff, executive associate commissioner of immigration, U.S. Immigration and Naturalization Service (INS); Frank D. Bean, Ashbel Smith Professor of Sociology and Public Affairs and director of the Population Research Center at the University of Texas at Austin; and Muzaffar A. Chishti, director of the Immigration Project, Union of Needletrades, Industrial, and Textile Employees.

**David Card** described some conceptual problems related to the analysis of the economic effects of immigration and presented new data comparing recent immigrants to past immigrants and to the overall population. One method of analyzing the effects of immigration on one or several labor markets is to consider

the effects of immigration on the United States as a whole, that is, to consider its effects on aggregate variables such as the employment rate, the average wage rate, and the wage differential between the high- and low-scale workers. Using this method, immigration would have an effect on the aggregate economy only if the rate of inflow of immigrants or the characteristics of the inflow of immigrants did not match the characteristics of the current overall population.

However, immigrants are not evenly disbursed across the country; they tend to be extremely concentrated in a small number of labor markets. Such settlement patterns can pose problems for those markets, such as requiring a larger buildup of their capital stocks, in the form of both private stocks and public infrastructure, than they otherwise would need. The geographical concentration of potential problems has led to a second method of analyzing the effects of immigration, namely, comparing an area in which there have been significant immigrant inflows (such as Miami during the Mariel boat lift) to an area with a similar economy but without the same immigrant inflows (such as Tampa) in order to draw conclusions about the effects of immigration on the first area.

Conceptual problems arise from both types of analysis. A problem with the comparative method is that the effects of the incoming labor force may be defused across other cities fairly quickly; for example, the injection of unskilled labor (the Mariellitos) into Miami might drive down unskilled labor prices across the entire country. If so, is there a valid counterfactual case that can lead us to a conclusion about the effects of immigration? If immigration is concentrated in a number of U.S. cities, can we use a comparison between those cities and the remaining cities for which we have standard data to draw any inferences about immigration's effects? According to Card, we should question the reliability of such inferences.

On the other hand, if we study immigration from a national perspective (looking at the United States as one labor market), there is no case with which to make a meaningful comparison (unless one is willing to make a comparison with some other country). Such a methodology is not, according to Card, empirical, but rather only a simulation-type methodology.

[Exhibits 1](#) and [2](#) provide the data with which Card sketched a picture of the recent immigrant population as compared to the overall population and immigrants in recent decades. He noted that

- Immigrants tend to be younger than the population as a whole, with a substantial fraction of the most recent immigrants (32.8 percent) being very young (aged 16 to 24 years).
- Immigrants tend to be people who count themselves as a race other than white.
- About half of the inflow of immigrants are of Hispanic origin, with about a third born in Mexico.
- A substantially larger fraction of the most recent immigrants, compared to the overall population, have less than a high school education (41.3 percent versus 22.1 percent), but a larger fraction have a college degree than does the overall population (23.2 percent versus 19.9 percent).
- Recent immigrants are concentrated in California (31.4 percent of 1990s immigrants versus 11.9 percent of the overall population), followed by New York, Florida, and Texas.
- Immigrants tend to be low in the income and wage distributions, although data on earlier immigrants indicate that there is a fair amount of economic assimilation into the labor market; moreover, 21.3 percent of early immigrants have incomes in the upper four deciles.

**Stanley Engerman** compared past debates about the effects of immigration policies with today's debates. He noted in particular the debates that ended in dramatic overhauls of American immigration policy, namely, the introduction of the literacy test in 1917 and the implementation of quotas by country and restrictions on immigrant levels in the 1920s.

The pattern of U.S. immigration was unique in the Americas at the start of the twentieth century due to the large share and national diversity of the white population, the limited numbers of Native Americans on the

mainland, and the exceptional growth of both white and black populations. The huge amount of undeveloped land permitted policymakers to encourage immigration; immigrants (including women and children) could serve as an industrial labor force, while the native born could take advantage of high agricultural productivity and land availability by remaining on their land or moving to newer and cheaper land.

The major change in U.S. immigration policy was the 1920s legislation that set absolute quotas and expressed an explicit interest in a more homogeneous society. Although the quotas were intended to increase the relative share of immigrants from Western Europe and to reduce the number of immigrants from Eastern and Southern Europe, they had the effect of reducing the absolute number of immigrants and the rate of immigration (the ratio of immigrants to total population). Since the 1920s the rates of immigration have generally been one-third less than in earlier times. Even in the two recent peak years (1990 and 1991) the average rate of immigration was only 0.66 percent, at least one-third less than earlier averages (during peak years before the 1920s the average annual ratio was nearly 1.0 percent).

Why has the recent pattern given rise to such politically conspicuous debates? First, the level of immigration is higher than it was in the 1920s, even though the rate of immigration is lower. Second, because of a declining fertility rate and a declining rate of increase in the total population, the ratio of immigrants to total population resembles that of earlier periods. Third, the geographical concentration of new immigrants in urban areas makes the effects of immigration on social expenditures, such as welfare, appear dramatic. Fourth, it is argued that the economy has changed, allowing fewer opportunities today and limited hope for the future. Fifth, the point of origin of immigrants has shifted from Europe to Asia and elsewhere in the Americas.

But do immigrant inflows necessarily mean a decline in opportunity for native-born workers? Engerman noted that with the cessation of immigration in the 1920s came a dramatic rise in wages. However, real wages rose and unemployment declined in the 1880s and 1900s—periods of very high immigration—as much as they did in the 1920s, while in the 1910s and 1890s—periods of low immigration—real wages declined and unemployment rates rose.

**Frank Bean** noted the rise in the levels and the changes in the composition of immigration to the United States. He remarked that similar patterns persist across all types of immigrant groups (legal immigrants, refugees and asylees, illegal migrants, and nonimmigrant admissions) and that the rise and changes in immigration are at least partly responsible for the generally distorted perceptions that U.S. citizens have about the composition of the U.S. population.<sup>1</sup>

Bean pointed to some possible consequences of a confluence between immigrant inflows and relatively poor economic conditions. For example, the 1910s, the years following the largest immigrant inflows of the century, were not good years economically (in both relative and absolute terms). While not suggesting that immigrant inflows caused the economic problems of the 1910s, Bean asserted that we must at least consider the fact that when these two events occur together, the economic consequences may be more severe than when they do not.

Bean noted that the optimal size of immigration inflows, from a policy perspective, is difficult to determine. Currently, the U.S. population is growing at about 1 percent per year (about 2.5 million people), of which 35 to 40 percent is due to immigration. Looking at the growth of the labor force and employment and assuming a given percentage of immigrants will seek jobs, Bean estimated that immigrants account for approximately 45 percent of employment growth. The key figure in such a calculation at any time is job growth. When job growth is minimal (as it was in the early 1990s), despite the amount of flex in the labor market, the addition of a million new immigrants a year will cause a difficult social and political situation.

Bean observed that when we speak of immigration policy, we usually mean legal immigration policy. There are, however, policies about illegal immigration that don't get discussed often. One could argue that since World War II, U.S. policy on illegal immigration has been to give the appearance of trying to control it while looking the other way. However, illegal immigration has recently come to the fore as a pressing issue. According to Bean, a society wishing to operate on the basis of rule of law must deal with this phenomenon before trying to make any substantial change in immigration law. In addition, that policy has outlived its usefulness. The United States is attempting to establish new relations with Mexico in which the two countries take bilateral actions regarding immigration and codify some practices into law. If these agreements are to appear legitimate, both



governments must stop looking the other way.

**Alexander Aleinikoff** spoke about the complexities of facilitating lawful immigration and enforcing immigration laws. He noted that in recent years in the United States there were about 500 million legal border crossings, the entry of about 700,000 to 800,000 permanent resident aliens (the largest number of any country), and the entry of about 100,000 refugees per year. Last year there were 1.2 million apprehensions by the border patrol of people attempting to cross the southwest border illegally, the incarceration in federal and state prisons of about 100,000 criminal aliens, and the deportation by the Immigration and Naturalization Service of about 40,000 criminal aliens. Moreover, half of illegal immigrants in the United States are visa overstayers, that is, people who entered the United States lawfully on nonimmigrant visas as students or visitors and stayed beyond their authorized time.

These realities point to a politics of immigration that is both interesting and confusing. The House and the Senate have passed immigration bills that are largely concerned with enforcement, for example, increasing the number of border patrol employees, establishing stiffer penalties for smuggling and other criminal conduct, and cracking down on false documents. The administration's view on immigration reform and control is to welcome further legal immigration only if strong action is taken against illegal immigration. However, this does not mean that the administration blames all of our social ills on aliens, legal or illegal. Rather, it believes, and the House and Senate bills confirm, that enforcement of immigration laws is a federal responsibility and that an effective enforcement strategy should focus on the border, the work site, and the removal of criminal aliens.

There are, however, some areas of controversy, for example, the 1986 law that imposes sanctions on employers who hire aliens not authorized to work in the United States. The measure was intended to deter the flow of illegal immigrants, but has been largely unsuccessful. Although there is a high degree of compliance with the law, there is a low degree of deterrence because of a lack of resources to enforce the law and the rise of false documentation.<sup>2</sup>

For employer sanctions to work requires a system by which worker documentation can be verified by employers. Such a system, however, has been opposed by people on both sides of the political spectrum. Those on the left claim that a verification system would not be cost effective as it would impose a burden on 100 percent of the workforce for a problem that applies to only 1 percent of the workforce; that errors in the INS database will result in the distribution to potential employers of incorrect information about workers; and that the verification system could substantially increase discrimination by making employers, concerned about sanctions, reluctant to hire anyone who looks foreign, regardless of whether he or she is a U.S. citizen or otherwise lawfully entitled to work in the country. Those on the right contend that a verification system would represent the creation of national databases with "Big Brother" potential. The INS has responded to these objections by conducting pilot projects in California, the Midwest, and Miami, with plans to expand the program to New York and elsewhere. After a couple of years the INS will evaluate the projects for cost effectiveness, effects on discrimination, and adequate protection of privacy.

**Muzaffar Chishti** stated that, unfortunately, immigration policy generally is not the result of studies of immigration and its effects: "It is amazing how little research has an impact on immigration policy." Policy is framed by the media and the popular mood in the country. Despite the fact that the United States is the "consummate immigrant nation," there is a continuing debate that indicates a lack of consensus on that point. According to Chishti, the most recent stage of the debate began during the 1992 presidential campaign with statements that certain immigrants are unable to assimilate to U.S. culture and society. A series of high-profile events—the Haitian boat people, the revelation that a nominee for attorney general had employed an undocumented worker, the World Trade Center bombing, and the arrival of the Golden Venture filled with Chinese workers who paid to be smuggled into the country—framed the public's perception about immigration. This negative perception culminated in California's Proposition 187.

According to Chishti, Proposition 187 also proved to be the turning point in the debate. The antiimmigrant fervor at the national level (marked by the introduction of restrictive legislation and the credence afforded previously unbelievable antiimmigrant commentators) forced the proimmigrant lobby into action. The lobby strove to make a sharp distinction between legal and illegal immigration and the policies governing the two. The recently passed immigration bill reflects that distinction by not reducing legal immigration and retaining the

refugee program.

Chishti cited three reasons for the swift turnaround in attitude: (1) the proimmigrant lobby made its message extremely simple by advocating the separation of legislation about legal immigration from legislation about illegal immigration; (2) it found support for splitting the bill (and retaining existing legal immigration law) from a conservative Republican on the Senate Judiciary Committee with strong views on immigration, namely, freshman Spencer Abraham (R-Mich.); and (3) it formed a formidable coalition that included unions, the National Association of Manufacturers, Americans for Tax Reform, the National Christian Coalition, and civil libertarians. Chishti concluded that the success of the coalition proved that immigration is too complex to be relegated to the fringe of the policy arena.

Notes

1. Bean remarked that recent survey responses by various racial groups about the fraction of the U.S. population they thought another group made up (for example, what percentage of the population is black or white) showed nearly across-the-board distortions by nearly all groups.

2. The law allows a good faith exception for businesses that inspect a prospective employee's documents; if it is deemed that the documents would appear genuine to a reasonable person, the business is not held liable for hiring an illegal alien. As many had predicted, this exception produced a large market in false documents.

[A summary of the third forum will soon be available as a Levy Institute special report. To request a copy, call 914-758-7700 or 202-737-5389 (in Washington, D.C.), fax 914-758-1149, e-mail [info@levy.org](mailto:info@levy.org), or write The Jerome Levy Economics Institute of Bard College, Annandale-on-Hudson, NY 12504-5000.]

**Exhibit 1 Characteristics of Immigrants and Total Population Aged 16 and Over, 1994-95**

	Total Population Aged 16 and Over	All Immigrants	1980s Immigrants	1990s Immigrants
Average age	43.1	41.7	35.4	32.8
Percent nonwhite	15.9	30.3	37.9	36.1
Average education (years)	12.6	11.5	11.2	11.4
Percent high school dropouts	22.1	36.7	42.4	41.3
Percent college graduates	19.9	20.4	18.2	23.2
Percent living in:				
California	11.9	32.3	38.1	31.4
New York	7.1	12.6	12.4	14.2
Florida	5.5	9.1	9.3	7.1
Texas	6.9	8.4	8.9	9.3
Central city area	23.8	40.8	46.8	46.9
Average earnings last year	\$15,170	\$13,000	\$12,300	\$8,500

Average hourly wage (\$/hour)	\$13.30	\$12.37	\$10.99	\$10.27
Percent in wage decile:				
Decile 1	10.0	11.7	13.8	20.1
Decile 2	10.0	13.4	16.4	18.8
Deciles 3-6	40.0	41.7	44.3	39.7
Deciles 7-10	40.0	33.1	25.4	21.3
Average family income	\$43,400	\$37,900	\$34,100	\$26,900
Sample size	224,994	28,600	9,507	4,810

Source: U.S. Department of Commerce, Bureau of the Census, Current Population Survey, March 1994, 1995.

<b>Exhibit 2 Characteristics of Immigrants and Total Population Aged 16 to 30, 1994-95</b>				
	Total Population Aged 16 to 30	Third and Later Generations	Second Generation	Immigrants
Percent in wage decile				
Decile 1	17.2	17.2	16.6	18.1
Decile 2	15.8	15.4	15.8	18.5
Deciles 3-6	47.1	47.4	45.4	44.8
Deciles 7-10	19.9	19.9	22.2	18.6
Average family income	\$39,900	\$40,800	\$44,000	\$31,100

Source: U.S. Department of Commerce, Bureau of the Census, Current Population Survey, March 1994, 1995.

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## Seminars

### The Legacy of Separate and Unequal Schooling

Alan Krueger, Professor of Economics, Woodrow Wilson School of Public and International Affairs, Princeton University

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Alan Krueger, professor of economics at the Woodrow Wilson School of Public and International Affairs at Princeton University, spoke about the legacy of separate and unequal schooling in the United States. He noted that the evidence about the effects of school segregation is weak because specific racial data on schools before

the late 1960s was not collected. However, Krueger has used responses to the National Survey of Black Americans to gauge the extent of school segregation. He found that schools were segregated prior to 1964 and that there was a sharp decline in racial segregation after 1964, contrary to studies in which 1968 was found to be the watershed year. He determined that student-teacher ratios were higher in segregated schools and that spending was lower in black districts. Krueger attempted to find the extent to which these factors affected later earnings.

In a study with David Card, Krueger found that for a given level of educational quality (measured by, for example, student-teacher ratio, length of the school term, and teacher pay), in general, earnings rose as the number of years of schooling increased.<sup>1</sup> Therefore, those blacks who grew up in states with lower-quality schools earned less, on average, than those who grew up in states with higher-quality schools. The gap between average white and black earnings closed from 40 percent in 1960 to 25 percent in 1980, with roughly 20 percent of the narrowing resulting from improvements in the relative quality of education. Krueger noted that evidence indicates that antidiscrimination efforts were responsible for much of the remaining narrowing of the gap.

What would have been the effect on earnings if the school resources of black schools in the past had been as high as the levels spent in white schools? Examining data from the 1920s cohort, Krueger found that per pupil spending in white schools was about 150 percent higher than in black schools; he estimated that with equal spending blacks would have earned about 21 percent more than they actually did. He also estimated that in 1970 (when the 1920s cohort would have been in their prime working years) the gap in resource spending accounted for 40 percent of the black-white earnings gap (which at that time stood at 48 percent).

Krueger also noted that lower-quality schooling might lead a student to complete fewer years of school. He tentatively estimated that lower spending on the 1920s cohort lowered educational attainment by about 15 percent. Moreover, lower educational attainment and earnings by parents likely affect attainment and earnings of their children. Krueger estimated this intergenerational transfer of earnings—that is, the reduced earnings for the 1940s cohort resulting from lower educational attainment and earnings of the 1920s cohort—at about 8 to 12 percent.

Krueger noted that all of his calculations were meant to be illustrative rather than precise point estimates. Among his caveats were that school spending might not capture all important and relevant aspects of school quality and there is considerable uncertainty about the effect of school resources on subsequent income, employment, and educational attainment. Despite these cautions, he concluded that "this exercise highlights that the separate and drastically unequal schooling endured by previous cohorts of African Americans probably casts a long shadow over current and future generations of black workers." Race matters, at least in part, because race used to matter.

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Note

1. David Card and Alan B. Krueger, "Labor Market Effects of School Quality: Theory and Evidence," Princeton University, Industrial Relations Section, Working Paper no. 357, January 1996.

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## Seminars

### **Economic Policy for a Winner-Take-All Society**

Robert Frank, Goldwin Smith Professor of Economics, Cornell University

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During his two lectures, Robert Frank, Goldwin Smith Professor of Economics at Cornell University, explored

possible explanations for the fact that certain individuals within any profession are more valued (that is, higher paid) than others within their spheres of operation. Although most of us can easily understand this phenomenon in the context of sports and entertainment, Frank found that it is also true in other occupations, including law, business, and medicine. He considered whether the increase in income among the very highest earners within an occupational grouping is a factor that has contributed to the growing gap in overall income distribution.

Most economists focus on differences in human capital endowments (such as education) to explain gaps in income distribution. Frank contended that although there have been no large shifts in the distribution of human capital, there has been increasing variation in the incomes of individuals possessing similar endowments. He observed that, within a specific market, certain individuals (winners) earn substantially more than otherwise similar individuals.

Frank noted a number of characteristics defining a winner-take-all market, including rewards based on relative (rather than absolute) performance and the concentration of those rewards in the hands of a few top performers. For example, the growing disparity between average CEO and average worker salaries is, in part, the result of the rising pay to a select group of CEOs. This higher pay is the result of the higher leverage of the few top candidates and open competition among all firms for these "best" few. High leverage results from the high costs associated with a firm's failure. Although the relative differences in decisions made by any two CEOs might be extremely marginal, the results of those differences can be large in terms of relative position in the market and financial payoffs. Other possible reasons for wider income dispersion within professions include the ability to clone the achievements of the top performers at a relatively low marginal cost (which allows relatively easy access to the best performances and substantially reduces the demand for lesser-quality performances) and network economies (the phenomenon in which a product gets more valuable as more consumers buy it, such as in the case of VHS recorders and IBM's MS-DOS system).

All the effects mentioned by Frank grow over time, in part because of feedback from each effect to itself and to other effects. The costs of a winner-take-all market are a more highly skewed income distribution and an inefficient allocation of resources (the latter resulting from overinvestment in becoming a "winner"). The benefit of a winner-take-all market is that access to the "best" goods is increased. Frank noted, however, that these same goods could be obtained at a lower cost than at present if fewer resources were invested by those competing to become "winners." He proposed that taxation could be used to alleviate the costs of winner-take-all markets while preserving their benefit. This goal might be accomplished through taxes imposed on very high income earners or a progressive consumption tax levied on the difference between income and saving.

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## Seminars

### **The New Basic Skills**

Richard J. Murnane, Professor of Education, Harvard University School of Education

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Richard J. Murnane, professor of education at Harvard University School of Education, discussed findings presented in his forthcoming book, *The New Basic Skills*, co-authored with Frank Levy. He noted that changes in the economy have affected the level of skills a high school graduate needs to obtain employment at a middle-class wage. Earnings among male high school graduates have declined since 1979, both in absolute terms and relative to earnings among college graduates (see [Exhibit 3](#)). Moreover, the gap between earnings of high school and college graduates also has increased. These declines can be attributed to a number of factors, although a decline in skills among high school graduates is not one of them. Rather, because higher skill levels are required in the workplace, employers are paying higher wages to those possessing those skills; high-paying employers therefore have become more selective in whom they employ. Murnane concluded that skills matter

more today in determining earnings levels.

Murnane and Levy's conclusions were based on two large sets of panel data, the first for individuals graduating from high school in 1972 and the second for individuals graduating in 1980. They examined these data to determine the relationship between math and reading scores on standardized tests and earnings levels six years after graduating. They found that the differences in earnings between high- and low-scoring individuals were larger for the second panel than for the first (despite the fact that the scores of the 1980 panel were slightly lower than the 1972 panel<sup>1</sup>) and strong math skills were more important in determining later earnings for the second panel (especially among women<sup>2</sup>).

Murnane and Levy examined firms employing a significant number of high school graduates to determine what skills mattered most in selecting employees. They found that all employers still value the "old skills" of timeliness, hard work, and a positive attitude, but high-paying firms demand more of their workers; they demand what Murnane and Levy call the "new basic skills." These firms expect employees to be able to:

- Read and do math at a ninth-grade level
- Solve semistructured problems by formulating and testing hypotheses
- Communicate effectively orally and in writing
- Work productively in groups with people from different backgrounds
- Work with computers

Murnane noted that schools might be improved by increasing students' effectiveness at core job functions (that is, at the new basic skills). Schools in general are not doing well at teaching these skills because it is difficult to get agreement that they are necessary. Parents do not generally call for change unless they are greatly dissatisfied with the education their children are receiving. Students often do not feel that these skills are important because they see no short-run return to the skills. Teachers are not necessarily trained to teach the new skills. Moreover, the predominant testing device—multiple choice—cannot measure students' ability to perform the new skills, and teachers continue to be trained to teach students how to pass such tests.

Murnane provided five principles by which schools can improve students' performance on the new basic skills. First, teachers, parents, administrators, and students must agree that acquiring the skills is important and that schools have been failing to provide adequate training. Second, jobs must be designed so that teachers, parents, administrators, and students have both the incentive and opportunity to contribute to solutions. Third, teachers, parents, administrators, and students must be provided with the training needed to pursue solutions effectively. Fourth, progress must be measured regularly. Fifth, all must persevere and learn from their mistakes; there are no "magic bullets."

A question not answered by Murnane is whether skill enhancement will boost the number of high-paying jobs for high school graduates. Murnane responded that some employers currently hire college-educated workers for jobs that high school graduates with the new basic skills could perform. Screening for the new basic skills is costly, and rather than incurring the costs, employers simply increase their educational requirement. Proficiency at the new basic skills by a large proportion of high school graduates would probably increase the share of high-wage jobs for high school graduates. However, it remains to be seen whether the supply-side factors will be sufficient to increase the number of such jobs.

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## Notes

1. The decline in scores was concentrated among those who had not gone on to college. Controlling for changes in scores, Murnane concluded that the increased demand for workers who had high math scores was a demand-side phenomenon.

2. Murnane surmised that the larger earnings differential between high- and low-scoring female grads was attributable to the fact that many traditionally female jobs (such as clerical occupations) required strong math skills; having such skills was therefore rewarded accordingly.

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<b>Exhibit 3 Median Earnings of 25- to 34-Year-Olds, in 1993 Dollars</b>			
	1979	1989	1993
<b>Males</b>			
College graduates	31,579	32,336	31,000
High school graduates	27,427	22,791	20,000
Earnings ratio <sup>a</sup>	1.15	1.42	1.55
<b>Females</b>			
College graduates	19,593	24,252	24,340
High school graduates	13,719	13,858	14,000
Earnings ratio*	1.43	1.75	1.74

\* Ratio of earnings of college graduates to earnings of high school graduates.

Sources: The 1979 and 1989 earnings figures were calculated from the 1980 and 1990 Public Use Microdata 1 Percent Samples of the U.S. Census of Population and Housing. The 1993 earnings figures were calculated from the Current Population Survey, March 1994.

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## Program Scholars

Research Associates **William J. Baumol** and **Edward N. Wolff** are conducting a research project entitled "Protracted Frictional Unemployment as a Heavy Cost of Technical Progress." They argue that there is more substance to the public's fears that new production techniques can threaten jobs than is acknowledged by either neoclassical or Keynesian economists. They note that neoclassical economists, who believe that the market tends automatically to bring the economy back either to full employment or at least to a natural rate of unemployment, seem inclined to believe that this process wipes out any joblessness created by technological change with a modest delay. The Keynesian economists, who believe that the level of employment can be adjusted by macroeconomic policy, are inclined to believe that policy is capable of eliminating the joblessness engendered by labor-saving innovation.

Baumol and Wolff suggest that the rapid pace of technological change can have two profound employment effects. First, it can materially increase frictional unemployment. Second, it can affect some classes of workers more than others because of the sunk-cost attributes of retraining workers to enable them to use the constantly emerging novel techniques. The least-educated workers; older, former jobholders; and women, particularly of childbearing age, are likely to be the groups most affected by the pace of change, suffering declining relative wages or protracted and possibly lifelong unemployment.

Weighing the evidence of the human cost of protracted unemployment, Baumol and Wolff note that it is simply not true that unemployment of one person for five years is somehow equivalent to unemployment of ten persons for six months each. In their research they are exploring the costs of joblessness beyond the loss of income, considering divorce, mental illness, suicide, violence in the home, and other social costs. The research will conclude with an appropriate public policy response. Baumol and Wolff are both professors of economics at New York University.

Research Associates **Robert Haveman** and **Barbara Wolfe** are conducting research that addresses the relationships among economic activity, underemployment, and human capital in the United States from 1973 to 1990. They endeavor to (1) document the growth of human capital in the U.S. economy since the early 1970s, (2) estimate inequality in the distribution of human capital within the working-age population and document any changes in inequality, (3) explore patterns of utilization of human capital within the working-age population (that is, changes in the overall utilization rate of human capital during the past 20 years) and the contribution of shifting patterns of human capital utilization among age, gender, and ethnic groups to changes in the overall capacity utilization rate, (4) identify factors that have determined measured changes in the growth, distribution, and utilization of human capital, and (5) explore the duration and determinants of underutilization over time.

If the objective of policy is to increase the utilization of human capital and, therefore, economic activity, so that every race, gender, education, and age group in the working-age population is working close to its capacity, then it is important to understand the aggregate level of underutilization and its distribution within the working-age population. Does the greatest potential lie in reducing economic inactivity among younger or older workers, among males or females, or among less-educated or more-educated workers? The answer to these questions will indicate whether policies targeted at youths (such as Jobs Corps and youth employment policies), older workers (changes in Social Security and disability benefits), or young women (changes in welfare policy) are likely to be more effective in increasing economic activity. Haveman is John Bascom Professor of Economics and Public Affairs at the University of Wisconsin, Madison, and Wolfe is professor of economics, preventive medicine, and public affairs at the University of Wisconsin, Madison.

Research Associate **David R. Howell** focuses on the implications of changes in industry characteristics, especially the adoption of information technologies, for employment, skill requirements, and earnings. Specifically, he is examining the effects of recent employment restructuring on young workers by race and gender. His results thus far imply a strong link between changes in the rates of labor market discouragement and changes in job opportunities, job quality, and educational requirements. Howell teaches at the Graduate School of Management and Urban Policy of the New School for Social Research and is a research associate at the C. V. Starr Center for Applied Economics at New York University. He received a Ph.D. in economics from the New School for Social Research.

Continuing the work he conducted while a visiting scholar, Research Associate **Takao Kato** is examining the relationship between human resource management practices (HRMPs) and productivity. In his current research he is examining interactions between various human resource policies in Japanese firms—such as employment stability, investment, and collective bargaining—and economic performance. Because much of the discussion concerning economic and business policies in the United States compares its domestic policies with those of Japan, an investigation of Japanese business may provide insights into changes in domestic policies that would enhance performance. Kato, associate professor of economics at Colgate University, received a Ph.D. in economics from Queen's University, Kingston, Ontario. He is the author of Public Policy Brief No. 19, Cooperate to Compete.

Visiting Scholar **Marlene Kim** is conducting work on welfare policy, discrimination, comparative worth, and pay-setting. She is simulating pending federal legislative proposals in order to estimate their effect on the working poor. She is also examining the extent to which current welfare policies meet the needs of the working poor. Preliminary findings suggest that most of the working poor are married, work long hours, and are in their prime working years and that most do not receive welfare benefits for which they qualify, even though these benefits would raise their standard of living substantially. Kim received a Ph.D. in economics from the University of California at Berkeley and is an assistant professor of economics at Rutgers University.



Research currently conducted by Resident Scholar **Oren M. Levin-Waldman** focuses on restructuring the welfare and unemployment insurance systems to achieve greater efficiency, equity, and effectiveness in the delivery of services. Levin-Waldman's research, which overlaps work being conducted in the Levy Institute's federal budget policy research program, also includes an examination of worker displacement due to plant closures. In particular, he is evaluating the effectiveness of the 1995 federal plant closing law in protecting workers and facilitating labor market adjustments. If the legislation represents a step in a process that will lead to a comprehensive national employment policy, it will have repercussions with respect to the overhaul of the current unemployment insurance system. Levin-Waldman is the author of Public Policy Brief No. 21, The Consolidated Assistance Program and Public Policy Brief No. 26, Making Unemployment Insurance Work. His book *Reconceiving Liberalism: Dilemmas of Contemporary Liberal Public Policy* will be published by the University of Pittsburgh Press. Levin-Waldman received a Ph.D. in political science from Temple University.

Senior Scholar **Joel Perlmann** is guiding a research initiative entitled "Ethnicity and Economy in America-Past and Present." The initiative focuses on the processes by which immigrants and their descendants are assimilated into U.S. economic life. It is hoped that this work will shed light on current policy issues related to immigration, such as international competitiveness, the labor market, income distribution, and poverty.

Perlmann is engaged in three research projects to further this initiative. The first, "The Jews Circa 1900: Social Structure in Europe and America," focuses on social characteristics that help explain the rapid socioeconomic rise of East European Jewish immigrants who entered the American economy at the turn of the century. Perlmann is using Census data that were previously unavailable or not machine readable to examine social and economic characteristics of East European Jewish populations who emigrated to the United States and those who remained in Europe.

Perlmann's second project, "Assimilation and the Third Generation," explores the assimilation of immigrants into the socioeconomic mainstream of the United States and the social and economic experiences of their native-born children. Special attention is paid to a few large groups whose absorption seemed especially slow and painful during the first and second generations: Irish immigrants who arrived in the mid nineteenth century, Italians and Poles who immigrated between 1880 and 1920, Mexicans who arrived throughout much of this century, and southern-born blacks who migrated to the North. Perlmann uses Census data in new ways in order to identify and trace second- and third-generation Americans.

Perlmann's third project, "The New Immigration's Second Generation," conducted with UCLA professor of sociology **Roger Waldinger**, reviews literature that deals with the economic progress and difficulties faced by children of immigrants today and compares their experiences with those of children of turn-of-the-century immigrants.

Perlmann, who also holds the post of Levy Institute Research Professor of History at Bard College, received a Ph.D. in history and sociology from Harvard University.

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## **New Working Papers**

Uncertainty and the Institutional Structure of Capitalist Economies

Hyman P. Minsky  
Working Paper No. 155, April 1996

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In this working paper Distinguished Scholar Hyman P. Minsky explores the theoretical and practical causes of

today's rising economic uncertainty and insecurity. He begins by noting views of uncertainty held by Keynes and adherents of the new classical economics by comparing Keynes's *The Treatise on Probability* and Sargent's *Bounded Rationality in Macroeconomics*. According to both views, decisions are made by agents based on varying degrees of ignorance and supposition; the agents have a more or less limited amount of knowledge and base their judgments on their own idea of how the economy works (their "model of the model"). In addition, agents are not homogeneous, but have differing abilities and histories. Thus the internal models used to guide decisions are not consistent from agent to agent.

Minsky notes that although according to Sargent's concept of bounded rationality, all agents at any one time need not be acting according to mutually consistent models, Sargent ignores a point stressed by Keynes about the decision-making process: Economic events at any one time are the result of past mental models (and corresponding actions and expectations), and those past models are different from current models (and correspondingly different actions and expectations); therefore, factors that might determine long-term expectations are in a continuous state of flux. Despite this difference, the gap between the ideas of the two schools of thought has narrowed.

Minsky points out that capitalism in the United States is an ever-evolving construct that recently entered a new stage: money manager capitalism. In this form of capitalism nearly all businesses are organized as corporations; pension and mutual funds are the predominant owners of financial assets; and managers of these funds are judged solely on the total return on fund assets (dividends and interest plus appreciation in share value). One consequence of the money manager structure is predominance of short-run considerations in decision making.

Historically, the public has had limited tolerance for uncertainty. During the New Deal era this intolerance led to the creation of institutions and arrangements to reduce uncertainty and create transparency in both financial markets and corporate governance. For example, crop insurance set floors to farmers' incomes, and deficits run by the federal government set floors to aggregate profit flows. However, the focus of money manager capitalism on short-run returns and uncompromised profit margins has increased economic uncertainty at the firm and plant levels through the chronic need to reduce overhead and variable costs. These activities have unraveled the traditional relationships between firms and workers and increased economic insecurity among employees.

Minsky asserts that since existing institutions and arrangements cannot contain this uncertainty, new institutions and arrangements must be created to offset the effects felt by the "losers" in the gamble imposed by uncertainty. Such measures are necessary to prevent these individuals from becoming alienated and hence receptive to an alternative to democracy. Accepting the view of Henry Simons that the focus of economic policy is not narrowly the economy, but rather to "assure that the economic prerequisites for sustaining the civil and civilized standards of an open liberal society exist," Minsky suggests that full employment programs analogous to certain New Deal programs (the Works Progress Administration, the Civilian Conservation Corps, and the National Youth Administration, for example) should be considered to meet these goals.

How would such programs be financed? According to Minsky, the U.S. economy has ample resources, but the question is one of how willing we are to mobilize these resources, that is, to tax and borrow for such projects. For example, welfare in its current form (AFDC and food stamps) exists because it is the cheapest way (short of a policy of doing nothing at all) to take care of the population in need. Full employment policies are more humane, but more expensive and require a larger and more innovative public sector.

For government to institute programs to offset the uncertainties of money manager capitalism, it must validate government debt with government revenues. The current high ratio of government debt to gross domestic product (GDP) is the result of the irresponsible fiscal policies of the 1980s; a responsible program would assure the decline of the ratio of federal debt to GDP over time from its current 65 percent to about 50 percent. The reduction could be accomplished by transforming the tax structure to a value-added revenue system in which, for example, the individual income tax is replaced by a progressive consumption tax with broad bands and a high per person deduction and value-added taxes are levied on production or distribution and on imports. Imposing such a revenue system would allow the United States to transform its economy from one based on transfer payments to a full employment economy, from one that generates resentment to one that maintains

commitment to democracy.

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[Editor's note: This paper was presented in San Francisco in January at the ceremony in which Minsky received the 1996 Veblen-Commons Award, given in recognition of the contribution made by an outstanding scholar in the field of evolutionary institutional economics.]

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### **The Consumer Price Index as a Measure of Inflation and Target of Monetary Policy**

Dimitri B. Papadimitriou and L. Randall Wray

Working Paper No. 164, May 1996

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Recent low and stable inflation rates are, according to most observers, the result of the Federal Reserve's monetary policy, and most observers do not seem to question that the Fed's sole responsibility is to fight inflation. However, as Executive Director Dimitri B. Papadimitriou and Research Associate L. Randall Wray, have shown,<sup>1</sup> the Fed has not been successful in selecting a monetary policy target that is closely correlated with inflation. In response to this flaw, some theorists and policymakers have advocated the use of an aggregate price index as both the target and the goal of monetary policy. In Working Paper No. 164, Papadimitriou and Wray evaluate the most frequently suggested of these indexes—the consumer price index (CPI)—for its appropriateness as a monetary policy target. They determine first which of the CPI's components have tended to raise it and then how a change in monetary policy would affect these components. They conclude that there are serious empirical questions about the transmission mechanisms through which monetary policy is supposed to affect the CPI. Therefore, even if it represented a perfect measure of the cost of living, they would still disagree with its use as a measure for monetary policy.

### **The Current State of Monetary Policy**

According to Papadimitriou and Wray, monetary policy is in a quandary because (1) there is no consensus on the relationship between the Fed's operating targets to some of its intermediate targets, (2) there is little consensus on the relationship between traditional intermediate targets and ultimate goals, and (3) there is a question about the ability of monetary policy to affect ultimate goals, such as unemployment and economic growth. Many appear to believe that the Fed can affect only the inflation rate, but this belief seems to have evolved without any clear idea about how monetary policy affects inflation. Clarification is necessary in light of the changes in the monetary and financial systems during the past 10 to 15 years. In fact, empirical evidence contradicts the belief that monetary policy has been a prime determinant of inflation.

Despite recent testimony by Fed Chairman Alan Greenspan indicating that he recognizes some of these problems, the Fed appears to remain convinced that higher interest rates will eventually slow spending, even though it harbors some doubt about whether such increases will slow inflation. We are therefore left with a situation in which many doubt the Fed's ability to affect any important economic variable except inflation; because of these doubts, many believe that the Fed should focus policy on "the" rate of inflation as measured by the CPI. As Papadimitriou and Wray note, "what used to be called an ultimate goal of monetary policy—inflation—has, in effect, become the target of policy even though no one is sure how the Fed is to hit this target."

### **The CPI and Monetary Policy**

Papadimitriou and Wray find the use of the CPI as a target problematic. They assert that the CPI deviates from an ideal target (which they define as a variable that is controllable via monetary policy and that accurately reflects market-induced price changes) because it provides an inaccurate portrait of actual market conditions.<sup>2</sup> In addition, some of the components of the CPI that have increased most rapidly are those that are least likely to be affected by monetary policy; therefore, monetary policy actions must be of increasing strength in order to induce a constant effect on the overall index. Further, in at least some situations, monetary policy can

perversely affect the index (that is, tight policy may increase the measured rate of inflation). This problem would not be resolved by changes to the index such as those proposed by, for example, the Boskin Report.<sup>3</sup>

Papadimitriou and Wray are concerned with the problem that results from differential rates of increase of certain components in the CPI product basket. To understand the extent of this problem, they examine the relative importance (measured as the nominal portion of spending of each component of the consumer basket, holding the component weights constant) and weighted contribution to inflation (measured as the contribution of the rate of change of the price of each individual item in the basket to the rate of change of the overall index) of each item in the CPI.

The authors' concerns are illustrated in their simulation in which the cost of housing component is assumed to grow faster than the remaining ("other") components (see [Exhibit 4](#)). The differential inflation rate quickly raises the relative importance and weighted contribution of the housing component. Substitution out of components with relatively high inflation rates, however, would eventually reduce the actual component weights that should be used to calculate the CPI, which, in turn, will be captured when the base weights are eventually changed. But if the base weights are changed only once a decade, the CPI would experience an upward bias to the extent (in this example) that the true component weight of housing is less than the fixed component weight. Thus, the change in relative importance gives an idea of the sort of bias introduced into the CPI because a fixed consumption basket is assumed over a 10-year period.

Note that the bias of the weighted contribution measures the degree to which the inflation of individual components causes inflation of the CPI. However, even if component weights were recalculated annually (that is, the difference between relative importance and component weights were eliminated), the growth of the weighted contribution of items experiencing higher-than-average rates of inflation would still exist. According to the authors, then, the problem associated with the concept of weighted contribution is not the result of the calculation method, but a reflection of the "common sense reality" of the domination of any aggregative index by items with above-average inflation rates.

Papadimitriou and Wray then analyze the historical data and find that three components—food, energy, and housing—account for most of the inflationary pressures of the 1970s and early 1980s and for most of the disinflation since the mid 1980s.<sup>4</sup> Excluding exogenously induced price increases for food and petroleum, much of recent inflation derives from rising prices for services, a sector not generally included in the transmission mechanism scenarios justifying typical changes to monetary policy (namely, that demand will be affected via a Fed-induced change in finance costs). Such policy is generally thought to have a relatively large effect on the prices of goods as opposed to services, as goods are thought to be more sensitive to changes in interest rates. Since services have become an increasingly larger component of both inflation and the actual market basket, monetary policy that primarily affects the goods sector must be increasingly restrictive (loose) in order to effect a constant decrease (increase) in the rate of inflation.

But the authors argue that the typical transmission mechanisms might not, in fact, work through the components of the CPI. In arguing their case, they pay particular attention to the housing sector. This sector is significant because its relative importance in the CPI is currently above 40 percent, its weighted contribution was 50 percent when inflation was high, and it is thought to be particularly sensitive to monetary policy. Based on their detailed analysis, however, Papadimitriou and Wray conclude that the manner in which changes in housing prices are measured within the CPI prohibits the operation of the transmission mechanisms generally assumed to hold for this sector. Moreover, it is difficult to understand how monetary policy can be used to fight inflation that results from medical care, oil price shocks, rising rents and imputed rents, education, interest costs, or tax hikes. It is unlikely that monetary policy could be used to reduce inflationary pressure resulting from any of these factors, factors that are so significant in terms of their contribution to the CPI measure of inflation. Under such circumstances, for monetary policy to work requires perversely punishing other sectors that do not contribute much to measured CPI inflation. Therefore, the CPI is not an appropriate target to guide monetary policy and "it would be premature to tie the Fed to any particular target, especially to 'price stability.'"

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## Notes

1. Dimitri B. Papadimitriou and L. Randall Wray, *Monetary Policy Uncovered*, Public Policy Brief No. 15,

The Jerome Levy Economics Institute of Bard College, 1994.

2. The authors do not insist that a "perfect" measure of inflation is required. For example, they stipulate that "if the portion of the index that the Fed can influence is large relative to the portion that it cannot, and if potential changes of the portion it can affect are larger than changes of the portion it cannot, then the imperfect index may still prove to be of practical use," although several qualifications to this statement are duly noted. 3. The problems associated with the bias in the measure of the CPI referred to in the Boskin Report (Michael J. Boskin, Ellen R. Dulberger, Robert J. Gordon, Zvi Griliches, and Dale Jorgenson, Advisory Commission to Study the Consumer Price Index, Interim Report to the Senate Finance Committee, "Toward a More Accurate Measure of the Cost of Living," September 15, 1995) and elsewhere are substitution bias, quality change bias, new product bias, outlet bias, and formula bias. However, as mentioned below, the authors contend that even absent these biases, the use of the CPI as a target for monetary policy is misguided.

4. Since the Bureau of Labor Statistics does not release data on component weights, the authors used data on relative importance to calculate weighted contribution. They used "fixed weights" based on relative importance over five-year periods. For the component weight, they used a constant relative importance weight for each five-year period, updated for the subsequent five-year period.

**Exhibit 4 Simulation Showing the Relative Importance and Weighted Contribution of Selected Components of the CPI under the Assumption of Differential Inflation Rates, Selected Years**

Year	CPI			Inflation (%)			Relative Importance (%)		Weighted Contribution (%)	
	Other	House	CPI	Other	House	CPI	Other	House	Other	House
1985	100.0	100.0	100.0	2.5	2.5	2.5	58.5	41.5	58.5	41.5
1990	113.2	139.9	124.3	2.5	10.0	5.9	53.3	46.7	23.6	76.4
1995	128.1	225.3	168.4	2.5	10.0	6.5	44.5	55.5	18.0	82.0
1996	131.3	247.8	179.6	2.5	10.0	6.7	42.8	57.3	16.7	83.4
1997	134.6	272.6	191.9	2.5	10.0	6.8	41.0	59.0	15.7	83.7

Note: The CPI here assumes a fixed-weight basket changed once per decade; a 1985 base period; component weights calculated in 1983-84, not adjusted until 1998, and divided into two categories: housing (weight equal to 41.5 percent) and other (weight equal to 58.5 percent); and that all components experienced a constant and uniform annual rate of inflation of 2.5 percent until 1987, when the inflation rate of the housing component rose to 10.0 percent per year.

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## **Economic Insecurity and the Institutional Prerequisites for Successful Capitalism**

Hyman P. Minsky and Charles J. Whalen  
Working Paper No. 165, May 1996

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In this paper, issued on the fiftieth anniversary of the Employment Act of 1946, Distinguished Scholar Hyman P. Minsky and Visiting Scholar Charles J. Whalen search for reasons to account for the difference between economic performance in the period from 1946 to 1966 and performance from 1966 to the present. The authors discuss a number of economic problems that arose during the later period, including slower growth, stagnant earnings, rising financial instability, and increasing inequality.

Minsky and Whalen acknowledge that factors such as globalization and technological change have undoubtedly played a role in the split performance. However, an often overlooked, but important factor is the evolution of the U.S. financial structure during recent decades. The authors explain that a key component of that evolution has been the rise of "money manager" capitalism. Important features of money manager capitalism are increased financial fragility (lower margins of safety in indebtedness and a greater reliance on debt relative to internal finance) and the introduction into the financial structure of a new layer of intermediation. In particular, managers of pensions, trusts, and mutual funds currently control the largest share of the liabilities of corporations. These managers are judged by only one criterion: how well they maximize the value of funds. As a result, business leaders have become increasingly sensitive to the stock market valuation of their firm.

Minsky and Whalen assert that current economic problems require that we reconsider how to measure economic success. In the early postwar period American policymakers could focus on overall economic growth, unemployment, and inflation. These measures, however, are no longer sufficient as indicators of citizen well-being, given existing wage stagnation and widespread employment insecurity resulting from longer employment searches, increased dependence on multiple job holdings, and the explosive growth in part-time and contingent work.

The authors outline the institutional prerequisites for a new stage of capitalism, which they call "shared prosperity" capitalism, in which economic security and social progress are mutually reinforcing. One prerequisite is a federal government that encourages competition among firms through innovation, improvement of product quality, and development of new markets, rather than through a reduction of labor costs. Other prerequisites are a national network of community development banks and a public sector that serves as employer of last resort.

Minsky and Whalen argue that it is possible to reduce present-day economic insecurity without sacrificing economic progress. The Employment Act should be commemorated not merely by looking back at the past fifty years, but by looking ahead toward a new era of institution building: "The goals of the Employment Act are best honored by working to achieve a new age of shared prosperity."

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## Conference

### **Recent Developments in the Financial Structure**

On April 11 and 12 the Levy Institute held its sixth annual conference organized under the aegis of its ongoing research program on reconstituting the financial structure. Given the rapid pace of technological change, the globalization of finance, and the evolving structure of financial markets and institutions, the conference, entitled "Recent Developments in the Financial System," explored policy options that enhance stability and promote competition in the dynamic financial system. Featured speakers (whose remarks are summarized below) were J. Kenneth Blackwell, treasurer of the State of Ohio; Neil D. Levin, superintendent of the New York State Banking Department; Eugene A. Ludwig, Comptroller of the Currency; Roberto G. Mendoza, vice chairman and director of J. P. Morgan & Co., Inc.; Ernest T. Patrikis, first vice president of the Federal Reserve Bank of New York; Jay N. Woodworth, president of Woodworth Holdings, Ltd.; and Janet L. Yellen, member of the Board of Governors of the Federal Reserve System. Conference sessions were entitled "Assessing the Role of Derivatives and Controlling Their Risks," "Electronic Banking: Competing and Regulating in a Technological Age," "Bank Megamergers, Glass-Steagall Reform, and Competition in Commercial and Investment Banking," and "The Financial Sector and World Economic Development."

### **J. Kenneth Blackwell**

Speaking about the losses experienced by municipalities resulting from derivatives deals, J. Kenneth Blackwell

stated that "public fund managers have replaced debt service with lip service." Although municipal investors preach caution, their portfolios represent increasing amounts of risk. Under pressure to boost revenues without raising taxes or cutting services, local treasurers attempt to make up the difference with aggressive investment earnings. As a result, "too many Main Street investors dive into the pool with Wall Street sharks" and participate in deals that they do not understand. "Derivatives are the financial equivalent of explosives on a construction site. Used properly they do the job like nothing else can, but used carelessly or by the wrong people, they blow up in your face."

Blackwell made it clear that he did not believe derivatives to be "inherently evil"; they are instruments that meet a specific objective-hedging risks. However, public fund managers should not be in the business of hedging risks; rather, they should be risk averse. Public fund managers should adhere to three investment priorities: safety, liquidity, and yield, in that order. They must do no harm. They should collect and protect public revenues and invest them only because "idle money means lost money." Above all, public fund managers should not lose money because that involves retaxing taxpayers or cutting services for which they have already paid. Funds with no or little risk have no need for derivatives.

Blackwell also stated his opinion that "broker-dealers share responsibility when an issuer's investment strategy backfires." Accordingly, investment firms should sign statements declaring that they have read and understood an issuer's investment policy statement before doing business. In the case of derivatives, for example, brokers create and market a product; if they do not accept responsibility for their product, who will? When the Ohio Treasury, the debt-issuing agent of the state, issues bonds, its products are backed by the full faith and credit of the State of Ohio; the value of its products is based on the economic well-being of the state, the confidence of its public fund managers, and the integrity of its elected officials. When any of the three qualities that determine debt value vary, someone (the Treasurer) must take responsibility for that change. Where does responsibility lie when a derivative strategy fails? In whom does the investor trust? Who is held accountable?

### **Neil D. Levin**

In his speech on recent developments in the New York State banking system, Neil D. Levin stated that the Community Reinvestment Act moved the system away from a process-based system to a performance-based system. This move was in everybody's interest as performance-based systems are supposedly much easier to measure. Still, the New York State Banking Department is concerned that the move may result in the worst of both worlds, requiring banks both to achieve certain performance measures and to record processes. Should banks fall short of performance goals, they could then explain such shortfalls to examiners in terms of processes.

Regarding safe harbor for New York, Levin noted his belief that the majority of banks are truly committed to serving their communities, whether they are doing so for idealistic or business reasons. A majority of banks have posted satisfactory ratings and do not try to achieve an outstanding rating because there is no reason, from a business standpoint, to spend extra funds to do so. Levin would like to provide some incentive for institutions to attempt to achieve an outstanding rating and proposed creating a fifth rating category: high satisfactory. This rating would not safe harbor 97 percent of institutions. Rather, an institution with a rating of outstanding would be safe harbored immediately until its next examination; two high satisfactory ratings would be required before the institution would be granted a safe harbor.

Levin observed that congressional action on Glass-Steagall reform does not appear imminent. What can and will the states do in the absence of such action? Although the FDICIA limits states' ability to grant new banking powers, there probably are some additional powers that the FDIC would approve. Because it is incumbent on states to ensure that their charters are as attractive and as competitive as possible, Levin predicted that in states that do not respond regarding banks' ability to sell insurance, banks will rethink maintaining their state charter. Banks will not be fooled into keeping state charters that are associated with a cumbersome, burdensome, and expensive regulatory system. Levin noted his commitment to preserving the dual state and national bank chartering system, a system in which choice is maintained and a concentration of power (ultimately bad for capital formation) is avoided for both domestic and foreign institutions. He maintained that competition between state and national chartering systems is probably healthy with regard to the quality of exams and supervision, fees, and overall efficiency.

Levin also observed that the situation with Daiwa Bank raised several questions for regulators. First, has supervision kept pace with the growth, scope, and complexity of the operations of foreign branches and agencies in the United States? Second, has supervision of domestic institutions kept pace in terms of requirements for internal controllers, internal auditors, and external auditors? Third, how do federal and state examiners react when they find a weakness that does not require formal enforcement action according to regulations? Today, in addition to having to supervise domestic institutions in a multistate environment, we are operating in a global environment. Supervision in that environment will be impossible without cooperation and coordination among supervisors worldwide.

### **Eugene A. Ludwig**

In his speech, "Financial Modernization for the Twenty-first Century," Eugene A. Ludwig discussed questions about the basic assumptions of the existing framework of analysis, questions arising from changes in the marketplace. Is geography the appropriate basis for determining what rules apply to the offering of financial services and who applies those rules? Are there legitimate financial activities that are in-and-of themselves too risky for financial institutions to undertake? Is it possible to judge such risks responsibly without regard to the strength or sophistication of either the institution's own risk management systems or the supervisory capacities of its regulator? Can the corporate structures mandated by the government address the risks of providing certain financial products and services?

Compared to their predecessors a generation ago, banks today have greater freedom to achieve geographical and product diversification, and such diversification enhances their risk management strategies, competitive position, strength, and stability. But the trend in the area of bank structure has been strangely backward. As the ability of banking organizations to determine their mix of products and services has increased, their ability to decide on the appropriate corporate structure for offering that mix has declined. Ludwig asserted that "we are now overdue for a reexamination of the costs and supposed benefits of government-mandated corporate structures, because the progress we have realized in our quest to make banks more competitive will be set back if we continue to force banks into structures that serve no clear public policy purpose." As the pace of competition continues to accelerate, these structural limitations, whatever their source, will fast become a source of competitive inequity that, ultimately, is quite likely to have a detrimental effect on the safety and soundness of the banking industry.

Ludwig proposed that there are three forces currently at work in the marketplace that eventually will require the government to place less emphasis on mandated corporate structures and greater emphasis on effective supervision. These forces are (1) industry consolidation, (2) the evolution of the bank charter, and (3) competition from nondepository businesses. According to Ludwig, statistics on industry consolidation tell

a story of how government-imposed structure forces the industry in one direction, while the market, when allowed to do so, moves the industry toward different, simpler, and more competitive structures. The growth of holding companies was the result of government requirements to adopt such a structure in order to conduct business across geographical boundaries and on a regional basis. Today, however, there is a clear market trend for bank holding companies to consolidate their operations, when they're empowered to do so, into the minimum number of charters possible.

In a review of bank chartering, Ludwig discussed several recent Supreme Court decisions and paid special attention to the VALIC (Variable Life Annuity Life Insurance Co.) and Barnett Bank cases. In the 1995 VALIC case the Supreme Court unanimously upheld the legal interpretation of the OCC (Office of the Comptroller of the Currency) that national banks could sell annuities. The case laid the foundation for a more competitive, more contemporary banking model by confirming that national banks are not limited to the specific powers and activities spelled out in the National Bank Act and by directing lower courts to give "controlling weight to a reasonable construction of the powers of national banks by the comptroller." Ludwig asserted that the importance of VALIC cannot be overstated and that the ruling is particularly significant given the wild card statutes in place in over 30 states. Taken together, VALIC and the state wild card statutes establish a legal framework in which the bank charters can evolve as the needs of the marketplace change. Moreover, as a direct consequence of the Supreme Court's ruling in the Barnett case (which affirmed the right of national banks in towns of less than 5,000 to sell insurance), greater numbers of consumers will enjoy the benefits of



competition in the insurance marketplace.

Ludwig observed that intensifying competition and the need to keep pace with technological changes will force banks to continue to search for ways to reduce costs. Many industry participants are urging Washington to help them do so by reducing the regulatory burden and eliminating the structural constraints on financial institutions. The need to reduce the regulatory burden is what fueled the Riegle-Neal bill's drive through Congress. However, the enactment of Riegle-Neal has not eliminated the regulatory burden, and the banking industry will continue to work for further reduction and to move toward simpler organizational structures when the law permits.

### **Roberto G. Mendoza**

In his speech "The Competitive Challenge Facing U.S. Wholesale Banks," Roberto G. Mendoza observed that there are only four purely wholesale global firms in the world-Bankers Trust, Morgan Stanley, Goldman Sachs, and J. P. Morgan (although from a competitive standpoint, one could add Merrill Lynch)-and predicted only three of these firms will survive.

He noted that the biggest boon, and also the biggest challenge, to these firms is technology. Technology has revolutionized the financial intermediary business. In the past financial intermediaries benefited from an information advantage, an advantage that has disappeared today. Technology has also, however, given them the capability to identify, segment, price, and distribute risk in a way that did not exist before. That capability has redefined the services provided by financial intermediaries; it has changed what clients expect from banks. Banks that can deliver these services quickly change their perceived market position and, by implication, their profitability.

According to Mendoza, technology has also "commoditized" large portions of financial business. A global firm's mix of business used to be seen as a continuum from, on one end, an advisory capacity (the image of the trusted banker sitting at the elbow of the chief executive) to, at the other end, activity in which the bank takes a pure equity risk-proprietary trading, equity investment, and certain types of derivative transactions. Most of the activity in wholesale banks falls somewhere between the two extremes. The banks distribute a risk or a security from the party who does not want to undertake the risk to the party who does want it. Because technology has taken away the information advantage, that distribution process has forced prices down. This does not necessarily make distribution activities unprofitable; it simply means that a firm can do very well only if it is a below-cost supplier of enormous scale. Technology has had the functional effect of taking the profitability out of a large part of the business in the middle.

Mendoza predicted that a fundamental characteristic that will define the successful global wholesale firm is the ability to intermediate risk. Despite the fact that banks have lost their information advantage, there is a greater need to intermediate risk. For example, currencies, commodities, and equity markets have become more volatile; the ability to combine intellectual capital with the computational ability associated with new technology makes it possible to segment risks in a fairly precise manner. Once segmented, risks can be appropriately priced, allowing the client to retain those risks in which the client has a comparative advantage in managing. Segmenting risk is an activity that requires the intermediary to maintain a high credit rating because, in order for the intermediary to perform hedging activities, the client has to believe that the intermediary has certain capabilities, which involve a massive investment in technology and very highly developed people, all attributes of a global wholesale firm having a long-term investment horizon.

Another challenge to wholesale banks is operating in a global market in which stakeholders differ in their requirements and expectations. In the United States wholesale firms have shareholders or partners who want high returns. U.S. firms must, however, compete with firms in other countries that in some instances have shareholders who require a return on equity of only 5 percent and have a medium-term return goal of 10 percent, levels that would be unacceptable for U.S. firms. Low returns by other firms put tremendous pricing pressure on the business as a whole and on the middle segment of the market in particular.

An aggravating factor is what Mendoza referred to as the national champion complex. Every country must have at least one firm participating in certain industries, such as the global banking business, and that firm has to be

a winner. Eventually, in many cases competition will force the firm to take excessive risks and it will go bankrupt (as in the case of Barings), or it will grow large and turn into a mechanism for social welfare (as has been the case of one or two continental banks). Competing in the same market with subsidized entities with such different return objectives poses a big challenge to U.S. wholesale firms.

A final challenge to wholesale firms is how to differentiate themselves from other firms. Pertinent questions such firms might ask is why they want to be wholesale firms and what that entails. Wholesale firms used to offer a wider range of services, such as retail services (in the broad sense of the term) involving branches, brokers, credit cards, and advertising in the newspaper; this range required many people of differing skills and large amounts of capital. Now, however, many wholesale firms do not offer this wide range. Rather, they can make a healthy living by concentrating on, for example, the high value-added segment of the business and allowing other firms to perform the distribution function. The ability to concentrate on one facet of the business depends on the assumption that a buyer of the firms' product is willing to unbundle. According to Mendoza, there is some evidence that this premise needs to be examined.

### **Ernest T. Patrikis**

Ernest T. Patrikis gave a speech entitled "Wholesale Financial Market Transactions." He noted that there are voluntary codes of conduct regarding transactions in wholesale markets in a number of countries, namely, England and certain Asian countries. In some countries these codes are promulgated by official bodies and cover all transactions in wholesale markets, be they gold bullion, foreign exchange, or securities. He asked why the United States did not have such codes and whether it was possible or desirable to have an overarching code for the marketplace.

Patrikis reported that he had called a group of associations, including the Securities Industry Association, Public Securities Association, New York Clearinghouse Association, International Swap and Derivatives Dealers Association, and Emerging Markets Traders Association. He asked them if it would be worthwhile to see if a code would be desirable and if one could be drafted. They agreed that it would be worthwhile, but because it was uncertain whether such diverse interests could reach consensus, their efforts were not publicized.

A committee, made up of two representatives from each of the associations in the group, examined every code of conduct in English they could find and broke down all provisions by topic. The committee members voted on which provision they thought was best on each topic and attempted to find topics that had not been covered. They narrowed their investigation to instruments in transactions in the wholesale financial market. In order to cover all entities that might have market power, they decided that the code should apply to any firm or government active in the over-the-counter market. Moreover, they agreed on the principle that all participants in the wholesale market are equal participants.<sup>1</sup> The instruments covered included financial resources, supervision training of employees, control, compliance, risk management, risk monitoring, independent risk monitoring, valuation, and external valuation. The committee established a system of real self-regulation (nonstatutory) as opposed to government-controlled self-regulation.

The feedback on the code was helpful. It became clear that two groups were not pleased with the report's contents: the End Uses of Derivatives Association and the Government Finance Offices Association. Levin noted that after Gibson Greetings and Orange County, he could understand the concerns of these groups.

The committee's code works in nearly the same way as the bank supervisor's guidelines to examiners. Guidelines are not given for each instrument; rather, each institution uses the principles and practices to make sure that what it is doing is proper and in accordance with best practices. Levin made it clear that the document is not law and cannot change law; rather, it is a voluntary code. However, if behavior in accordance with the code became common practice and was generally perceived as common practice, the law merchant might apply to give the code some force of law.<sup>2</sup>

Levin observed that there are situations in which firms, especially dealers, ought to be careful. The firm ought to first know itself, making sure that it has the competence and expertise to handle a transaction; it also should see if its customer has that same expertise. "We call that appropriateness, not suitability, and do it to protect

ourselves from reputational risk."

### **Jay N. Woodworth**

In "The Coming 'Train Wreck' in Japan's Financial System," Jay N. Woodworth noted that a number of major Japanese financial institutions now have somewhat impaired financial statements, which imposes some nontrivial risk on the global settlement system. Such impairment is cause for concern because these somewhat shaky trillion-dollar-sized financial houses are doing major transactions that will have enormous effects on markets and financial institutions throughout the world.

Woodworth commented that things began to change in Japan last fall after Daiwa Bank experienced problems in the United States. Although Daiwa initially was treated in the Japanese press as yet another example of Japan-bashing by overzealous U.S. regulatory authorities (notably, the Federal Reserve) and a hostile American press, the Japanese Ministry of Finance was deeply concerned that its regulatory compartmentalization had restricted its knowledge. The downgrading to near-junk levels by public agencies of the debt of Japanese banks indicated that something would have to be done. At the risk of losing foreign access for major Japanese financial institutions, the Ministry of Finance decided that the banks would have to write off at least some of their bad loans and comply fully with the 8 percent Basel capital standard by March 31, 1996. Thus far, ¥8.8 trillion-roughly \$85 billion-has been written off.

Woodworth contended that the Japanese financial crisis was the result of a number of factors. First, financial institutions were rigidly compartmentalized, and competition, especially from outside, was carefully managed within a highly regulated environment. Second, in the early 1980s deregulation, which conferred newly granted powers to Japanese thrift institutions (much the same as in the United States), came right after the peak of the real estate market. This environment spawned a period of speculative excess outstripping that in the United States in the late 1970s. The speculative period was followed by Japan's four-year recession, which generated skyrocketing nonaccruals and problem assets. Third, banks were thinly capitalized; too much of their capital consisted of hidden reserves in the form of the market value of equity holdings that had greatly increased in value. Fourth, keiretsu ties were excessively strong. Within a keiretsu cross-shareholding ties among financial firms and industrial corporations are strong. However, by the mid 1990s it was realized that these ties, although they provided the group with certain advantages, also contained some weaknesses for Japan; some shareholdings proved to be illiquid and created deep, serious, and unwanted entanglements during an already stressful time.

Woodworth observed that it has taken a "train wreck" to force a far-reaching new consensus that will enable Japanese politicians to address the problems with public funds, but the resolution of the crisis is still in transition. The apparent solution to Japan's problems was presented last summer in the form of a commission's report to the Ministry of Finance. The report contained a blueprint for comprehensive reforms roughly paralleling some measures implemented in the United States. The reforms would, for example, give the authorities power to close financially troubled banks as soon as they become insolvent rather than waiting a few years or decades; establish an institution similar to the Resolution Trust Corporation to take over failed thrifts; encourage thrifts to become commercial banks; replenish the bankrupt deposit insurance system; and codify standards to take care of conflicts of interest among officers and directors, between banks, other thrift institutions, and other keiretsu companies. Unfortunately, the report outlining these reforms was viewed as diluting the powers of the Ministry of Finance and appears to be too bitter a pill for Japanese politicians to swallow. Moreover, large banks that have not failed are busy tending to their operations by scaling back their domestic and international activities; these banks do not want to rescue failed banks. We will soon see if pressure by the large banks is adequate to force the implementation of increasingly tough, public, international standards. Woodworth gave his opinion that more will be necessary to accomplish this goal.

### **Janet L. Yellen**

According to Janet L. Yellen, credit risk has been the major risk incurred by the financial institutions. This was because interest rate risk could be managed easily by making sure that the contractual interest rate on the loan varied with the cost of funds. Over the past 15 years traditional intermediation changed dramatically at many of the nation's largest banks. Also, large nonbanks, including investment banks, captive finance companies, and

insurance companies, have increasingly become major players in the intermediation process, employing the same technological advances as banks.

Chief among the innovations at the major banks has been loan securitization. Bank-sponsored loan securitizations currently involve over \$200 billion in outstanding securities (sponsored primarily by the very largest banks), and account for about 20 percent of the credit activities of these large institutions. Yellen noted that although securitization holds the potential for transforming the traditional paradigm of intermediation, it does not relieve banks of their major traditional job, namely, to measure, assume, and manage credit risk. Indeed, we now know that securitization can result in the undertaking by banks of as much as or even more credit risk than traditional lending.

Securitization raises questions about policy that are similar in scope to, although often more complicated than, questions about traditional lending. Yellen noted two questions of importance: How should the credit risk associated with lending and securitization activities of a bank be measured? How much capital should be required of a bank for a portfolio of given riskiness? Yellen asserted that although the Basel Accord on international capital standards of the mid 1980s was a good compromise for the time it was reached, it is paradoxically simultaneously very complex and quite simplistic when it comes to credit risk. In the mid 1980s the technology of credit risk measurement was not sufficiently developed to allow "finely tuned" capital requirements, and "there was an overarching need to set minimum capital requirements in the face of a long decline in bank capital levels." Also, securitization and other complex credit activities were not as prevalent as today. As a result, the one-size-fits-all approach to capital requirements for credit risk is becoming increasingly problematic.

Bankers at the most forward-looking of the large institutions, however, are trying to do the two things necessary to determine capital adequacy for credit risk: to measure risk statistically and to follow consistent rules in allocating capital to cover the measured risk. In contrast to the one-size-fits-all standard of regulatory capital rules, the statistical procedures used by banks to measure credit risk and rules to allocate capital often result in a wide range of internal capital allocations, even for a particular category of credit instrument. For example, according to a 1995 industry study, approximately 60 percent of the top 50 banks internally allocate capital by risk grade of commercial loans. The problem increasingly faced by bank supervisors is that evolving regulatory requirements, no matter how complex, are not likely to capture the complexity of risk positions that bankers are actually undertaking.

Yellen opined that she feared that "we may be reaching the point that for our largest, most complicated institutions, a bank's formal regulatory risk-based capital ratio, let alone its simple equity-to-asset ratio, is not as useful a signal of financial soundness as we would like it to be." The complexity and diversity of the means by which some of the most sophisticated banks measure and deal with credit risk make the application of rigid capital rules less appropriate. At some point, the technology for measuring credit risk will become sufficiently robust to warrant a major renovation of prudential capital regulations for credit risk. As regulators develop increasing confidence in the ability of banks to quantify and manage credit risk, the natural course will be to find ways to reflect these competencies and apply them to regulatory and supervisory capital standards.

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## Notes

1. Levin noted that many might disagree with this view—those who, for example, feel that there is a difference between the buy side and the sell side, with the buy side requiring more protection—because of the concern that every dealer firm might not require regulation or supervision. The Securities and Exchange Commission holds that position because it doesn't believe in comprehensive, consolidated supervision, a view somewhat shared by the Fed. Levin was hopeful, however, that they would someday achieve competent comprehensive consolidated supervision.

2. Levin explained that the law merchant evolved from practice in English law. Chancellors would render judgments in cases arising in commercial transactions on the basis of what merchants said was common practice in the community. The law merchant still is law in the United States and might apply to the voluntary guidelines if enough "merchant" institutions participated, although it could not change what is already in an agreement.

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### **Program Scholars**

Distinguished Scholar **Hyman P. Minsky** has contributed to many academic journals and the public press. Professor Minsky's work-encompassing the financial fragility of and the current crisis in banks, thrifts, insurance companies, and junk bond markets-is the impetus for and the guide of the public policy research program on financial sector restructuring. He also is a member of the Levy Institute's Board of Advisors. Minsky, professor emeritus of economics of Washington University in St. Louis, received a Ph.D. in economics from Harvard University.

Research Associate **Steven M. Fazzari's** current project (which also falls into the area of the federal budget policy program) is an empirical estimation of the relative importance of the channels through which fiscal policy affects investment. Fiscal policy may affect investment through its influences on (1) interest rates and the cost of capital, (2) the business cycle, and (3) firms' financial condition. Policies aimed at affecting interest rates-such as tax incentives, budget deficits, and saving incentives-are thought to influence investment by reducing the cost of capital. Policies aimed at influencing the business cycle are believed to have a short-term effect on the health of the economy and possibly a longer-term influence through investment effects. Finally, policies aimed at altering firms' financial condition-either through internal cash flow or through external debt-could affect the cash that firms use to finance investment internally or the health of the financial sector that provides investment finance through debt or equity issues. Fazzari's work will help direct policymakers' attention to those policies that seem to be most effective at stimulating investment and, hence, economic growth. Fazzari is associate professor of economics at Washington University in St. Louis. He received a Ph.D. in economics from Stanford University.

Research Associate **L. Randall Wray** addresses the ability of the Federal Reserve to conduct monetary policy. He reviews the actions of the Fed under the direction of Paul Volcker and Alan Greenspan, during which time monetary policy has been especially restrictive. Focusing on the Fed's recent history, Wray examines the Fed's use of particular variables to gauge economic performance and monetary trends and explores the effectiveness of these variables in predicting inflationary pressures. Wray, a professor of economics at the University of Denver, received a Ph.D. in economics from Washington University in St. Louis.

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### **A New Facility for the IMF?**

John Williamson  
Working Paper No. 157, May 1996

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In this working paper, John Williamson, senior fellow at the Institute for International Economics, evaluates proposals to create a short-term financing facility within the International Monetary Fund (IMF). The emphasis in this facility would be on the period within which the IMF would respond to a request for assistance, rather than on the duration of the loan.

According to Williamson, there are two situations in which existing arrangements within the IMF do not allow

for a response quick enough to be effective: when a country is attempting to defend a pegged exchange rate and when default is imminent. Some have suggested that any new facility be able to lend to alleviate these circumstances. Those who support freely floating exchange rates, however, are opposed to supporting a pegged rate regime and favor restricting such activity by any new facility. Others would support this activity by a new facility only in cases that pose a systemic threat.

Williamson focuses on the broadest of the purposes that could be fulfilled by a new facility: assisting countries to finance capital flows "judged to be unjustified by the fundamentals and therefore destabilizing." Proposals directed at fulfilling this purpose (which date back some years and have been enjoying a recent resurgence) stipulate the countries that should have access to such a facility, the terms and level of access, the maturity of loans, and the source of the facility's financing.

The author concentrates on a proposal laid out in a paper presented to the IMF executive board entitled "Short-Term Financing Facility" (September 1994). The paper suggests that a broad range of member countries should have access (22 industrialized countries, 12 Latin American countries, Korea, the 5 large Association of Southeast Asian Nations countries, Egypt, Israel, Jordan, Morocco, Tunisia, Turkey, Hungary, Poland, and South Africa). Terms of access would require that the right to borrow be approved at the time of an Article IV consultation and only after a comprehensive review revealed that the country had a strong record of appropriate economic policies and performance that were expected to continue and that there was no fundamental imbalance in its balance of payments. Once approved, the country might be expected to provide a "handful" of key financial statistics as long as the line of credit was available. The level of access would be commensurate with the size of reserve losses that a country could sustain over a short period, although shocks would not be fully financed and the facility would not be used to finance large or sustained capital outflows. The maturity of any facility loans would be short, with a suggested basic maturity of three months with the possibility of a three-month rollover. Financing would be provided from normal IMF sources, including the possibility of activating the General Arrangements to Borrow (GAB).

Williamson evaluates the interests of countries expected to be eligible to draw from a new facility and countries that would not be eligible. The dominant consideration for potential participants would be whether the facility would actually work. A facility loan might be enormously valuable in providing the time necessary for adjustment measures to take effect, but it might also delay necessary adjustments if it were granted before adequate measures were adopted. The IMF would therefore be required to make a judgment on whether such measures had, in fact, been adopted. Unfortunately, some critics contend that the IMF's record on such analysis has been lacking of late.

Another important consideration is the speed with which loans would be disbursed. A preapproved line of credit would allow any loan to be dispatched with necessary speed, but, some argue, preapproval would impose demands on the analytical capacity of the IMF. Another potential problem is whether the IMF is capable of making loans large enough to alleviate the types of problems such a facility is proposed to address. Williamson suggests that if additional resources are necessary, they might come from an increase in the size of the IMF's regular resources, in the size of commitments to the GAB, in the number of countries contributing to the GAB; from an alternative GAB-like facility created for such a purpose; or from borrowing in the financial markets.

Nonparticipants would, of course, be interested in different issues. There could be some positive spillover from participating countries in that participating countries would be able to avoid unnecessary deflationary adjustments, thereby maintaining import demand. Another consideration for nonparticipants is whether loans by the new facility would crowd out existing IMF activities. Nonparticipants might also be concerned if the creation of a new facility reinvigorated the IMF, which, according to the author, has provided few services of direct value to participants since the mid 1970s. The creation of the new facility could extend the scope of effective surveillance beyond the countries that borrow from the IMF.

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## Capital Inflows and Macroeconomic Policy in Sub-Saharan Africa

Louis Kasekende, Damoni Kitabire, and Matthew Martin

Working Paper No. 158, May 1996

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Little has been written about capital flows to sub-Saharan Africa (SSA), largely because of the flows' small size and data limitations. In this working paper, Louis Kasekende, executive director for policy and research at the Bank of Uganda; Damoni Kitabire, commissioner for the Macroeconomic Policy Department for the Ministry of Finance and Economic Planning in Kampala; and Matthew Martin, U.K. Ministry of Finance, explore these inflows, noting that although they are small compared to those into other countries, they are in proportion to the size of the recipient economies.<sup>1</sup> The authors examine the scale and composition of capital inflows, their causes and sustainability, their effect on macroeconomic stability, and their responsiveness to policy measures for six SSA nations: Kenya, South Africa, Tanzania, Uganda, Zambia, and Zimbabwe.

[Exhibit 5](#) shows the change in the composition of private capital flows to SSA nations. Most of the changes are in the same direction as in other developing regions, but the magnitude of the changes in other regions is generally greater than in SSA countries. The absolute size of these changes are, however, still small. For example, portfolio investment was no more than U.S.\$120 million per year and foreign direct investment was around U.S.\$1.6 billion during the period 1990 to 1993, with foreign direct investment lower in real terms than in the early 1980s. Overall, SSA inflow trends were similar to those in other small countries, with short-term bank loans and foreign direct investment playing a greater role than medium- to long-term loans and portfolio inflows.

Kasekende, Kitabire, and Martin identify a number of determinants of recent capital inflows, which they classify as pull (internal) or push (external) factors. Pull factors include debt restructuring and increased confidence resulting from political and economic reforms. Push factors include decreased international interest rates, the trend toward portfolio diversification, and the cyclical downturn in developed countries (which reduced economic activity and the demand for investment funds there).

Whether capital flows to SSA countries are sustainable is a matter of some contention. The composition of inflows (that is, short-term loans and portfolio investment) would appear to make them a priori unsustainable. The macroeconomic environment in these countries will be key in sustaining inward capital movements. Kasekende, Kitabire, and Martin note that private capital inflows have effects on the stability of the private economy that are generally recognized as positive. However, the authors identify possible adverse effects on the exchange rate, balance of payments, the saving-investment and consumption mix, and monetary and fiscal variables. The authors identify three types of policy measures to offset the negative effects of capital inflows: measures to increase foreign exchange demand, measures to reduce aggregate demand and offset inflationary effects, and measures to reduce the scale of capital inflows or to influence their composition in favor of investment. The need for intervention, however, depends on the size of capital inflows, their causes, and their sustainability.

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### Note

1. The views expressed in this paper are the authors' and do not reflect the views of the Bank of Uganda or the Ministry of Finance and Economic Planning in Kampala. Because it is still difficult to find consistent data on African inflows, the findings presented in this working paper are characterized as preliminary and are limited to countries for which data are relatively reliable. The authors note that data problems will be addressed in a forthcoming project entitled "Capital Inflows and Macroeconomic Policy," to be funded by the Swedish and Danish governments.

**Exhibit 5 Composition of Private Capital Flows to Developing Regions, Percent Change**

	1978-1982			1990-1993		
	Latin America	Asia	Sub-Saharan Africa	Latin America	Asia	Sub-Saharan Africa
Foreign direct investment	15.1	15.0	9.8	33.0	37.5	140.3
Portfolio	4.9	3.6	0.0	68.1	14.2	10.9
Long-term bank loans	63.6	53.9	53.9	-32.1	21.7	-143.5
Short-term bank loans	16.4	27.5	36.3	30.5	27.0	92.3

The Anatomy of the Bond Market Turbulence of 1994  
Claudio E. V. Borio and Robert N. McCauley  
Working Paper No. 159, May 1996

According to Claudio E. V. Borio and Robert N. McCauley, "the bond market sell-off of 1994 has begun to show up on lists of market events against which risk management systems are judged." Examples of other such events are the 1987 stock market crash and the 1995 Kobe earthquake. There has been little analysis of the cause of the 1994 decline, and Borio and McCauley fill the void by examining a number of factors that might explain the rise in volatility during that year.<sup>1</sup> The authors investigate four types of one of these factors, market dynamics: volatility persistence,<sup>2</sup> relationships in the direction of market movements, foreign disinvestment, and volatility spillover effects from other markets.

Borio and McCauley found that persistence had strong explanatory power. The implied bond volatility in two successive weeks accounted for 58 to 93 percent of the variance in volatility.

They found "strong but not ubiquitous evidence" that a rise in bond yields led to higher volatility. In the United States and Canada they found no relationship between bond prices and volatility. In Japan, Sweden, and Spain, however, they found a symmetrical directional relationship, that is, increases or decreases in bond yields were associated with similar increases in volatility. In the remaining eight countries they studied, they found a partial directional relationship between volatility and bond prices, that is, volatility rose when bond yields rose, but did not respond when yields fell by a similar amount. The authors offer several possible explanations for the apparent directionality of volatility, including asymmetries in inflation risks and options trading strategies.

Borio and McCauley found that international capital flows played a role in the rise in bond volatility in 1994, especially for European countries that experienced a sell-off of government bonds. The sell-off, the authors explain, reflects "the greater proclivity among foreign investors to leverage their holdings of bonds."

The authors found that spillover effects were not a factor that could explain the general rise in bond market volatility.

In investigating other factors that might contribute to bond market volatility, Borio and McCauley found some evidence that uncertainties about monetary and fiscal policies were sources of volatility. Changing expectations and domestic economic factors (such as the inflation record or volatility in the money market), however, did not



appear to explain volatility.

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#### Notes

1. The analysis is of data for 13 countries—the United States, Japan, Germany, France, the United Kingdom, Italy, Canada, Australia, Belgium, Denmark, the Netherlands, Spain, and Sweden—on weekly yield volatility for 3-month, at-the-money, over-the-counter options on 10-year benchmark government bonds.
2. The authors acknowledge this aspect does not explain the initial cause of volatility, but state that "an econometric evaluation of any other factor must take persistence into account."

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## **Intervention Versus Regulation: The Role of the IMF in Crisis Prevention and Management**

E. V. K. FitzGerald  
Working Paper No. 160, May 1996

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In this working paper, E. V. K. FitzGerald, of the Finance and Trade Policy Research Center at Oxford University, investigates roles that the International Monetary Fund (IMF) might play given its mandate to provide institutional support for a global capital market that can promote trade and investment and given current worldwide economic instabilities, such as highly volatile exchange rates and financial and macroeconomic instabilities experienced in nonindustrialized countries.

The experience of steady growth and price stability under the Bretton Woods system is often cited in support of a return to a managed fixed-rate system. FitzGerald contends, however, that although exchange rate instability might be related to the major financial crises of the past 20 years, such instability is not the source of financial crises; rather, factors such as the worldwide integration of financial markets and the development of heterogeneous financial instruments have created new sources of instability. In the new worldwide financial system exchange rates function as asset prices (that is, they reflect international capital flows) as well to regulate trade flows. Current account balances are, then, more likely a function of internal imbalances than of trade imbalances. Moreover, because interest rates reflect the desire to hold a given stock of bonds, their fluctuation does not cause international capital markets to clear (that is, cause saving to equal investment on a global scale).

Recent theoretical models have moved away from the standard model of international capital flows to those in which flows between industrialized countries are divided among portfolio acquisition, foreign direct investment, bank credits, and official development assistance, each of which is largely determined by the quality of a country's bonds. However, such models have not been explicitly extended to the lesser-developed countries (LDCs); capital flows there are still assumed to be exogenously determined.<sup>1</sup> In fact, claims FitzGerald, LDCs rely on international capital flows to sustain investment. As a result, when worldwide volatility rises, LDCs suffer disproportionately from slower growth, a higher cost of debt service, and denied access to private capital.

When the IMF was formed, it was assumed that LDCs would be somewhat sheltered from volatility because capital would flow through central banks; this, of course, is no longer the case. The facts that capital does not flow through central banks and that capital markets have become integrated internationally have led to new problems (such as increased systemic risk) for any global financial regulator. Resolution of these problems would require a regulator to function as a lender of last resort (a role that the 1994 Bretton Woods Commission views as central to the future of the IMF) and to establish an orderly financial market via prudential regulation of financial intermediaries.

FitzGerald argues that restrictions under Article VI of the IMF's Articles of Agreement that might seem to prevent the IMF from functioning as a lender of last resort are, in practice, no longer applied. However, the need to conduct open market operations to perform this function might prove problematic for the IMF in terms of the necessarily broad scope of a lender of last resort function and the acceptability of potential reserve sources. FitzGerald notes that the other function of global central banking-prudential regulation-is already being performed by the Bank for International Settlements (BIS) in its role, for example, as coordinator of the OECD (Organization for Economic Cooperation and Development) central banks. The BIS also performs oversight duties for settlement systems (for example, by acting as agent for the private European Currency Unit clearing and settlement system), thereby working to improve market transparency and strengthen market infrastructure.

According to FitzGerald, the creation of an orderly market would require the ability to influence national propensities for net financial saving, long-term expectations on asset yields, and attitudes about liquidity. The first could be influenced through international tax regulation and the other two through prudential supervision of capital markets. An argument also exists for the creation of some system of orderly workouts modeled after U.S. Chapter 11 bankruptcy provisions. Such a system, however, would require a system of private international law, which does not currently exist.

In any case, to be effective, a system of intervention and regulation would require close coordination between the IMF and the BIS. An early-warning structure that could respond to emerging crises would also be necessary; however, because such a structure would require substantial enhancement of IMF powers, it is not clear if the IMF would be the best institution to fulfill this responsibility. The conferral of such powers (or close cooperation between those institutions that might have such powers) would depend, in part, on recognition that current nation-based regulations are inadequate. Considering the extreme unlikelihood that supernational authorities will be established and the limited capacities (and interests) of private actors, managing global capital markets will have to be done through intergovernmental arrangements, but with much more management of private actors by existing international institutions. However, given the move toward deregulation by certain national and sectoral interests seemingly unconcerned about threats posed by market disorder, "it is difficult to see what might press them to support reregulation." At best, then, global regulation of finance might have to be constructed "within a hierarchically organized world economy as in effect exists in the trade areas within the GATT/WTO system."

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#### Note

1. FitzGerald notes that "although some advance has been made on the interaction between new trade theories, capital flows, and LDC growth on a global basis in neostructuralist 'North-South' models, capital flows are still treated as exogenous except for borrowing limits imposed by existing sovereign debt burdens."

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## **Globalization, Capital Flows, and International Regulation**

Andrew Cornford and Jan Kregel  
Working Paper No. 161, May 1996

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In the postwar period prior to 1990 policy proposals aimed at reducing the instabilities associated with increased capital flows focused on increasing market efficiencies so that nominal variables would reflect real conditions in the economy. However, those in charge of financial resource flows applied theories largely unconcerned with fundamentals, resulting in such financial market instabilities as volatility in the foreign exchange market. Andrew Cornford, of the Global Interdependence Division of UNCTAD (United Nations

Conference on Trade and Development), and Jan Kregel, of the University of Bologna, examine the policies of the postwar period and the reasons for their failure to produce economic stability. They then explore the means by which instability might be reduced.

### **The Postwar Period**

The author's examination of the postwar period begins with the 1960s.<sup>1</sup> That decade was marked by brief periods of intense speculation, with disequilibrium generally noted by a current account deficit. Policies to correct the situation usually involved cutting output and economic growth. Some theoreticians posited that fixed exchange rates were the culprit causing the instability and that floating exchange rates, in combination with policies of internal price restraint, would overcome the problem. Possibly in response to such theoretical arguments, floating exchange rates were introduced in the 1970s. However, even those countries that undertook policies to maintain domestic price stability were not shielded from the effects of countries that did not undertake such policies; as a result, speculation-and instability-continued.

Since fixed exchange rates did not appear to be the culprit underlying disequilibrium, an alternative explanation was sought. Beginning in the 1980s "inappropriate" government policies were identified as the source of foreign exchange market instabilities. It was thought that removing regulations governing financial markets would be the cure; "governments would be forced to introduce fundamentally sound policies, for if they did not, financial institutions would take advantage of the freedom from regulation and refuse to finance them." Money market managers proved to be "very inefficient taskmasters"; they allowed governments to continue unsound financial policies, leaving central banks to cope not only with fighting inflation, but with compensating for profligate fiscal policies. Countries with the most unsound policies, therefore, experienced the highest interest rate differentials, thereby raising capital inflows and reinforcing instabilities.

During the latter part of the 1980s increased international policy coordination was called upon to create stability. However, when forced to choose between appropriate internal and appropriate external policies, most countries tended to choose the former. Moreover, some studies indicated that coordination would not necessarily produce stability. They found that exchange rate movements were not a function of economic fundamentals (except in the very long run) and thus had no policy relevance; therefore, "if exchange rates do not reflect economic fundamentals, then it is difficult to argue that introducing policies to produce sound economic fundamentals will cause exchange rates to converge to them."

Despite these arguments and the fact that neither floating nor managed exchange rates appeared to impose stability on foreign exchange markets, policy recommendations during the 1990s continued to insist that sound economic fundamentals would produce stability. In developing economies this led to increased reliance on capital flows. As a result, capital markets were liberalized and asset markets privatized (so that the assets necessary to trade in capital markets could be created), thus establishing an additional avenue from which instabilities could be introduced. Therefore, as Cornford and Kregel explain, the instabilities of the 1990s are different from those of earlier periods in that they encompass both domestic financial markets and foreign exchange markets.

### **Possible Remedies**

Cornford and Kregel consider if the problem of instabilities in developing countries can be assuaged by installing controls on capital flows. They note that controlling outward capital movements with direct controls can be impossible without also instituting policies that would restrict payments for international current transactions (such as limits on the size and use of currency that can be taken out of the country by travelers and requiring official permission to open foreign banking accounts). Moreover, capital controls on both inward and outward flows can pose problems for internal macro management. Despite these drawbacks, developing countries experiencing surges in capital inflows have enacted direct controls on both inward and outward flows.

Cornford and Kregel also examine indirect control measures-such as capital requirements, a Tobin tax, a tax on all cross-border payments, and a punitive tax on short-term profits derived from currency trades-that could also be used to stem instabilities. The feasibility of using capital requirements to cover market risk has been reduced

by new procedural rules adopted by the Basel Committee. Conclusions about the likely effects of a Tobin tax are still speculative. Moreover, there are several problems associated with the implementation of such a tax, such as its structural effect on the market, the questions of where the tax would originate (location) and over which instruments it would be imposed, and the possible refusal by some financial centers to impose the tax. A cross-border payments tax, while simpler to impose, would not eliminate all forms of evasion. Such a tax would also meet with strong political resistance, since it would be imposed on a wider variety of instruments than a Tobin tax.

A tax on short-term profits from currency speculation, such as the 100 percent tax proposed by Warren Buffet, would "seem a tall order," but is worth examining. One problem is that variation in tax systems would complicate designing such a tax. For example, the tax treatment of profits derived from holding certain positions might depend on whether the positions were considered to have been taken for hedging or speculative purposes. It would appear that imposing a profits tax could be based on this distinction. However, since distinctions differ across countries, achieving international agreement on a definition could be even more difficult than the practicalities associated with implementing a transactions tax.

The authors observe that the two major causes of increased financial market uncertainty were the introduction of floating rates (which helped turn foreign currency into an investment asset) and extensive financial market deregulation (which likely raised the overall level of real and nominal interest rates). According to Cornford and Kregel, "this suggests that the aim of proponents of transactions taxes is to reproduce the equivalent of a more regulated financial system with fixed exchange rates." They explore the possibilities of creating such a framework. They conclude that resolving the conflicts between monetary and financial issues would be especially important for the developing countries whose economies are much more sensitive to external shocks. The principles and standards of the WTO could serve as a starting point for such a framework.

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#### Note

1. The 1950s are not included in the analysis because the decade reflects "an interregnum, for most of the European countries were subject to exemptions from [IMF] Articles and benefited from sharp underevaluations of their currencies."

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### **Capital Account Regulations and Macroeconomic Policy: Two Latin American Experiences**

Guillermo Le Fort V. and Carlos Budnevich L.

Working Paper No. 162, May 1996

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A resurgence of perceived opportunities by international investors has resulted in a new policy debate regarding the regulation of capital flows into certain South American countries. The integrationist camp defends totally open markets on the grounds that they result in a more efficient financial sector, greater asset diversification, and other benefits; those in the isolationist camp support regulating capital inflows on the grounds that they generate macroeconomic instability and reduce the effectiveness of monetary policy. Noting that there are both costs and benefits associated with external capital flows, Guillermo Le Fort V., international director of the Central Bank of Chile, and Carlos Budnevich L., manager of financial analysis for the Central Bank of Chile, argue against both extremes, opting instead for a policy falling somewhere between the two.<sup>1</sup> An intermediate policy of gradual and limited financial integration has been adopted in Chile and Colombia, two countries experiencing capital account surpluses. Le Fort and Budnevich examine the macroeconomic and financial results during the 1990s of the countries' policies regarding external capital accounts.

In the early 1980s the Chilean financial system was wracked by insolvency that was deepened by recession. By 1983 volatile international capital inflows, resulting from the removal of restrictions to such flows, had precipitated a widespread crisis. Having weathered this experience, Chile's financial institutions are cautious and concerned about maintaining moderate current account deficits. Policies to accomplish this goal include a targeted range for the medium-term current account deficit, foreign exchange market and capital account

regulations, and a limit to the degree of integration of external and domestic markets.

According to Le Fort and Budnevich, effects of these policies have been

- n A reduction of the degree of risk perceived by international investors (as witnessed by a rating of Chilean public debt analogous to a Standard and Poor's rating of A-), resulting in a rise in the inflow of external funds
- n A change in the composition of the capital account in favor of foreign direct investment (FDI) and long-term portfolio investment and away from external debt and a change in the composition of external debt in favor of medium- and long-term debt and away from short-term financing (both resulting from capital account regulations, specifically, the reserve requirement)
- n A tight monetary policy, as measured by a 6 percent real, short-term, annual interest rate and a decline in inflation from about 30 percent in 1990 to about 9 percent in 1994 (the latter the result of expenditure controls)
- n An export-led expansion averaging about 6 percent per year (the result of the reserve requirement)

The authors note, however, that the reserve requirement cannot stem currency appreciation, which has averaged about 4 percent per year. They also conclude that capital account regulations have not impaired the financial system. "In fact, despite the regulations, the financial system and the capital markets have achieved very significant development in Chile over the past few years."

In contrast to Chile's experience, Colombia's financial sector reforms were structural in nature, taking the form of opening the economy to additional international trade through the elimination of administrative restrictions to imports and a generalized reduction of tariffs, subscribing to bilateral international trade agreements with other Latin American countries, implementing measures to increase the exchange rate's flexibility, removing restrictions on external investment, cutting the overall tax rate, liberalizing the labor market, privatizing various public enterprises including the social security system, and legalizing the independence of the central bank.

At the beginning of the 1990s Colombia began to experience a large inflow of international reserves, but recently this trend has changed, causing the current account to move from surplus to deficit. Does the change in the capital account imply that the reforms have failed? Le Fort and Budnevich reject the argument that the new capital account trend was driven by capital flows and attribute it to an import boom (brought on by trade liberalization) and a sudden adjustment of the stock of durable consumption goods. They also note that the composition of the current account has changed, with foreign direct investment rising steadily, short-term debt fluctuating around zero, and debt flows rising from 1 percent to 5 percent of GDP. Moreover, exchange rates reflect economic fundamentals, the domestic budget has been in balance or surplus, and the economy has grown at a moderate to slightly elevated rate. However, inflation has remained a chronic problem, persisting at 20 to 25 percent. The authors attribute this performance to effective capital controls, arguing that even in an economy with high domestic interest rates and low disposable income, public debt has remained relatively low. Moreover, despite steady inflation and a noninterventionist, crawling-peg exchange rate system, the foreign exchange market has not experienced undue pressure.

Le Fort and Budnevich conclude that the economic performance of Colombia and Chile in the 1990s has been good compared to their historical performance and performance in other countries in their region. The authors credit the reserve requirement and other capital account regulations with playing an important role in this success. Consistent macroeconomic policies and microeconomic incentives are, of course, the main reasons behind the economic achievements of these two countries.

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Note

1. The views presented in this paper represent the opinions of the authors and are not necessarily those of the Central Bank of Chile.

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# Managing Foreign Capital Flows: The Experiences of Korea, Thailand, Malaysia, and Indonesia

Yung Chul Park and Chi-Young Song  
Working Paper No. 163, May 1996

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Between 1990 and 1994 developing countries in Asia posted \$261 billion in net capital inflows, an amount equivalent to about half the total inflows to all developing countries. Although foreign direct investment accounts for the largest portion of net inflows to Asia, the share of portfolio investment has been steadily rising, from an average of 8 percent of net inflows between 1983 and 1989 to 24 percent between 1990 and 1994. Suggested reasons for the increase in portfolio investment have been a high demand for capital coupled with favorable growth prospects, deregulation and liberalization of capital accounts, domestic financial reform (which has facilitated foreign investment in domestic securities), lower interest rates, and international portfolio diversification. Capital inflows have been important in supporting high rates of investment, particularly in Indonesia, Malaysia, and Thailand, but short-term capital inflows also have threatened macroeconomic instability by inducing volatility of key financial variables such as the exchange rate. Threats to stability have, in turn, led countries to install direct control measures to dampen large swings in short-term capital inflows. In this working paper, Yung Chul Park, of Korea University and the Korea Institute of Finance, and Chi-Young Song, of the Korea Institute of Finance, analyze the experiences of Korea, Thailand, Malaysia, and Indonesia in managing these capital inflows.

Park and Song found that for each of the four countries, following the surge in capital inflows, inflation rates rose (although they note that there is not necessarily a causal relationship between the two events) and real effective exchange rates declined (the result of a gradually rising share of investment to GDP and fiscal discipline). Moreover, there appeared to be no long-term rise in financial market volatility as compared to the period preceding the rise in capital inflows.<sup>1</sup> The authors attribute this to policies of exchange rate sterilization, monetary stabilization, and fiscal restraint. In particular, exchange rates likely remained stable because each country adopted a similar interventionist policy to prevent rapid appreciation of the nominal rate. Although Malaysia and Thailand did experience some short-run increases in stock market volatility, stock market volatility did not increase; volatility actually declined in Korea following the rise in net inflows. Interest rates did experience some volatility in Korea and Malaysia. In Korea the interest rate rises were the result of interest rate liberalization (in 1990 through 1991), the introduction of the Real Name Financial System (in 1993), and increased capital inflows. In Malaysia interest rate volatility was actually less than in the period preceding capital inflows, although there was some rise in volatility in 1994 when the monetary authorities eased their commitment to stabilizing interest rates through sterilization.

Park and Song point out, however, that sterilized intervention to maintain exchange rates and the money supply is not a policy that can be used successfully to deal with sustained capital inflows over the long run because it can result in an increased money supply, inflation, and higher exchange rates and, moreover, may produce a vicious cycle of capital inflows as a result of domestic and foreign interest rate differentials. Park and Song examine policy measures that might be used to deal with the negative effects of sustained capital inflows, including flexible exchange rate policies coupled with continued fiscal restraint; encouraging capital outflows, such as through central bank swap arrangements; direct controls over capital inflows, including taxation of foreign exchange transactions, limiting foreigners' holdings of domestic currency, and restricting domestic banks' foreign borrowing; and increasing reserve requirements, such as with a variable deposit requirement. The authors conclude that capital inflows to East Asian economies are likely to continue because of the ongoing liberalization of capital account transactions, a growing need for foreign capital, and favorable growth prospects. The governments of the four studied countries are likely, then, to consider at least one of the above measures to try to limit economic instabilities. "While it has shortcomings, the currency transactions tax would certainly be one of the most effective measures in reducing volatile short-term speculative capital movements."

1. This conclusion was based on the author's estimates of GARCH variances of the rate of change in weekly average nominal exchange rates of the local currency against the U.S. dollar and of the variance of weekly stock returns in each country.

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## Symposium

### Global Capital Flows in Economic Development

This spring the Levy Institute hosted a symposium entitled "Global Capital Flows in Economic Development." The symposium was co-sponsored by the Levy Institute, the United Nations Conference on Trade and Development (UNCTAD), and the Intergovernmental Group of Twenty-four on International Monetary Affairs. Papers accompanying some of the formal presentations are summarized above as new working papers. Conference sessions concentrated on global financial instability and regional perspectives on global finance with cases from Latin America, Africa, and East Asia. A summary of a policy roundtable on global economic development policy follows.

The roundtable was chaired by **Roger Lawrence**, deputy to the secretary-general of UNCTAD. **Paul Streeten**, of Boston University, said that an international economic system concerned with development involves (1) a current account surplus generated by a country or group of countries, (2) financial institutions able to convert the current account surplus into long-term loans or direct investment on acceptable terms, (3) a center producing the industrial goods upon which the loans are made, and (4) a military power to enforce contracts and maintain peace. Since the 1970s these functions have not existed within one country and have not been coordinated into a single system, but have been divided among different groups of countries. According to Streeten, a global institution carrying out the functions is needed. One way to coordinate them would be to consolidate three sources of underutilized resources: (1) Japan's current account surplus, (2) the surplus of labor and industrial capacity of the countries of the Organization for Economic Cooperation and Development, and (3) the surplus of semiskilled and unskilled labor in the third world.

**John Williamson**, of the Institute of International Economics, found it more logical to ask whether we still need a World Bank at all, let alone Streeten's "super World Bank," to channel the Japanese surplus to developing countries. He contended that the "missing market" that motivated the creation of the World Bank has reappeared; there is an international financial market today that performs the function of financial intermediation on the international level.

Since international and domestic financial markets are prone to market failure because of externalities and information asymmetries, there is a need, according to **Yung Chul Park**, of the Korea Institute of Finance, for an international regulatory framework to manage international finance in a more efficient manner. He thought this institutional regulation would operate more efficiently at the regional than at the global level. Predictions that only twenty or so large, multinational, financial institutions with commercial banking, insurance, and investment operations will survive over the next five or ten years make the need for such supervision seem more pressing.

Williamson listed six rules to consider when arriving at a policy prescription. First, level of debt is important; a country can have too much debt. Second, there is a real difference between debt and equity, and equity should be sought over debt. It should be sought in the form of foreign direct investment and equity market investment in both multinational corporations and local corporations. Additionally, long-term loans should be preferred to short-term loans. Third, a country should not be too modest with capital controls, but also should not expect too much from them. Fourth, it is important to focus on market fundamentals. Fifth, orderly work-out procedures are important. Sixth, the bonus system of traders and managers needs to be altered so that they receive remuneration over a long-term rather than a short-term period.

There has been a huge increase not only in the international mobility of finance, noted **H. Peter Gray**, of Rutgers University, but also in the maneuverability of direct investment. The question is what has been the effect of the new mobility of capital. It probably has not benefited the low-income and low-middle-income developing countries, because preventing capital flight becomes more difficult, but has benefited the high-income developing countries. According to Gray, capital controls are going to be more expensive and less efficient throughout the world. He found volume and control to be the problems of the inflow of portfolio investment. He concluded that poorer developing countries would become poorer and richer developing countries would become richer, but that downstreaming foreign direct investment would be one of the dampening effects on this polarization process.

**Gerry Helleiner**, of the University of Toronto, pointed out that there is an extensive econometric literature that suggests that financial deepening is important to the efficiency of investment and growth processes. Nevertheless, he asked whether at the global level financial deepening generates different effects and whether deepening involves some negative externalities for some of the players. Perhaps the lower-middle-income and low-income developing countries are disproportionate losers. At the international level change and volatility in financial indicators do matter for real phenomena, at least insofar as they affect real exchange rates. Helleiner outlined five policy concerns. First, provisions on financial services of international organizations, such as the World Trade Organization and the International Monetary Fund, should be reasonably consistent with one another. Second, many policies may not be in the best interests of developing countries. Third, some international financial institutions and governance bodies should be strengthened. Fourth, there is a lack of knowledge or certainty about the different motivations and behaviors of different actors in financial markets. Fifth, equitylike instruments in which sovereign borrowers could have their servicing obligations linked to something that describes their economic performance would reduce the need for debt work-outs. It is the equity characteristic, the risk-sharing element, that is missing from sovereign debt discussions.

Scheduled for completion in April is a G-7 committee report that will recommend institutional reforms to deal with sovereign debt servicing difficulties in a systematic way. **Barry Eichengreen**, of the University of California at Berkeley, contributed to the report and discussed some of his recommendations related to an international bankruptcy court. Bankruptcy codes and laws have several good objectives, according to Eichengreen. They encourage adherence to the terms of loan contracts, innovations in the structure of loan contracts, and efficient levels of investment. They prevent creditors from dismantling an enterprise in which the assets are worth more in place. They have the power to implement a reorganization plan and to protect other stakeholders. Good bankruptcy codes minimize direct insolvency costs. Finally, they provide incentives for sharing information and encourage voluntary negotiated work-outs.

Because of the problem of moral hazard and the dramatic heterogeneity in bankruptcy practices across countries, Eichengreen concluded that an international bankruptcy court would ultimately not be feasible. Nevertheless, he asserted that some of the positive effects of a bankruptcy court could work through a set of more modest proposals. His policy prescription included government and International Monetary Fund (IMF) recognition of bondholder steering committees to represent creditors in negotiations; establishing a mediation and conciliation service affiliated with, but independent from, the IMF; and changes in bond covenants to permit a majority of creditors, instead of all, to alter the terms of settlements. The IMF could play an expanded role in the process to reinforce the ex-ante bonding role of debt and to be the source of new money that sometimes must be injected.

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## Program Scholar

Distinguished Scholar **Wynne Godley** has developed an accounting-based model, the Levy Institute/New



Cambridge model (Levy/NCM), of the open U.S. economy that utilizes accounting stocks and flows measured at both current and constant prices. He has used the model to pose questions about the efficacy of the international payments adjustment system in light of the deterioration of the U.S. trade deficit since 1991. Godley is heading a unit that will use the Levy/NCM to prescribe policies for the United States that also will have implications for the rest of the world. With co-author George W. McCarthy Jr. of Bard College, Godley recently completed an economics textbook, tentatively titled *An Introduction to Institutional Economics*, based on his model. He is the author of *Public Policy Brief No. 23, A Critical Imbalance in U.S. Trade*. His other recent publications include "U.S. Trade Deficits: The Recovery's Dark Side?" (with co-author William Milberg), "The British Economy Under Mrs. Thatcher" (with co-author Ken Coutts), and "Time, Increasing Returns and Institutions in Macroeconomics." Godley is a professor of applied economics at Cambridge University. He received a Ph.D. in applied economics from Oxford University.

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## Program Summary: Federal Budget Policy

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### Program Scholars

Resident Scholar **Neil H. Buchanan** is concerned with issues related to public finance and fiscal policy, focusing on budgeting procedure, public investment, and the budget deficit. The first of his two current research projects is an examination of the macroeconomic consequences of current proposals to revamp or replace the federal income tax system, including an explicit analysis of the effect of such tax changes on the national saving rate. The second is a longer-term effort to continue development of the Levy Institute/New Cambridge model (Levy/NCM) of the U.S. economy, a model created and developed by Distinguished Scholar Wynne Godley. By integrating the domestic and international accounts, the Levy/NCM allows users to create simulations that capture an array of the domestic and international interactions caused by changes in the U.S. economy.

**Jonathan M. Neale**, Cambridge University Visiting Scholar for the 1995-96 academic year, is examining Keynes's influence on U.S. economic policy from 1920 through the 1960s. Included in his investigation is a consideration of the validity of revisionist interpretations that loosely classify some U.S. classical economists as "Keynesian" prior to the publication of *The General Theory*. Neale is a Ph.D. candidate in economics at Cambridge University.

Visiting Scholar **Charles J. Whalen** is exploring various aspects of fiscal policy, including historical, theoretical, and comparative aspects of biennial and capital budgeting. His goals are to assess current policy proposals and to suggest federal budget reforms to improve the economic performance of the United States. Whalen, former assistant professor of economics at Hobart and William Smith Colleges and former visiting fellow at the New York State School of Industrial and Labor Relations at Cornell University, received a Ph.D. in economics from The University of Texas at Austin. He is the author of *Public Policy Brief No. 20, Assessing the Constitutional Route to Federal Budget Balance*.

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## New Working Paper

## Understanding the 1994 Election: Still No Realignment

Oren M. Levin-Waldman

Working Paper No. 156, April 1996

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The change in the composition of Congress resulting from the 1994 election was viewed by some Republicans as a "triumph of conservatism over the perceived abuses of liberalism." In this working paper, Resident Scholar Oren M. Levin-Waldman examines polling data to explore whether the rejection of Congressional incumbents was a function of their perceived corruption or a desire to elect representatives whose ideology better reflected those of the electorate. Levin-Waldman analyzes polling results in the context of two models that might explain the results of the 1994 election: a traditional model in which incumbents are rejected for failing to deliver on their campaign promises and a realignment model in which the rejection is part of a general pattern of political realignment.

Realignment, as defined originally in the political science literature, is marked by a "critical" election in which voter turnout is high, results represent a sharp change in the previous composition between parties, a restructuring occurs along party lines at all levels of government, and the results persist over a long period of time. Realignments, then, represent systemic changes in American politics.

Realignments occur when an issue or issues polarizes voters significantly enough to motivate them to change party affiliation. The magnitude of realignment depends on the scope of the grievance, the extent to which the proposed remedy is resisted, the motivation and capacity of the party's leadership, the degree of the division between the parties, and the degree to which voters are attached to their current party.

Subsequent modifications of the model have created some ambiguity in appraising whether realignment might be occurring. Such modifications allow realignments to occur over time (instead of in a sudden shift) as a gradual decline in long-term party loyalty. A problem arises in identifying a "critical" election, that is, a change in party identification, as opposed to a one-time rejection of a party's candidates.

The model also predicts that realignments will occur periodically, namely, about every 30 years. Past realignments have occurred during the Civil War, 30 years later (in the 1890s), and 36 years after that (as marked by the onset of the New Deal era). Accordingly, a realignment should have occurred sometime during the 1960s. Some proponents of the model argue that the 1968 election was the beginning of the emergence of the Republican party as the dominant party, with regional shifts in party affiliation in the American heartland and the South. Other scholars have been frustrated in their search for the realignment that should have occurred in the 1960s. Critics of the model contend that it breaks down because there are no longer precise markers signifying shifts in American politics. There has been increasing fragmentation because of a decline in party loyalty since the 1960s.

Levin-Waldman examines Gallup surveys and National Election Studies (NES) micro data to determine whether the 1994 election represents a political realignment consistent with the model. Those who argue that a realignment occurred point to the fact that Republican victories occurred at the state and national levels of government and that the electorate voted for a Congress that would promote family values and a more limited role for government. They rest their case on voter dissatisfaction.

Levin-Waldman points out that voter turnout in the 1994 election was not high. In addition, he notes that even if people were dissatisfied, there was no issue or set of issues that appeared to polarize voters. Some suggest that voters used the midterm election to express dissatisfaction with President Clinton. The survey data seem to bear out this suggestion; the economy (and Clinton's handling of it) and family financial situations do not appear to have been critical issues in the election. Levin-Waldman also finds that although voters identified themselves as conservative, a majority wanted more or the same level of federal spending for most programs. Although people said they support more traditional family values, it is difficult to know how they define "family values."

Levin-Waldman also finds that a majority of respondents felt that neither party could do a better job than the other. However, in reply to questions about solving specific problems (such as unemployment, health care, the economy, taxes, the deficit, and welfare), most voters in 1994 said that Republicans could do a better job, a reversal from 1992, when most respondents felt that Democrats could do a better job.

Given the overwhelming Democratic victory of 1992, Levin Waldman questions whether the 1994 victory represents a trend. He finds that it is not clear from the survey results whether the electorate has changed its party affiliation. Moreover, there seems to be no evidence of a polarizing issue, greater electoral involvement, or durable change that is consistent with the realignment model. Instead, the data suggest that the election points toward a dealignment.

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## Program Scholars

Senior Fellow **Walter Cadette's** areas of special interest include public policy, business capital spending, and international trade. Cadette is examining the options available in the aftermath of the failure of the Clinton administration's health care plan. This examination will include (1) a description of the health care delivery system in the United States, including Medicare and Medicaid, the private third-party payment system, sources of escalating health care costs, and the rising number of uninsured; (2) an analysis of responses of the government and the private sector to rising health care costs; and (3) an analysis of the policy choices available to remedy existing problems. Cadette is a former vice president and senior economist at Morgan Guaranty Trust Company and editor of the bank's publication *World Financial Markets*. He received an M.A. from Georgetown University and did further graduate work in economics and finance at New York University.

Research being conducted by Research Associates **Kris Feder** and **Michael Hudson** will assess the extent to which capital gains accrue as economic rent and, based on this estimate, the distribution of benefits of a capital gains tax cut to the real estate industry. In one study, Feder and Hudson calculate a value for economic rent in order to assess the effect of rent on consumer budgets. National Income and Product Accounts (NIPA) statistics show that rental housing has remained a steady 4 percent of national income since World War II, while the imputed rent for owner-occupied housing has risen from 4 to 8 percent. Bureau of Labor Statistics data show that during the same period rental costs have risen from 21 to 25 percent of disposable personal income. Feder and Hudson's initial findings suggest that the real estate gains of landlords and bankers during this period have been made at the expense of consumers and state and local governments. Their preliminary analysis from a second study, on the neglected role of real estate in the capital gains debate, reveals that 60 percent of capital gains accrue as real estate gains. Therefore, a reduction in the capital gains tax rate would benefit primarily the real estate industry, rewarding land speculation more than new direct investment.

Kris Feder, assistant professor of economics at Bard College, previously taught at Franklin and Marshall College, West Chester University of Pennsylvania, and Temple University. Her areas of specialization are public sector economics and history of economic thought. Feder received her Ph.D. in economics from Temple University. Michael Hudson is a visiting scholar at New York University. He has served as consultant to institutional investors on balance of payments and flow of funds analysis and as economic adviser to government agencies and the United Nations Institute for Training and Research. He was research director for the Henry George School of Economics and Sociology. He received his Ph.D. in economics from New York University. Feder and Hudson are co-authors, with G. J. Miller, of *A Philosophy for a Fair Society*, published by Shephard-Walwyn.

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