



Report

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Conference: 11th Annual Hyman P. Minsky Conference on Financial Structure: Can the Financial Structure Avert an Economic Downturn?

Scholars, policymakers, and business leaders gathered at the Levy Institute April 26–27 for the 11th Annual Hyman P. Minsky Conference on Financial Structure. Participants, including Federal Reserve Board vice chairman Roger W. Ferguson, discussed changes in the financial structure and their impact on the financial market and on policy, the current state of the American economy and the ability of monetary and/or fiscal policy to stem what appears to be a slowdown, and the causes of and cures for global financial crises.

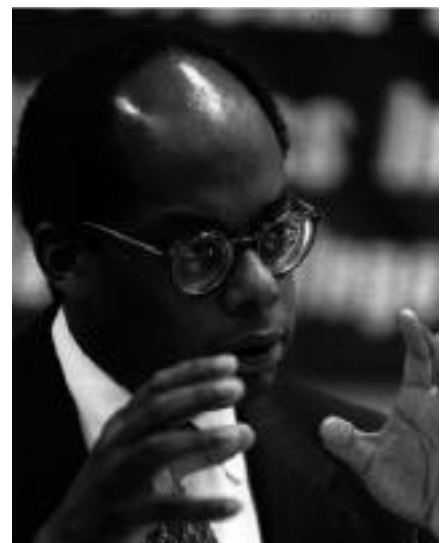
Brief notes on the participants' remarks are given here.

Speaker: Thomas M. Hoenig

In recent years a number of International Monetary Fund countries have suffered some sort of financial crisis. While each crisis was unique, Thomas M. Hoenig, president of the Federal Reserve Bank in Kansas City, said there were some commonalities from which five important lessons can be learned.

The first of these is that market regulation must be more adaptable. Financial markets change and therefore, so must regulation. However, policymakers need to understand that when regulation changes in order to adapt to the market, regulatory changes themselves then create change in financial markets. Thus, regulation must change again. It is important, said Hoenig, for policymakers to realize this relationship between regulation and the markets.

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ROGER W. FERGUSON, FEDERAL RESERVE BOARD VICE CHAIRMAN, SPEAKS AT THE 11TH ANNUAL MINSKY CONFERENCE

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


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

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Conference *Continued from page 1*

A second lesson is that while regulatory change is important, it can be difficult and costly. In addition, it can be a destabilizing rather than a stabilizing factor in markets. This means that regulatory change must be carefully managed and sometimes phased in. A third lesson is that once a financial crisis arises there is no easy solution for dealing with it. In a sense, Hoenig said, it must simply be toughed out. Crises are difficult to resolve and very often, those attempting to do so lack the information they need.

Given this difficulty in dealing with crises, Hoenig said, the fourth lesson is that policy should focus on crisis *prevention* rather than crisis *resolution*. Regulatory and supervisory policy should aim to improve monitoring of the financial system through increased transparency and improved market discipline. One possible threat to market discipline is consolidation in the financial system, which could lead to financial institutions that believe they are “too big to fail” so that government will always come to their rescue.

A final lesson, said Hoenig, is that there is value to having a diversified system of financial intermediation, rather than one that relies mostly on the banking system. If one sector of such a system gets into trouble, other sectors may be able to step in to keep credit available. Hoenig admitted that not all sectors in the financial system are perfect substitutes for one another, but stated that diversification is still best. This diversification will pose new challenges for central banks, most of which have policies that focus on the banking system. However, banks are only a part of the entire financial system and crises today are no longer banking crises, but financial crises. As a result, central banks must rethink their roles and policies.

Session 1. The State of the U.S. Economy

This session was chaired by Senior Scholar WALTER M. CADETTE. Participants were ROBERT J. BARBERA, executive vice president and chief economist at Hoenig & Company; DAVID A. LEVY, Levy Institute vice chairman and director of forecasting; THOMAS I. PALLEY, assistant director of public policy at the AFL-CIO; and Senior Scholar L. RANDALL WRAY, also a professor of economics at the University of Missouri, Kansas City, and a senior research associate at the university’s Center for Full Employment and Price Stability.

Barbera discussed the framework of what many term the “new economy,” but to which he referred as the “brave new world.” Often, when a bubble bursts, the economic framework that justified it is repudiated. In the most recent case, the bubble burst, but its framework remains, in part because the bubble created the brave new world framework, not the other way around. It is time, Barbera said, to dismantle that framework.

Levy addressed the direction the American economy is headed and warned that debt servicing is becoming unmanageable for both households and firms. He discussed how four cycles of the economy that are often seen as “virtuous” have become “vicious”: the nonfinancial economy, credit conditions, market wealth effects, and international linkages. All four of these cycles are in trouble and in the near term, he reported, we can expect a difficult period of adjustment, but once this has passed, a brighter future lies ahead.

Palley said that America’s 11 years of economic expansion have come to an end and it is time to assess the causes of the expansion and to consider policies that can deal with its loss. A number of inconsistencies from this period that were often hidden now reveal structural problems. One is that despite the expansion, income distribution did not improve. Palley said that it is important to understand that there are two household sectors and that the one with incomes under \$50,000 holds most of the debt. Lower interest rates will not encourage more spending because most in this group are in no position to borrow more. However, as a policy, lower rates can help them manage the debt they have. Palley said that government policy should focus on helping the middle- and lower-income classes and suggested such things as tax cuts, stronger unions and labor standards, and higher minimum wages. Such policies, he said, should also be promoted on a global scale.

Wray examined the case for large tax cuts as a policy aimed at dealing with the economic slowdown. President George W. Bush’s proposal for a major tax cut has been opposed by some Democrats who argue that the government should not cut taxes based on projected growth of the budget surplus, as the projections could be wrong. However, Wray argued that not only should there be a major tax cut, but it should be \$450 billion, three times the figure proposed by the president. Such a cut, he said, should be targeted at the bottom three-quarters of the population. Without such cuts, said Wray, there will be no surplus.



LEFT TO RIGHT: THOMAS M. HOENIG; DIANE SWONK; MARC FABER

Speaker: Roger W. Ferguson Jr.

In September 1999, the finance ministers and central bank governors of the Group of Ten nations commissioned a study of the possible effects of financial consolidation on central bank and finance ministry policies. Roger W. Ferguson Jr., vice chair of the Federal Reserve Board of Governors, presented some of the findings from this study and their implications. The report found that, in the nations studied, mergers and acquisitions occurred at increasingly high levels throughout the 1990s. Acquisitions of banking firms accounted for 60 percent of all mergers. Joint ventures and strategic alliances also increased during the 1990s. In the United States, which accounted for nearly half of these, the arrangements were mostly domestic; however, in the other 12 countries studied, most were cross-border.

Financial consolidation decreased substantially the number of banking firms during the 1990s in almost every nation studied. Still, at the national level, banking structures differ greatly, ranging from very unconcentrated in Germany and the United States to highly concentrated in other nations. The study also found that financial consolidation has created a number of large and complex financial institutions. The forces that seem most at work in promoting consolidation are financial deregulation, improvements in financial technology, globalization of financial and nonfinancial markets, and shareholder pressure for increased performance. Ferguson said that these forces are likely to continue and thus so is consolidation.

Consolidation poses potential challenges for monetary policy in three key areas. First, it could make it more difficult for central banks to implement policy if it reduces the efficiency of the market for central bank reserves or those used to conduct monetary policy operations. Second, consolidation could affect the transmission mechanism linking changes in the interest rate to those in the real economy and alter credit channels of monetary policy. Third, it might affect the environment in which policy is conducted.

Despite these challenges, the study finds that financial consolidation has not significantly affected the ability of central banks to achieve the objectives of monetary policy. Many central banks reported that the effects of consolidation have been small, in part because the financial markets important for monetary policy have remained competitive. This means, Ferguson noted, that central banks should keep close watch on the competitiveness of markets and should monitor the transmission mechanism for their potential future effects on monetary policy.

Ferguson concluded by addressing the effects of consolidation on financial risk, the payment and settlement system, and the efficiency of financial institutions, competition among such firms, and credit flows to households and small businesses. The study found that existing policies appear adequate to contain financial risk in the intermediate term, but policymakers should pay attention to possible long-term effects. Consolidation has led to a greater concentration of payment and settlement flows among fewer parties, but this does not

seem to have reduced competition for payment and settlement services. With regard to efficiency, the study found that consolidation does not seem to increase it as much as firms claim. Thus, Ferguson said, policymakers should carefully examine claims of efficiency gains in proposed consolidations.

Speaker: Diane Swonk

Diane Swonk, chief economist and senior vice president with Bank One Corporation, addressed the question of whether the United States is now in a recession, which she does not believe to be the case. Wall Street may be having its problems, but it is only one aspect of the American economy. Main Street America is doing well. Those who now claim we are in a recession are the same people who, one year ago, were saying the United States was in a new economic era where business cycles and inflation no longer existed. The pessimism expressed by some today reflects a fact of human nature: people tend to look at the recent past to extrapolate into the future.

The recent slowdown, Swonk said, should not have been a surprise. The signs were there—the mortgage boom had ended, gas prices were rising, investment had been inflated due to preparations for Y2K, and a bad winter led to snow days and productivity slowdowns. Producers were overstocked and thus production slowed, but, as Swonk pointed out, consumers are more resilient than many think. Credit is still easily available. The labor market is in good shape and has acted as a shock absorber during this slowdown. In addition, mortgage rate financing is up and vehicle production, after four quarters of decline, is back on the rise. The product shelves are bare, which means production will have to pick up to refill them. Swonk disputed the argument that the decline in stock market wealth will curb consumer spending. Wealth, she said, is not that concentrated in the stock market; it is also held in other forms, such as home equity. People who realize capital gains rarely spend them as income, but reinvest them.

Swonk gave the Federal Reserve much credit for its willingness to make policy shifts as the economic situation changed. She cited as evidence the fact that in the summer of 1998 the Fed was ready to tighten due to inflation fears, yet entirely reversed its position by the fall. It also allowed the economy to continue to grow at the pace it has. While some have said the Fed reacted too slowly to the current slowdown, Swonk noted

that it has at least been willing to react by lowering rates. The Federal Reserve appears to be “hedging risks,” meaning that although it will not say the United States is in a recession, it is acting on the risk of one, which makes clear that it will not allow the economy to falter.

Swonk said she believes that with regard to financial markets, now is a good time to buy. Despite the concerns of Wall Street, Main Street is likely to continue to do well and she expects consumers to continue spending. Swonk said that while we may not see profits return to the levels of the recent past, we are nevertheless poised for a rally.

Session 2. Regulatory Issues in the Financial Structure

This session was chaired by Assistant Director FRANCES SPRING. Participants were GILLIAN G. H. GARCIA, a consultant on the interface between macroeconomics and financial sector issues; and JANE D'ARISTA, director of programs at the Financial Markets Center.

Garcia, who formerly worked at the International Monetary Fund, discussed the role of deposit insurance, which she defined as essentially a form of consumer protection, in financial systems. She discussed research that examined differences in deposit insurance systems and the links between deposit insurance and financial crises. A good deposit insurance system, said Garcia, can help a nation deal with financial crises, but a bad system can actually make the situation worse by, for example, contributing to moral hazard. Some deposit insurance systems are publicly funded but privately managed, some privately funded and managed, and some publicly funded and publicly managed. Garcia cited as dangerous those systems privately managed by bankers because of conflict of interest. A good system should have an independent deposit insurance agency and a wide coverage of depositors but a low value of coverage.

D'Arista focused her discussion on the issue of debt. She believes that the Federal Reserve has abandoned its goal of controlling the supply of credit in favor of controlling the demand for credit. It is in the area of debt that one sees the Fed's inability to control credit expansion. D'Arista said that allowing the development of a debt bubble of the current magnitude is evidence of failed policy. This debt bubble is in three sectors—household, business, and the financial sector itself.



LEFT TO RIGHT: STEPHEN G. CECCHETTI; BRUCE GREENWALD; JAN A. KREGEL

The debt levels in all three are unprecedented. D’Arista said that what is needed is some way for the Fed to gain control over credit expansion. This could be achieved, she argued, by changing to an asset-based reserve requirement system.

Speaker: Marc Faber

Marc Faber, an investment advisor, fund manager, and broker-dealer, started his discussion by noting that there were two important economic changes at the end of the 20th century. One was the fall of communist nations, which suddenly added millions of people to the capitalist system. The second was the emergence of a truly global capital market, which, up until the 1990s, was thought would help developing regions industrialize. Only recently did the danger of a global capital market become visible, when capital could come pouring in and then be quickly withdrawn from a market. While things looked very promising in the early 1990s, by the end, the bubble had burst.

Faber cited the boom as a technology-driven one. Many investors failed to see the dangers in new technology, such as overestimation of demand and underestimation of supply, competition from new technologies, a rapid rate of obsolescence, excessive valuations, and falling cost of capital. As an example, Faber cited the case of the auto industry: in its early years many people, believing that the need for tires would lead to an increased need for rubber, rushed to invest in rubber tree plantations, only to see the invention of synthetic rubber cause

a huge drop in rubber prices. In today’s world, change is rapid; the latest hot product can quickly lose its luster. Market penetration may be faster, but the growth curve—rapid acceleration followed by deceleration—has not changed.

Faber noted that new products are constantly being introduced. Few succeed, but when they do, competitors are quick to enter the market. Prices decline faster today than in the past; it took television prices about 25 years to decline—much more slowly than prices for fax machines and computers. Firms producing such products cannot expect profits to remain high for long. It is this profitability that is an issue, not productivity, Faber said. An industry can be productive but not profitable, agriculture being a prime example.

Faber focused on China as an example of a nation undergoing great change that, in turn, has implications for others. It is rapidly taking market shares from other nations, something likely to continue as China gains access to more and more technology. Faber questioned how some can expect increased trade with China to benefit the United States. He predicted that China will export more goods to the United States rather than increase its U.S. imports.

It is wrong, said Faber, to assume that business is bad in times of falling prices. In fact, it is the opposite. The greatest innovations and inventions have been introduced during times of weak prices. Deflation is not a bad thing, because all prices fall, including those of stocks. We are currently, however, in an unusual “falling wave” marked by falling commodity prices,

interest rates, real wages, and agricultural depression. In such a period there is innovation as firms seek to cut costs and there are mergers and acquisitions as they struggle with sluggish markets.

There are different theories regarding what will follow this current downward trend. Faber said that much depends on what happens around the world. For example, if Asia grows economically, its demand for energy may increase, which could increase oil prices. An optimist might view the current situation in Asia, where stocks are still down, as an opportunity to buy. Such stock manias as the one we recently witnessed have always existed; Faber argued that they are not necessarily irrational. The mania follows uncertainty, the opening of new territories, the entering of which is always a bit of a risk. Going in is rational; what is not is the pricing.

Our greatest problem today is that we are in a deflation environment. The worst thing in such a situation is to have a high level of debt. Debt cannot continue to grow at current rates, Faber stated, adding that something would soon have to give. He cited the case of Japan, a nation that is now spending more than 60 percent of its tax revenues on debt servicing. Governments are not the only ones likely to feel financial pressure in coming years. Some multinational corporations are also likely to see their profit growth stall. The 1990s were a golden age for many of these businesses, as they moved into emerging markets where production costs were low and there were few competitors. However, Faber said, they created competitors when they outsourced production to smaller firms and taught them their production methods.

In the United States, Faber said, the economy is likely to hold up for a short while and then plunge as consumer confidence drops and spending with it. Emerging markets will feel the impact of the drop in American consumption; however, the effect on them will not be severe, because they are not as dependent on exports as some think. There are predictions that the U.S. dollar will also weaken, but, as Faber asked, "Against what?" Other currencies are also in decline.

Faber ended with a call for increased focus on the problem of wealth inequality, which he cited as unprecedented today. Growth is greatly hampered by the fact that 80 percent of the world's population is willing to consume, but cannot. The purchasing power of this majority, he said, must somehow be increased.

Session 3. The Changing Role of Monetary Policy

This session was chaired by Levy Institute President DIMITRI B. PAPANIMITRIOU. Participants were STEPHEN G. CECCHETTI, professor of economics, The Ohio State University, and research associate, National Bureau of Economic Research; Senior Scholar JAMES K. GALBRAITH, professor at the Lyndon B. Johnson School of Public Affairs and the Department of Government, University of Texas, Austin, and director of the University of Texas Inequality Project; BRUCE GREENWALD, Robert Heilbrunn Professor of Finance and Asset Management at Columbia University Business School; Visiting Senior Scholar JAN A. KREGEL of the United Nations Conference on Trade and Development; and MARTIN MAYER, guest scholar at the Brookings Institution.

Cecchetti's discussion focused on features of the new economy and what they mean for fiscal and monetary policy. He said that research indicates that the technology sector was responsible for much of the economic growth of the recent past. Another interesting feature was the near-absence of inflation. Some have attributed this to successful Federal Reserve policies, but Cecchetti said this could also be because, at least until recently, there were significant price drops in certain sectors, such as energy and medical care. In this new environment, central banks will face several challenges in developing monetary policy: forecasting inflation, differentiating between permanent and transitory shifts in productivity growth trends, and maintaining control of the level of their own liabilities.

Galbraith concentrated on the question of what sort of philosophy has guided the Federal Reserve in recent decades. In the late 1960s and early 1970s, monetarism was the dominant view. The Fed's difficulty was that it had a mandate to curb inflation but no effective method for carrying it out, other than running the economy at excess capacity. This may be why the NAIRU doctrine was so appealing. Although Galbraith said that Greenspan's speeches indicated he is not entirely committed to the doctrine of the NAIRU, to his credit, he was willing to see how low unemployment could go without leading to inflation. Still, he continued to issue inflation warnings. However, inflation failed to materialize; Galbraith said this may be why Greenspan turned to the theory of the new economy. Galbraith concluded that what we really had was not a new economy, but a bubble, and one that the Fed should have



LEFT TO RIGHT: JAMES W. PAULSEN; PETER HOOPER; KARIN LISSAKERS

noticed by the fall of 1999. It may, however, be time for us to reconsider some of our economic views, including the role of government in the allocation of capital.

Greenwald also spoke about the policies of Alan Greenspan. If the Fed chairman's policies are so good, he inquired, why have other central bankers not been able to copy them? The economic situation in recent years has been good in the United States, but not as good in most of the rest of the world. Things have gone well for Greenspan, but not because he is in control of the situation; rather, he has been lucky. The rest of the world has been in trouble and price competition has kept prices low in the United States. Reductions in health care costs also helped to keep inflation in check, and importantly, the zero household saving rate has come at a time when the government and foreign sectors have been building surpluses.

Kregel surmised how Hyman Minsky might have viewed monetary policy in the current economic situation, that is, in an era of continuing government surplus and disappearing government debt. He said that Minsky would not be concerned that the disappearance of this debt would create problems with the money supply. Rather, he would suggest that the Federal Reserve focus on stabilizing asset prices by placing a floor under them, with the discount window being the most appropriate way to do this. In addition, said Kregel, Minsky would recommend that the discount window be open to segments of the non-monetary financial system, such as U.S. securities dealers and savings and loan associations.

The logical result of this situation would be a recommendation that commercial banks issue currency.

Mayer presented an optimistic view of the economy despite its recent downturn. Innovation, he said, will keep the economy moving. However, we are unlikely to see profits as large as those of recent years. Part of the cause of the current situation is overinvestment, not by banks, but by companies that provide goods to startup companies in exchange for stock in the newcomers—a system that worked fine when stocks were going up. These “trade credits” funded the new economy, but there was no collateral behind them. Mayer closed by noting that central bankers face a difficult task in developing policies because there are so many unknowns. No one, including the Fed, really knows whether a given stimulus or restraint will affect economic activity, the cost of living, markets, or all three. Perhaps, he said, more attention ought to be paid to asset pricing.

Speaker: James W. Paulsen

James W. Paulsen, chief investment officer with Wells Capital Management, said he may be a bit pessimistic about the economy but is optimistic about the markets. The current economic environment presents challenges for policymakers, firms, and consumers. Paulsen noted five key aspects of the recent economic situation: the absence of inflation, the profit and productivity miracles, low unemployment, and fiscal surplus. Most who look at the 1990s

see a decade of rapid and strong growth, but Paulsen said that in terms of sales, it was a weak decade. Thus, the real catalyst for these five aspects was lack of demand. In the post–Depression world, sales were driven by developed-world demand, but in the 1990s sales died and the result has been overcapacity.

The driving force behind demand, Paulsen noted, has not been the consumer, but the corporate sector, which has been continuously lowering prices to encourage consumer spending. It is these price decreases that have stimulated consumer spending, not fiscal or monetary policies. (In fact, Federal Reserve policies may have lowered prices even more: seeing an increase in growth, the Fed assumes inflation will follow and tightens, causing prices to drop even further.) The overcapacity problem is likely to continue because firms have made large investments in production that will only lead to an increase in supplies. We have a great productive capacity but not the demand.

Paulsen said that in recent years the United States has had a deflation economy. GDP figures looked good but were attained through overproduction. The question we now face is how to stimulate demand. One suggestion has been to encourage the world's less-developed countries to increase their wealth so their populations can buy more products. The recent Asian financial crisis actually contributed to general price declines, which in turn stimulated domestic consumer spending. So long as firms can keep cutting costs, the fact that unit sales can be up even as prices drop is not a problem—except, of course, for employees who lose their jobs in the cost cutting.

One result of this cost cutting, said Paulsen, is that we now have a lean corporate sector. We may or may not have a recession, but if so, restarting the economy will be difficult due to the current oversupply. It may be that we will have to wait until we use up what we already have and need to start producing again. It will be especially troublesome if we cannot restart the high tech sector, which is a large part of the economy. The Fed has dropped interest rates in an effort to stimulate the economy, but that is not working and neither will a lower dollar, because many people around the world hold dollars as a form of safekeeping. Still, despite such problems, Paulsen believes the United States will come out of its slump in much better shape than will other nations in economic difficulty.

Speaker: Peter Hooper

Peter Hooper, managing director with Deutsche Bank Alex. Brown, discussed the current economic situation and prospects for the future. He said he expects to see a global slump, followed by a slight recovery next year. Economic indicators show that we are not yet in a recession, but close to it, and Hooper said he expects to see additional rate cuts by the Federal Reserve. He cited four key causes of the current slowdown: the bursting of the stock bubble, tight credit, a strong dollar, and increased energy prices that have cut into profits.

Hooper said the technology sector has played a key role in the current slump and predicted that investment in technology, such as computers, will continue to drop. Continued high energy prices are also likely to cut into corporate profits. Adding to lower earnings expectations will be increased unit labor costs. Hooper said that labor productivity growth has kept down unit labor costs, one reason why inflation has remained low. However, he said, labor productivity is expected to decline and once that happens, labor costs will rise.

With regard to consumers, Hooper expects consumer spending to decrease, which will be reflected in a slowdown in retail sales. Many consumers had saved via the stock market, but as consumer confidence declines, the personal saving rate is likely to move up. The search for security is also a reason why the dollar has remained strong: like Paulsen, Hooper suspects that many are holding dollars as a form of safe reserve.

In terms of the future, Hooper said that he expects a further decline in capital spending and doubts that we will see a strong rebound in the stock market. One bright spot is in the area of inventory adjustment. With the exception of the technology sector, these are doing well. But the economy may still need much help to recover. Hooper said he expects the Federal Reserve to ease even more than it already has. In addition to Fed policy, he said, fiscal stimulus is needed.

Session 4. Issues in International Finance

This session was chaired by Levy Institute President DIMITRI B. PAPADIMITRIOU. Participants were ROBERT Z. ALIBER, who teaches international finance at the University of Chicago; KARIN LISSAKERS, former executive director of the International Monetary Fund; and PARUL JAIN, associate director of the Investment Research and Portfolio Strategy Group within the Administration and Finance Division at TIAA-CREF.

Aliber compared the economic situations in Japan and the United States. In his view, the “bubble” here began when Japan, which had excess savings, shifted its investments to other Asian nations, giving them a bubble that has now shifted to the United States. Aliber said that the real impact of a bubble is in the investment-to-gross domestic product ratio. In Japan this ratio has been in decline the past 10 years and Aliber expects to see a similar continued decline of this ratio in the United States. The United States can also expect to see a decline in the growth of the consumption rate. In the aftermath of its bubble, Japan has experienced both permanent and transitory shocks; the United States can expect the same. Among these aftereffects will be a surge in the cost of capital and adjustments in many sectors.

Lissakers focused on policy issues and expressed a less gloomy view of the situation than did many other participants. The International Monetary Fund, she said, should focus on crisis prevention, which she argued it has. For example, many nations have been encouraged to move from fixed to floating exchange rates. The latter act better as shock absorbers and the fact that many nations now have them means that they are in better economic situations than in the past. Emerging economies also have improved fiscal policies; they are managing their finances better, strengthening their banking sectors, and seem more committed to achieving financial balance. Also contributing to a stronger economic situation in emerging economies is the fact that many are giving their central banks more independence and staffing them with more capable people. Lower inflation rates in many countries is evidence of these changes. Finally, the IMF has successfully helped emerging economies institute best practices codes and standards and develop better relations with creditors.

Based on an examination of the East Asian financial crisis, Jain presented a less positive view of IMF policies. Although domestic actors were also to blame for the Asian financial crisis, Jain argued that IMF actions toward the crisis favored creditors over debtors, as is often the case. The Fund’s policies inadvertently pushed countries into Ponzi financing, with countries borrowing in order to meet interest payments. Jain called for consideration of a new IMF structure, one better able to deal with funding issues, regional financial crises, and their containment. She suggested that a less centralized IMF structure based on regions might be more effective.

New Working Papers

The Causes of Euro Instability

Philip Arestis, Iris Biefang-Frisancho Mariscal,
Andrew Brown, and Malcolm Sawyer

Working Paper No. 324

www.levy.org/docs/wrkpap/pdf/324.pdf

Contrary to the predictions of its proponents, the euro has declined in value by over 25 percent against the U.S. dollar, by 30 percent against the yen, and by 13 percent against the pound sterling since its inception in January 1999. In this working paper Visiting Senior Scholar Philip Arestis, also of South Bank University in London, Iris Biefang-Frisancho Mariscal of the University of East London, Andrew Brown of South Bank University, and Visiting Senior Scholar Malcolm Sawyer, also of Leeds University, examine the causes of the general decline in the value of the euro by assessing the various explanations offered in the existing literature. They find these explanations lacking and they offer one of their own.

The argument most prevalent in the literature—that the euro’s decline in value is purely a result of U.S. strength—is somewhat underdeveloped, say the study’s authors. Having reviewed the poor performance of the European Central Bank and assessed the level of macroeconomic convergence of the euro zone countries, they conclude that both the U.S. strength and the euro zone’s own underlying weakness are to blame. The institutions now backing the new currency, they point out, tend by their very nature to promote deflation; as a result, the euro zone’s prospects will remain bleak for as long as these institutions are in place.

Endogenous Money in a Coherent Stock-Flow Framework

Marc Lavoie

Working Paper No. 325

www.levy.org/docs/wrkpap/pdf/325.pdf

In this working paper Marc Lavoie of the Department of Economics, University of Ottawa, examines a method first proposed by Levy Institute Distinguished Scholar Wynne Godley in the early 1980s to model monetary macroeconomics.

Godley's method was itself inspired by the writings of James Tobin and his associates. Lavoie examines the method and provides examples of potential uses in order to show its importance to economic research.

The method, based on a transactions matrix, tracks all flows and can be used for many purposes—to illustrate the monetary circuit of credit funds; to demonstrate that there can be a separate portfolio (stock) demand for money, but not one independent from the rest of the model; to show that there cannot be an excess supply of credit; to handle the cases of credit for speculation purposes and high liquidity preference; to underline that endogenous money at fixed interest rates is still compatible with any government deficit; and to show that even when banks meet liquidity norms, loans of larger amounts do not necessarily induce higher interest rates. Lavoie argues that much progress in the comprehension of monetary phenomena can be achieved through use of the methodology as developed by Godley.

Making EMU Work: Some Lessons from the 1990s

Jörg Bibow

Working Paper No. 326

www.levy.org/docs/wrkpap/pdf/326.pdf

The agreement that created a common European currency prescribed that a mandatory process of convergence precede the launching of the euro into a stable economic environment. Thus, in 1991 European nations began instituting policies considered conducive to convergence and stability. In this working paper, Visiting Scholar Jörg Bibow investigates the lessons learned from Europe's convergence process of the 1990s. He challenges the conventional focus on labor market institutions and "structural rigidities" as the root causes of Europe's poor employment record. Bibow argues that macroeconomic demand management, particularly monetary policy, played the key role.

Bibow's analysis, which concentrates on Germany, shows that fiscal consolidation was accompanied by monetary tightness of an extraordinary degree and duration. This finding is of interest for the past as well as the future, for the Maastricht regime much resembles the one that produced the unsound policy mix of the 1990s: a constrained fiscal authority paired with an independent monetary authority free to impose its will on the overall outcome. Bibow's findings thus highlight a key asymmetry in the Maastricht regime that is likely to continue

to inflict a deflationary bias on the system. This policy bias, he argues, can be overcome only if the European Central Bank deliberately assumes its real role of generating domestic demand-led growth, thereby resolving the euro zone's key structural problem: asymmetric monetary policy. Concerning the conventional structuralist theme, Bibow's analysis debunks the "Dutch myth" of supply-led growth through structural reform. He stresses that this peculiar strategy, a popular fallacy of composition, is not an option for the euro zone.

Part-Year Operation in 19th-Century American Manufacturing: Evidence from the 1870 and 1880 Censuses

Jeremy Atack, Fred Bateman, and Robert A. Margo
Working Paper No. 327

www.levy.org/docs/wrkpap/pdf/327.pdf

The growth of manufacturing was central to the economic development of 19th-century America. In the early stages of industrialization, production was frequently part-time or seasonal, with some establishments shutting down operations for weeks or months at a time. However, as transportation improved, the geographic scope of markets widened, and technological and organizational change created economic incentives for more continuous operation, a growing share of firms operated on a full-time basis, or so it is generally believed. This conventional wisdom, however, rests on limited quantitative evidence, especially for the period between the end of the Civil War and the turn of the century.

In this working paper, Jeremy Atack of Vanderbilt University, Fred Bateman of the University of Georgia, and Senior Scholar Robert A. Margo use unpublished data from the manuscripts of the 1870 and 1880 censuses of manufactures—the earliest comprehensive estimates available—to examine the extent and correlates of part-year manufacturing during the late 19th century. Although the typical manufacturing plant operated full-time, part-year operation was not uncommon during this time period. The likelihood of part-year operation varied across industries and locations with plant characteristics. The authors find that workers in such plants received slightly higher wages than did workers in full-time manufacturing plants, which may have compensated them somewhat for their losses and possible inconvenience.

Events

CONFERENCE

After the Bell: Education Solutions outside the School

June 4–5, 2001, Annandale-on-Hudson, New York

Almost 35 years ago, James Coleman and his co-authors issued their controversial report on inequality in schooling. The document, later known as the Coleman Report, reached the troubling conclusion that the strongest predictor of academic performance was not school-based dynamics, but rather the student's family background as measured by such things as household income and parents' socioeconomic status. Since the publication of this controversial report, many researchers have examined the methodology and reanalyzed the original data, which comprised information on more than 600,000 students in 4,000 schools, and found that the overall pattern of findings held steady. This conference, which marks the 35th anniversary of the Coleman Report, will address such questions as:

1. Why, after 35 years of evidence that schools are marginal to academic achievement, have educational politics and policy continued to focus almost exclusively on schools?
2. What would an education policy look like if it did not mention the word "school"?
3. Can government address achievement differences that are rooted in the home?
4. What are the political implications?

This conference is being organized by Dalton Conley of the Center for Advanced Social Science Research at New York University. For program and registration information, visit the Levy Institute website at www.levy.org.

CONFERENCE

What Has Happened to the Quality of Life in America and Other Advanced Industrialized Nations?

June 6–7, 2001, Annandale-on-Hudson, New York

During the 1990s, the gap between the United States and other advanced industrial nations expanded in terms of per capita income (as conventionally measured). However, it is not clear whether the level of well-being in the United States has grown concomitantly with per capita income, or whether American citizens are necessarily better off than their counterparts in other advanced countries. To determine this requires a means by which to measure "well-being." The purpose of this conference is to assess available measures of well-being, propose new ones, and analyze and compare possible measures.

This conference is being organized by Senior Scholar Edward N. Wolff of New York University. For program and registration information, visit the Levy Institute website at www.levy.org.

Publications and Presentations

Publications and Presentations by Levy Institute Scholars

VISITING SENIOR SCHOLAR

PHILIP ARESTIS

Publications: “Financial Development and Economic Growth: The Role of Stock Markets” (with P. O. Demetriades and K. Luintel). *Journal of Money, Credit and Banking* 33:1 (2001); “Recent Banking and Financial Crises: Minsky versus the Financial Liberalisationists.” In R. Bellofiore and P. Ferri, eds., *Financial Keynesianism and Market Instability: The Economic Legacy of Hyman Minsky, Volume 1*. Northampton, Mass.: Edward Elgar, 2001.

Presentations: “Is There a Trade-Off between Inflation and Output Gap?” (with G. M. Caporale and A. Cipollini), Beyond Inflation Targeting, Meeting of the Money, Macro and Finance Group, South Bank University, London, March 22; “Research in the U.K.,” University of Zagreb, Croatia, April 5; “Growth Theory: New Evidence from Panel Data” (with P. O. Demetriades and B. Fattouh) and “Threshold Effects in the U.S. Budget Deficit” (with A. Cipollini and B. Fattouh), Royal Economic Society, University of Durham, U.K., April 9–11; “Finance, Growth, and Crises,” University of Ljubljana, Slovenia, April 18; “Reflections on the Experience of the Euro” (with Malcolm Sawyer), Conference on Financial and Monetary Integration: Lessons from Europe for the Americas, Kalamazoo College, May 11–12.

SENIOR SCHOLAR

WALTER M. CADETTE

Publications: “The Economics of Health Care Funding.” *Quarterly Commentary*, First Quarter, 2001; Review of Andrew J. Rettenmaier and Thomas R. Saving’s *The Economics of Medicare Reform*. *Eastern Economic Journal* 27 (2001).

Presentation: “Financing Health Care: There Is a Better Way,” Annual Henry George Lecture at St. John’s University, Jamaica, N.Y., April 3.

VISITING SENIOR SCHOLAR

ROBERT A. MARGO

Presentations: “Productivity in Manufacturing and the Length of the Working Day: Evidence from the 1880 Census,” Department of Economics, Rutgers University, New Brunswick, N.J., April 16; “Rising Wage Dispersion across American Manufacturing Establishments, 1850–1880,” Center for Population Economics, University of Chicago, May 4; “The Wage Effects of the Civil War,” conference in honor of Stanley Engerman, Department of Economics, University of Rochester, June 9.

PRESIDENT

DIMITRI B. PAPADIMITRIOU

Publication: “Minsky’s Analysis of Financial Capitalism” (with L. Randall Wray). In R. Bellofiore and P. Ferri, eds., *Financial Keynesianism and Market Instability: The Economic Legacy of Hyman Minsky, Volume 1*. Northampton, Mass.: Edward Elgar, 2001.

Media: Interview with *Market Call*, CNNfn, April 18.

VISITING SENIOR SCHOLAR

MALCOLM SAWYER

Publications: “Kalecki on Imperfect Competition, Inflation, and Money.” *Cambridge Journal of Economics* 25:2 (2001); “Minsky’s Analysis, the European Single Currency, and the Global Financial System.” In R. Bellofiore and P. Ferri, eds., *Financial Keynesianism and Market Instability: The Economic Legacy of Hyman Minsky, Volume 1*. Northampton, Mass.: Edward Elgar, 2001.

Presentations: “Economics of the Third Way” and “The NAIRU, Aggregate Demand and Investment,” University of Lecce, Italy, April 2–3; “The Decline of the Euro,” “An Alternative Growth and Stability Pact for Europe,” and “Economics of the Third Way,” Trinity College, Hartford, Conn., April 18–20; “Reflections on the Experience of the Euro” (with Philip Arestis), Conference on Financial and Monetary Integration: Lessons from Europe for the Americas, Kalamazoo College, May 11–12; “Monetary Policy and Endogenous Money,” Conference on Post Keynesian Economics, Notre Dame University, May 13–14; “The NAIRU as a Barrier to Full Employment,” Centre of Full Employment and Equity, University of Newcastle, Australia, June 13–14.

SENIOR SCHOLAR

EDWARD N. WOLFF

Publication: “Has Japan Specialized in the Wrong Industries?” In Magnus Blomstrom, Byron Ganges, and

Sumner La Croix, eds., *Japan's New Economy: Continuity and Change in the Twenty-First Century*. New York: Oxford University Press, 2001.
Media: Interview for *Money Weekly*, Canadian Broadcasting Corporation, March 27.

VISITING SENIOR SCHOLAR

L. RANDALL WRAY

Publication: "Minsky's Analysis of Financial Capitalism" (with Dimitri B. Papadimitriou). In R. Bellofiore and P. Ferri, eds., *Financial Keynesianism and Market Instability: The Economic Legacy of Hyman Minsky, Volume 1*. Northampton, Mass.: Edward Elgar, 2001.

Presentations: "Policy for the Coming Recession," Singer Island, Fla., March 19–20; "Fiscal and Monetary Policy for the Coming Recession," Wayne State College Economics Forum, Wayne, Neb., April 12; "Incarceration of the Surplus Population: America's Solution to the Unemployment Problem," Association for Institutional Thought, Reno, Nev., April 20.

VISITING SCHOLAR JÖRG BIBOW

Publication: "Comment." In J. Hölscher, ed., *50 Years of the German Mark: Essays in Honour of Stephen F. Frowen*. New York: Palgrave, 2001.
Presentations: "The Stability-Oriented Monetary Policies of the European Central Bank," Monetary Policy in a World with Endogenous Money and Global Capital, Berlin, March 23–25; "Easy Money through the Back Door: The ECB versus the Markets," Skidmore College, Saratoga Springs, N.Y., May 1, and Canadian Economics Association, McGill University,

Montreal, May 31–June 3; "What Has Happened to Monetarism?" History of Economics Society, Wake Forest University, Winston-Salem, N.C., June 29–July 2.

RESEARCH ASSOCIATE

WILLEM THORBECKE

Presentations: "The Rise and Fall of the Inflation Risk Premium," Federal Reserve Board, Washington D.C., April 3, and the Washington Area Finance Conference, American University, Washington D.C., April 14; "Modeling the Socioeconomic Impact of the Crisis: The Case of Indonesia," World Bank, Washington, D.C., May 10.

RESIDENT RESEARCH ASSOCIATE

LYNNDÉE KEMMET

Presentation: "Private versus Public Financing of Economic Development: The Politics of Economic Development in a Local Region," New York State Political Science Association, New Paltz, N.Y., May 4–5.

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