The Levy Economics Institute of Bard College

Report

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CONFERENCE: 15th ANNUAL HYMAN P. MINSKY CONFERENCE ON THE STATE OF THE U.S. AND WORLD ECONOMIES

Economic Imbalance: Fiscal and Monetary Policy for Sustainable Growth

Central bankers and academic and private sector economists gathered at the Levy Institute on April 21 and 22, 2005, to discuss possible policy responses to several important imbalances in the U.S. economy, including the current account deficit and the country's negative private sector balance. Individual papers focused on such topics as monetary policy, the possible existence of a real estate "bubble," the impacts of government deficits, and the effects of Asian competition on the U.S job market. The speeches and presentations given at the conference are summarized in this issue of the *Report.*

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

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Welcome and Introduction: DIMITRI B. PAPADIMITRIOU

Papadimitriou, president of the Levy Institute, presented the latest Institute strategic analysis, which he coauthored with Anwar M. Shaikh, Claudio H. Dos Santos, and Gennaro Zezza. The analysis is summarized on page 1 of the April 2005 *Report.*

Speaker: SANDRA PIANALTO, FEDERAL RESERVE BANK OF CLEVELAND

Pianalto emphasized that maintaining price stability was crucial for economic performance, regardless of the existence of economic imbalances. She said there was a global consensus on the importance of price stability. This sentiment is by no means to be taken for granted, as the dangers of complacency about inflation have been well illustrated by economic history. Pianalto pointed to the fate of "falsifiers of money" in Dante's *Divine Comedy*: an eternity in one of the deepest parts of hell.

Pianalto said that recent economic history, on the other hand, demonstrates the great benefits of price stability, that is, low and stable inflation. Inflation in the industrialized countries fell from 9 percent in the first half of the 1980s to 2 percent early in the 2000s. In developing countries, the corresponding change was from 30 percent to 6 percent. Meanwhile, economic performance has improved in many nations. Average rates of growth have increased, the frequency of business cycles has fallen, and fluctuations in economic activity have moderated. Many factors have contributed to these trends, Pianalto said, but low inflation has been an indispensable ingredient.

The large budget deficits of recent years present a challenge to central bankers. On the one hand, deficits are smaller relative to the total output of goods and services than they were in parts of the 1980s. But further problems lie ahead in the form of demographic changes that will put pressure on public budgets. The Fed has a role to play in dealing with fiscal problems. High deficits, Pianalto argued, increase the equilibrium level of the interest rate, because they increase the overall demand for savings. The federal funds rate should not be allowed to stay far below the equilibrium rate as the latter rises. Deficits need not be inflationary, provided that the central bank is diligent in this task. The central bank's job is easier if fiscal pressures are not strong.

The Fed's commitment to price stability should also be maintained, according to Pianalto, as the current account adjusts toward balance. (The current account balance is the amount by which exports exceed imports, plus net flows of income across the border.) The falling exchange rates that could accompany such an adjustment would make imports more expensive and could contribute to inflation, necessitating a tightening of policy. Like budget deficits, adjustments of the current account could increase the equilibrium interest rate, which would require similar action on the part of the Fed.

Pianalto stated that a gradual and orderly transition toward balance was the most likely eventuality. Should the adjustment prove more stressful, involving financial market crises, the Fed might need to provide added liquidity to avoid systematic market failure. In the meantime, the Fed should not take preemptive measures to rectify imbalances, said Pianalto, but should rather concern itself with price stability.

Session 1. The State of the U.S. and World Economies

The session was moderated by Dimitri B. Papadimitriou of the Levy Institute. Other participants included Steven B. Kamin of the Federal Reserve Board, James W. Paulsen of Wells Capital Management, and Frank Veneroso of RCM.

Kamin explored the possibility of a "disorderly" reversal of the large U.S. current account deficit. In this scenario, which has been put forward by many observers for a long time, investors would suddenly stop purchasing U.S. securities. The result would be a rapid drop in the value of the dollar, a rise in interest rates, a fall in the stock market, and most importantly, a recession. Kamin argued that while this scenario might well apply to a developing country, it was less characteristic of the experience of the industrialized world. Kamin and his colleagues studied 23 episodes of current account adjustments in recent times in the developed world. On average, growth fell as the large current account deficits in each country were corrected. However, growth remained positive, and the changes in interest rates and stock prices were moderate. Kamin showed that those economies where growth fell dramatically as the current account deficit fell were already overheating anyway. Kamin noted that this country differs from the ones he studied in several respects: it has a larger GDP; trade makes up a smaller percentage of its GDP; most of its debts are denominated in its own currency; and its economy is more flexible.

Paulsen started by observing that many economists are predicting slow growth over the next year or so. Among the

Left to right: Frank Veneroso, Steven B. Kamin, and James W. Paulsen

Steven B. Kamin

reasons are rising oil prices, tightening Federal Reserve policies, the potential exhaustion of the American consumer, and the threat of a collapse of the dollar. Paulsen argued that increased growth and inflation might be in store for the U.S. economy. Real interest rates have risen, but they remain low. Long-term interest rates remain fairly high, in comparison to short rates, a sign that generally indicates strong growth. Firms seem to have plenty of cash, and the government deficit is growing. U.S. consumers, whose spending has helped to carry the world economy for some time, may be overextended, but continue to show an amazing resiliency. Paulsen argued that the economy's remarkable capacity for inflation-free growth during the 1990s rested on the availability of cheap imports. Any reversal of the current account deficit might threaten the ability of the United States to "import deflation."

Veneroso recounted how he became interested in Minsky's theory of financial crises when, as an economic development adviser, he observed collapses of many developing financial markets. He said that he sees the risk of another financial crisis related to China in the near future. One key risk factor is the ratio of investment to GDP in that country, which is currently around 50 percent. Experts cite duplicative investments in buildings that remain unoccupied, industries with vast excess capacity, and so on. Chinese firms have financed their investment binge by going into debt, rather than by issuing equity. Veneroso believes that the effects of a possible debt crisis in China would be blunted by aggressive state intervention to support banks and other firms. Still, with many investors around the world making various forms of bets on the success of the Chinese economy, the ripple effects of a crisis would be widespread.

Speaker: DAVID D. HALE, HALE ADVISORS LLC

Hale pointed out that the booming housing market helped President George W. Bush win reelection in 2004, despite a weak job market. Turning to the current account deficit, he argued that the solution might lie in unleashing the pent-up spending power represented by the reserves held in Latin America, East Asia, and South Africa. Hale offered the opinion that Japan and China are likely to continue their policy of buying dollars in order to keep the exchange rate steady, at least in the near term. In Japan's case, policymakers are concerned that a revaluation of the yen—staved off for now by the actions of the Japanese central bank—could lead to a return of deflation. On the other hand, China is unlikely to allow its currency to appreciate because of its consensus-driven, relatively cautious government, and its dependence upon a strong export sector.

One factor that might force China to change its mind involves the "sterilization" of its dollar purchases. Sterilization means that after the Chinese central bank buys dollars with yuan, it in turn soaks up excess yuan by selling securities, so that the total amount of yuan in circulation stays roughly the same. If the central bank does not sterilize, the money supply rises each time it buys foreign currency. The cost of this process might rise prohibitively as the interest rate on bonds goes up in the coming months. Still, current Chinese exchange rate policy is likely to persist for at least 12 to 18 months, Hale said.

What are the likely impacts of the current account deficit on the United States, and what policies might be appropriate? Hale argued that in order to cut the current account deficit by half, the United States would have to countenance capacity

David D. Hale

Bruce C. Kasman

utilization rates of 93 percent. The Fed regards rates that high as potentially inflationary, so it would probably respond by sharply increasing interest rates, so as to slow down the economy.

Whether this scenario unfolds depends upon the dollar policy of the Fed, which in turn depends upon Bush's appointments to the Fed Board of Governors. Martin Feldstein, one of the top candidates to replace Alan Greenspan as chairman, strongly favors a devaluation of the currency. The views of the other men on the short list for the job, Ben S. Bernanke and R. Glenn Hubbard, are not well known. Should the next Fed chair, whoever he or she might be, pursue a weaker dollar, and should that effort prove successful, interest rates will have to rise. Since housing prices depend upon the ability of potential buyers to borrow money at low rates, property values might dramatically fall in this scenario.

The title of Hale's talk was "Do the Republicans Need a Trillion Dollar Current Account Deficit to Keep the White House in 2008?" At the end of his speech, Hale answered this question in the affirmative, arguing that the Republicans will find it politically necessary to maintain a buoyant housing market in the next electoral cycle, an imperative that will require even higher current account deficits.

Session 2. Monetary Policy in the U.S. Economy

Greg Hannsgen of the Levy Institute was the moderator of this session. The other participants were Bruce C. Kasman of JPMorgan Chase, Albert Wojnilower of Craig Drill Capital Corp., and L. Randall Wray of the University of Missouri–Kansas City and the Levy Institute.

Kasman commented that the U.S. economy has recently gone through a period of healing from the recession of 2001. Forces are now in place for a period of reflation, and these forces dwarf the powers of any individual policy actors. Many are concerned that various imbalances in the economy could lead to recession or worse, but the most important balance—between profits on the one hand and wages and salaries on the other—is in good shape. This fact, argued Kasman, is often not recognized because weak-looking conventional hourly wage figures give the misleading impression that consumers are living solely on borrowed money. Among the developments that indicate possible reflation are: Asia's recovery from its financial crisis and the Japanese deflation; falling labor supply led by reduced immigration and labor force participation; and rising benefits costs for firms. A modest increase in core inflation this year is the likely result, and the Fed will have to respond strongly. A hike in policy-determined interest rates could lead to a recession later this decade, perhaps as early as 2007.

Wojnilower commented on the role of monetary policy in today's economic environment. The current Fed policy is to gradually raise rates to offset the threat of significant inflation, while avoiding sharp or unexpected increases that might unsettle financial markets. Wojnilower argued that incremental monetary actions were unlikely to have much effect on industry, because the profitability and growth incentives to business investment overshadow small changes in the cost of funds. Thus, in an era of credit-led expansion, relatively large measures are eventually required, and these usually lead to crises that threaten the lives of financial institutions and markets.

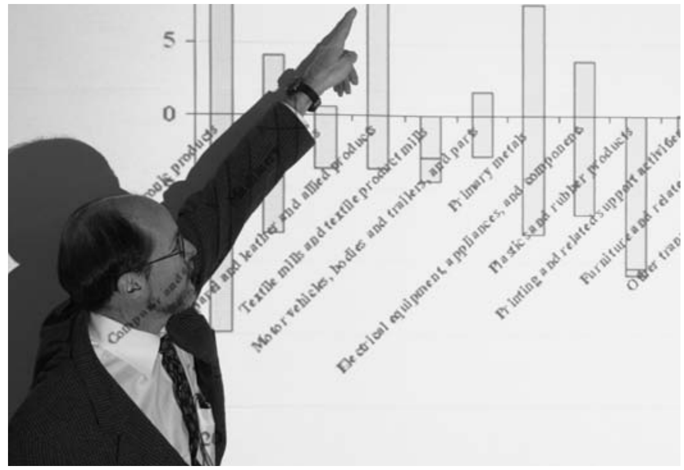
A key element of financial growth is the spread between short-term and long-term interest rates, which is still significant. A large margin between interest rates of different maturities ensures that financial market participants can easily profit from the "carry trade": borrowing money at low rates to purchase higher-yielding, long-term assets. As long as the Fed assures markets that interest rate hikes will be "measured," the carry trade represents a sure bet. This analysis does not, according to Wojnilower, imply that interest rates should be raised willy-nilly; one should merely recognize that the end of the current cycle of financial expansion could well prove messy.

Wray presented work he has published as Levy Institute Public Policy Briefs Nos. 79 and 80. Summaries of these briefs can be found on page 9 of the January 2005 issue and page 5 of the April 2005 issue of the *Report.*

Session 3. Financial Instability in a Global Economy

The moderator of this session was W. Ray Towle of the Levy Institute. Robert Z. Lawrence of Harvard University and the Institute for International Economics (IIE) presented a paper. Edwin Truman of the IIE, who was scheduled to give a presentation in this session, was unable to attend but provided a written contribution.

Lawrence started by pointing out that the impact of trade and outsourcing on the U.S. job market had been a major issue in the presidential election of 2004. There is little wonder that employment has been a major concern of the electorate, as growth in employment following the 2001 recession has been very slow relative to previous economic recoveries. The manufacturing sector is the one that has seen most of the job loss in recent years; since this sector is particularly vulnerable to foreign competition, it is possible that the nation's massive trade deficit might be to blame. To examine this issue, Lawrence used input-output analysis, which involves tracing labor inputs and intermediate goods (the ingredients of the goods and services bought by consumers) as they move through various sectors of production. Lawrence argued that this was necessary, because each dollar of, say, steel imports contains some amount of inputs from other industries and sectors. Similarly, manufactured goods are used as inputs in service industries. So, to trace the effect of imports, exports, and domestic sales, one must look backward to the goods and services that were ingredients in each product. One could then find the number of jobs in all industries used to produce exports and the number of jobs that



Robert Z. Lawrence

hypothetically would be used to produce the goods the nation imported, allowing a calculation of the net effect of trade on the jobs picture. Lawrence provided evidence that trade is not to blame for the dearth of employment in the manufacturing sector and that a lack of domestic investment is the true culprit. To the extent that trade is to blame, the problem lies more with a lack of exports than with a surfeit of imports.

Truman's paper commented on the implications of the probable adjustment of the current account toward balance. Truman argued that the adjustment would lead to an eventual closing of the current account deficit to around 1 percent of GDP from its current level of 4 percent. In some accounts, a narrowing of the deficit is linked to an increase in U.S. output. But over the medium term, Truman argued, output is determined by supply, and the economy is at full employment. This means that a reduction in imports is associated with a decline in consumption, rather than an increase in GDP. A reversal in the current account would likely be accompanied by a fall in the real value of the dollar, which would make imports more expensive, further reducing the American standard of living (the "terms-of-trade effect"). The more rapidly the adjustment takes place, the sharper it must be. Truman labeled the low rate of U.S. saving as the "core economic policy issue today." An appropriate policy response to the current situation would involve reducing the government deficit and increasing the federal funds rate, but neither lawmakers nor the Fed seems willing to play its needed role. Truman argued that the United States should not deliberately attempt to reduce the value of its currency. He also argued that if foreign central banks began to

Richard W. Peach

James K. Galbraith

scale back their purchases of dollars, the impact on the dollar might not be as large as some foresee.

Session 4. The Macroeconomic Prospects for the U.S. Economy

The moderator for this session was Ajit Zacharias of the Levy Institute. The other participants were Lakshman Achuthan of the Economic Cycle Research Institute (ECRI), James K. Galbraith of the University of Texas at Austin and the Levy Institute, and Richard W. Peach of the Federal Reserve Bank of New York.

Achuthan related how Otto Eckstein, the late economist, said that the main challenge economists faced in forecasting was to predict the upper turning points of the business cycle. Achuthan argued in favor of the use of a method pioneered by Wesley Mitchell, Arthur Burns, and Geoffrey Moore. In 1950, Moore combed the data for series that tended to move ahead of the business cycle, coming up with a list of eight leading indicators. Recent work has shown that the same list of indicators correctly predicted business cycle turning points in the latter half of last century. As an example of the success of this approach, Achuthan recalled that in March 2001, 95 percent of economists did not think there would be a recession, but ECRI correctly foretold the downturn of that year. As for the current situation, Achuthan forecast economic growth and stability for the next few quarters, rather than an accelerating decline in growth rates. Moreover, a period of runaway inflation does not seem to be on the horizon. With regard to the employment picture, the sudden plunge in manufacturing employment that followed the last recession was simply too deep to be a normal cyclical event, a fact that the ECRI approach revealed early on.

Galbraith focused on the likely consequences of large budget deficits. Many economists have predicted that the deficits, by reducing national savings, will reduce economic growth in the long run. However, a recent article by two critics of deficits indicates that there is little empirical support for the notion that deficits cause interest rate increases, a key element in the case against deficits. Galbraith said that while the article appraises several views of the effects of budget deficits, it leaves out the Keynesian position. Keynesians would argue against the assumptions made by the authors of the article that deficits always come at the expense of private capital accumulation and that capital accumulation is the main determinant of future economic output. To the contrary, Galbraith argued that technological advances and expansions of economic demand drive economic growth, and the two often go hand in hand. A process of accelerating demand and technical progress can make large deficits sustainable and beneficial to the economy. Thus, while the authors of the article do a service by demonstrating the negligible impact of deficits on interest rates, they accept a doomsday scenario of accumulating debt that rests on dubious theoretical foundations.

Peach cited widely discussed data indicating that the recent period has seen unusually rapid appreciation of housing values, relative to the general level of inflation. He described the views of many economists who are concerned about this trend. Many believe that house prices are out of line with fundamental values because of unrealistic expectations of future appreciation. A related line of argument is that an increasing share of houses are purchased by investors who do not plan to live in their property. Peach's criticism of such views centered on the most commonly used index of house prices, which is constructed by the Office of Federal Housing Enterprise Oversight (OFHEO). This index has risen by 353 percent since 1977, but it does not capture the price of a home of constant quality. Since the size and quality of homes has been increasing, said Peach, the OFHEO index overstates the magnitude of the recent run-up in purchase prices. A constant-quality index, which takes into account the number of bedrooms in a home, the location, and so on, has increased by only 215 percent since 1977. Peach presented evidence that the gap between the OFHEO and constant-quality indices is partly related to home additions and improvements.

Paul Davidson

Speaker: PAUL DAVIDSON, NEW SCHOOL UNIVERSITY

Davidson discussed recent current account deficits and alternative exchange rate systems. He began by pointing out that even a large devaluation of the dollar might not improve the balance of trade between the United States and the rest of the world. A devaluation results in a cheapening of U.S. imports and a reduction in the price of our exports to the rest of the world. If U.S. consumers are unable to wean themselves from imports following a dollar devaluation, they could wind up paying more dollars for a slightly lower volume of imports. Meanwhile, foreigners would pay less of their own currency for a given amount of U.S. goods, but might not take advantage of the opportunity to increase the physical volume of goods imported from the United States. Davidson argued that calls for a decline of the dollar by government officials and by the Fed may turn out to be self-fulfilling prophecies, if speculators are convinced that there is money to be made by betting against the dollar.

Davidson cited the period from roughly 1950 to 1973 as an illustration of the benefits of a regime of fixed exchange rates. The value of the dollar was fixed at a certain amount of gold, and the noncommunist world experienced a rate of growth that was faster than in any previous era. Crucial to this success was the fact that creditor nations bore much of the responsibility for correcting current account imbalances. Today, the dollar is still the world's main reserve currency, but its status is threatened by speculative forces and widespread support for exchange-rate flexibility.

There are also strong forces on the side of maintaining the value of the dollar. Davidson pointed out that much of the economic success of the Asian economies rested upon their ability to export goods to the United States, and these economies are unlikely to relinquish the U.S. market. If efforts to reverse the U.S. current balance were to succeed, many Asian exporters would face widespread bankruptcies, unemployment, and unstable banking systems.

In the aftermath of World War II, John Maynard Keynes called for a new financial system that incorporated the insights he developed by studying the British economy during the Depression. His proposals were designed to prevent a general lack of demand, which might otherwise arise if surplus nations accumulated reserves instead of spending them. The burden of eliminating a trade imbalance would fall on creditors, rather than debtors, in Keynes's proposed system. Individual governments could take steps to control the flow of capital, so as to avoid the devastating effects of speculative capital inflows and outflows.

Davidson's own proposal involved the creation of a new international reserve asset (the International Money Clearing Unit, IMCU) that would be held by central banks. The exchange rate between national currencies and the IMCU would be fixed. Unused balances of IMCUs could be lent on a short-term basis to nations in need of liquidity. There would be a trigger mechanism to encourage creditor nations to spend what were deemed to be excessive balances of IMCUs. Changes in exchange rates vis-à-vis the IMCU would be made in order to maintain the IMCU's purchasing power.

Davidson acknowledged that some would regard his plan as utopian. But he warned against a defeatist attitude that might itself block needed changes.

Speaker: DONALD L. KOHN, FEDERAL RESERVE BOARD

Kohn said he expected a moderation of inflation later this year. He said that several spending imbalances, including the U.S. current account deficit, might be viewed as worrisome. Kohn argued that reasonable assumptions about the behavior of economic actors implied the imbalances would be unsustainable. For example, consumers, whose saving rates have been very low, could reasonably be expected to rein in their spending eventually, in the interest of saving for retirement. Moreover, lenders are unlikely to continue to buy U.S. securities unless interest rates rise.

Kohn next raised the issue of whether the current account balance, government deficit, and dearth of private savings would be corrected without serious disruptions in the economy. He argued that recent shifts in the Fed's interest rate policy might ease the transition to a more sustainable path, and he said that the Fed will probably continue raising rates at a "measured pace," provided growth is sustained and inflation remains contained. Interest rate increases encourage saving and could potentially help keep real estate values at a reasonable level.

There are other reasons to be optimistic about a relatively painless reduction in the economy's imbalances. Foreign governments may decide to reduce their holdings of reserves if they perceive that higher rates of return can be obtained by domestic investment, or if they wish to have more freedom in setting monetary policy. Moreover, there are reasons to be optimistic that both consumers and the federal government will understand the need to increase their rates of saving. A key to an orderly movement toward balance is that current behavior be based on realistic expectations for short-term interest rates, the exchange rate, rates of return on capital investments, and housing prices. As an example of the kind of problem that can result from unrealistic expectations, Kohn cited the case of the collapse of the high-tech bubble in 2000. All in all, he expressed optimism that adjusting the economy's imbalances would not by itself threaten the good performance of the economy, but he warned against complacency.

Kohn next commented on the role of policy in dealing with imbalances. He said that a reduction of fiscal deficits might help prevent an upward movement in interest rates that could otherwise hold down investment and productivity growth and lead to large asset price movements. U.S. trading partners could also contribute to a solution, both through stimulative macroeconomic policy and structural reforms. Further reductions in trade barriers and increased exchange rate flexibility would also be of help. Regulation should be used to ensure that financial institutions will be able to weather any abrupt changes in asset prices. The influence of the major imbalances on Fed interest rate policy, on the other hand, was limited, according to Kohn. The Fed should not refrain from anti-inflationary efforts simply because such efforts might increase debt-service burdens or undermine housing values.

New Policy Notes

Is the Dollar at Risk?

KORKUT A. ERTÜRK

Policy Note 2005/3

www.levy.org/pubs/pn_3_05.pdf

In a new policy note, Research Associate Korkut A. Ertürk of the University of Utah argues that a potential fall of the dollar holds great dangers for the United States, as well as the possibility of profound changes to the international political order.

Ertürk begins by outlining the predicament presented by the U.S. current account deficit. This deficit threatens the value of the dollar. Some hold out the hope that a decline of the dollar could help the U.S. economy by making its exports cheaper and driving up the dollar price of imports. But the more important effect would most likely be a sharp increase in interest rates, a development that could threaten the current recovery. Thus, much hangs on the future of the dollar, which in turn depends upon the willingness of foreign central banks to continue to trade their own currency for U.S. money.

Ertürk outlines three possible scenarios. The first is a continuation of present trends, in which the United States maintains its role as the "importer of last resort." The second would be an abrupt collapse of the value of the dollar, leading to financial turmoil around the world. Ertürk argues that the fear of the second alternative is keeping alive the first. Is there a third way? The third scenario might be a world in which the

United States was significantly weakened, both economically and politically. The Asian central banks may be reluctant to sell off their dollars, but Asian governments have shown an increasing interest in using their resources to buy real assets around the world. As the U.S. dollar lost its appeal, capital might return home to some of the developing countries, reducing the vulnerability of those countries to the exit of "hot money." Finally, Ertürk says, it is conceivable that a new alliance might take shape, bringing together China, with its huge markets; Russia, with its nuclear capability and oil; and Europe, with a potential reserve currency.

Imbalances Looking for a Policy

WYNNE GODLEY
Policy Note 2005/4
www.levy.org/pubs/pn_4_05.pdf

The U.S. current account deficit reached 6.3 percent of GDP in the first quarter of this year. What is the likelihood of a reversal of this vast imbalance and what would be the implications for the economy as a whole? In a new policy note, Distinguished Scholar Wynne Godley tackles the latest developments regarding these issues. One point he makes is that the nation's imports now exceed its exports by more than 50 percent. This means that exports have to grow at a more rapid rate than imports, just to keep the trade balance steady. What's more, it would be difficult to cut back on imports without suffering a loss of economic growth.

The nation's economy has been powered in recent quarters by huge amounts of private borrowing, with the saving rate falling very low. Economists seem to disagree about the nature of the problem and its solution. It is doubtful that the latter can be reached through the unaided action of the market.

The predicament faced by the United States involves a lack of viable alternatives for future growth and sustainability. A huge expansion of exports might be helpful, but that seems unlikely. As of now, in the absence of adequate exports, growth is being fueled by private debt, but this trend cannot go on forever. Rising interest rates pose a further threat to growth. Stimulus in the form of government deficits cannot be ratcheted up much further. Godley concludes that "there is plenty to worry about."

New Levy Institute Measure of Economic Well-Being Report

Economic Well-Being in U.S. Regions and the Red and Blue States

EDWARD N. WOLFF and AJIT ZACHARIAS
www.levy.org/pubs/lmw_mar_05.pdf

In a new Levy Institute Measure of Economic Well-Being (LIMEW) report, Senior Scholar Edward N. Wolff of New York University and Research Scholar Ajit Zacharias gauge the economic well-being of Americans in various regions of the United States. They also compare average and median well-being in the so-called "red states"—those that voted for George W. Bush in the last election—with similar measures of well-being in the "blue states"—those that fell in John Kerry's column on election night, 2004.

LIMEW differs from standard measures of household income because it includes several additional factors that add to a household's well-being, including goods and services produced within the household and many services performed by the government. LIMEW also counts well-being derived from assets in a different way from official measures of well-being. Previous LIMEW reports have provided more detail on the exact makeup of LIMEW and how it differs from measures compiled by the U.S. Census Bureau. (See the October 2004 issue of *Report*, p. 3, for a brief summary.)

Many findings in this report are interesting and different from conventional wisdom. LIMEW grew by 12.6 percent from 1989 to 2001. Between those two dates, disparities in median LIMEW between whites and nonwhites fell, a development due in part to a narrowing of the gap in net worth between racial groups. Though median well-being was higher in the Northeast than in the other major regions of the United States, this advantage was smaller in 2001 than in 1989.

There were sharp differences in well-being between the red and blue states, but that gap fell between 1989 and 2001. Inequality in the distribution of well-being rose for both groups of states, and this increase was higher in the blue states. Disparities in the well-being of different racial and ethnic groups fell between 1989 and 2001 in the red states but remained about the same in the blue states.

Since the role of government is an important issue dividing many residents of the red and blue states, it is interesting to compare how residents in each region benefited or lost owing to government activity. The report finds that net government expenditures (those that directly benefit households, minus taxes) were negative in the blue states and positive in the red states.

Some of these findings present analysts with a paradox in accounting for the outcome of the recent presidential election. The narrowing of racial and ethnic gaps in well-being that took place in the red states might be one factor in deciding the election, but issues of racial and economic justice appear to play a relatively small role in the Republican agenda. And the fact that the red states enjoy a net benefit from government spending and taxation is at odds with the Republican party's calls for a smaller government. The authors of the report conclude that pollsters may be correct in attributing the appeal of the Republican Party to noneconomic issues.

New Working Papers

Asset Ownership along Gender Lines: Evidence from Thailand

RANIA ANTONOPOULOS and MARIA S. FLORO
Working Paper No. 418
www.levy.org/pubs/wp418.pdf

Many economic studies have examined the distribution of assets among households in various demographic categories. In a new working paper, Research Scholar Rania Antonopoulos of New York University, the coordinator of the Gender Equality and the Economy research program at the Institute, and Research Associate Maria S. Floro of American University examine the distribution of assets within the household.

Antonopoulos and Floro use data from a survey of squatter households in Bangkok. The sample was confined to couples; each member of each couple was interviewed separately. Real (tangible) assets, including means of transit (owned by 25 percent), jewelry (25 percent), business assets (10 percent), and household appliances (99 percent), turned out to be very important for this group of households. Appliances and vehicles tended to be jointly owned by households, while individuals tended to hold items such as tools and sewing machines. The asset most commonly owned individually by women was jewelry, though vehicles constituted the greatest proportion of the monetary value of women's assets. Women also often owned shop assets. The majority of financial assets were in informal investments.

Antonopoulos and Floro next use econometric techniques to find the factors that make a household or individual more likely to own a particular type of asset. Surprisingly, holding all other individual and household characteristics constant, women tend to have more real assets, though this difference was not statistically significant. Moreover, men own more assets than women in individual accounts.

Women's assets are more likely than men's to be in a tangible (as opposed to financial) form; the authors suggest that such assets might afford the bearer a greater degree of control vis-à-vis other household members. Jewelry, in particular, can be pawned easily in Thailand, making it desirable as a way of paying for subsistence in hard times, a responsibility often held by women. Women also tend to be more involved in home-based informal work, including piecework, which almost certainly accounts for the fact that they own items such as sewing machines in large numbers.

When it comes to financial assets, there were also striking differences across gender lines. Women held a greater stock of informal (underground) financial assets, while men held more formal accounts and investments.

The authors call for future research to see how all of these results hold up for other samples. In particular, data at the national level are needed.

FDIC-Sponsored Self-Insured Depositors: Using Insurance to Gain Market Discipline and Lower the Cost of Bank Funding

PANOS KONSTAS
Working Paper No. 419
www.levy.org/pubs/wp419.pdf

Currently, depositors in U.S. banks and savings and loans enjoy government insurance for up to $100,000 in deposits. This system has been successful in preventing bank runs and providing a safe investment vehicle for U.S. citizens. Nonetheless, the system of insurance is not perfect. Because depositors are aware of insurance, they can deposit money in banks that take excessive risks, without fear of losing their own money. Unscrupulous banks are therefore free to make loans to high-risk, high-return projects or borrowers, and the government must foot the bill when the inevitable defaults occur.

Panos Konstas of the Federal Deposit Insurance Corporation offers a solution to this problem, known as moral hazard, in a new working paper. Some previous proposals have included abolishing deposit insurance altogether, which would perhaps encourage depositors to avoid entrusting their money to banks that were taking excessive risk. The problem with this solution is that the public would be deprived of a way of protecting their savings, and savers would lose money each time a bank became insolvent.

Konstas proposes making depositors take responsibility for potential losses in a way that would preserve the risk-free option of insured investments. Depositors would make deposits in a government-sponsored entity called the Self-Insured Depositors' Financing Office (SIDFO). These deposits would be backed by the government as usual. SIDFO would then loan depositors' money to self-insured (SI) depositors, who would in turn make *uninsured* deposits in traditional banks. The SI depositors would be required to include some of their own capital in their deposits to the banks. In the event of a bank failure, the SI depositor's capital would be at risk. If the SI depositor was able to withdraw only part of its deposit, it would be required to subtract the loss from its capital, paying back SIDFO its entire investment.

The system would have several advantages. First, since SI depositors, unlike traditional depositors, would risk losing their money, they would avoid unsound banks. Such banks would have more difficulty attracting funds than they do currently, perhaps encouraging all banks to think twice before making imprudent loans or investments. A second advantage would be that the government (SIDFO) would enjoy two layers of protection from bailing out failed banks. First, the banks' own capital would be used to make up for any bad loans. In the event that the bank became insolvent anyway, the SI depositor would take the loss, paying for his or her poor investment. Meanwhile, the depositors in SIDFO would enjoy a risk-free investment. Thus, Konstas's somewhat complex plan would preserve many of the benefits of the current insured system, while reducing moral hazard and costs to the government.

Is the Equalizing Effect of Retirement Wealth Wearing Off?

EDWARD N. WOLFF
Working Paper No. 420
www.levy.org/pubs/wp_420.pdf

In earlier studies, scholars have found that retirement wealth acts as an equalizing force with regard to overall wealth. This evening effect arose owing to the fact that retirement wealth, including the expected value of pensions and future Social Security payments, was distributed more equally among the population than nonretirement wealth. In a new working paper, Senior Scholar Edward N. Wolff of New York University uses data from the Federal Reserve's Survey of Consumer Finances to show that this equalizing effect has diminished since 1983, partly because of the shift from "defined benefit" plans to "defined contribution" plans. The former are pension schemes that guarantee a certain payment based on work history, while the latter depend upon the performance of the worker's individual account. The period 1983 to 2001 saw an 18-percentage-point drop in the portion of U.S. households that enjoyed defined benefit pension coverage.

The data do reveal some favorable developments. First, more households enjoyed some form of pension wealth in 2001 than in 1983. Moreover, mean pension wealth has increased by 60 percent in inflation-adjusted terms. However, *median* pension wealth—that of the person with more pension wealth than 50 percent of the population—declined 5.9 percent from 1983 to 2001. Moreover, many of those with defined contribution plans have relatively small accounts (around $10,000 to $30,000). This indicates that mean pension wealth increased because those at the top of the distribution did very well, not because of widespread gains.

This information helps explain a puzzle in the data. Historically, the inequality of net worth across the population has increased when either the inequality of incomes or the ratio of stock prices to home prices has increased. Since both of these things happened from 1983 to 2001, one would have expected wealth inequality to grow rapidly over this period. But in fact, the distribution of wealth became only modestly more unequal. This paradox disappears once pension wealth is added into the picture. When pension wealth is included, wealth inequality did rise as rapidly from 1983 to 2001 as one would have expected, based on the performance of the stock market and income inequality.

A Simplified Stock-Flow Consistent Post-Keynesian Growth Model

CLAUDIO H. DOS SANTOS and GENNARO ZEZZA
Working Paper No. 421
www.levy.org/pubs/wp_421.pdf

As reported in earlier issues of the *Report*, a number of scholars associated with the Levy Institute have been revivifying a once-dormant field known as stock-flow consistent modeling. The group believes that in order to draw proper conclusions from an economic model, it is important to take into account the necessary relationships between the economies' "stocks" and "flows." Stocks, as economists have relished teaching for generations, are the amounts of assets and debts in the economy, including, for example, the balances of checking accounts. Flows, on the other hand, are the funds that change hands during a unit of time, such as the income of an individual that is deposited into his or her bank account.

One drawback of previous stock-flow models, at least in the eyes of some observers, is that they involve so many equations that their properties cannot be analyzed using a pencil and paper. One must make assumptions about various quantities and simulate the path of the economy using a computer. It is therefore difficult to make generalizations about the models.

In a new working paper, Research Scholar Claudio H. Dos Santos and Research Scholar Gennaro Zezza of the University of Cassino, Italy, attempt to address such concerns by simplifying the usual stock-flow consistent model. The result is a smaller model, but one that brings together insights from diverse sources. The careful attention given by the authors to the role of stocks, for example, enables them to show how net worth affects the purchases of consumers. Also, businesses respond to changes in the value of their equity. Some other aspects of the model draw upon themes in the post-Keynesian literature. For example, prices are determined by a fixed markup over costs, and investment responds to the level of capacity utilization.

Dos Santos and Zezza analyze the behavior of their model in both the long run and the short run. They are able to show that the model can be reduced to three equations. The short-run solution involves given stocks of assets inherited from the previous period; it does not assume the structure of the economy has remained constant over the "long run." The long-period solution assumes that the relationships that characterize the economy have stayed constant over a long enough period for the variables to reach their equilibrium values.

The authors argue that their model can easily be modified to incorporate many of the ideas proposed by various schools of economic thought. For example, in the spirit of many "new Keynesian" models, lending to firms can be limited by firms' financial fragility and the level of overall demand for goods and services.

The Disutility of International Debt: Analytical Results and Methodological Implications

GREG HANNSGEN
Working Paper No. 422
www.levy.org/pubs/wp_422.pdf

When small developing countries go into debt, they often sacrifice more than interest payments. International financial institutions such as the International Monetary Fund often impose conditions on borrowers that include stringent monetary policies and cuts in government services. These programs have very real economic consequences for borrowers, but also impose nonmonetary costs, such as a loss of sovereignty or standing in the world. Greg Hannsgen models such costs in a new working paper, drawing methodological conclusions that range beyond his immediate topic.

Hannsgen presents two models of small open economies. In the first model, the country loses utility (well-being) if it borrows abroad and gains if it lends, a phenomenon he calls sovereignty-loss disutility. (Hannsgen later argues that the utility maximizing type of model is inadequate to the task at hand.) The results of this first model are far different than a model without sovereignty-loss disutility. First of all, the country tends to defer its consumption, compared to the usual model, since borrowing carries with it an extra cost. Second, and perhaps more surprisingly, the country tends to underinvest, preferring to run down its capital stock as an alternative to borrowing.

In Hannsgen's second model, national income varies in an unpredictable way. Potentially, the country can benefit from the existence of international debt markets by borrowing in hard times and paying back its loans in good times. Hannsgen modifies this standard model by including a loss of utility when the country is in recession and must borrow. This is again to highlight the negative effects of IMF programs, etc. As one might expect, the country borrows less money when this form of sovereignty loss disutility is included in the model. Hannsgen shows that the country may lose access to the international debt market altogether in this situation.

Hannsgen next takes a broader view, evaluating how well his utility-maximizing model captures the essence of the problem at hand. He argues that his model illustrates the shortcomings of some standard methodological doctrines of conventional economics. Generally, these doctrines involve the notion that when attempting to model the values of a consumer, producer, or country, the only scientific approach is to treat observed values as unexamined and given "tastes," and never as moral beliefs whose rationale must be understood and evaluated.

Is More Mobility Good? Firm Mobility and the Low Wage–Low Productivity Trap

STEPHANIE SEGUINO
Working Paper No. 423
www.levy.org/pubs/wp_423.pdf

Does globalization help workers? Research Associate Stephanie Seguino of the University of Vermont provides evidence in a new working paper that at least one aspect of globalization not only reduces wages but also has an adverse effect on the productivity, or output per hour, of workers.

Seguino focuses on the effects of foreign direct investment (FDI), which includes the construction of new factories in foreign countries and mergers and acquisitions across international borders. Seguino hypothesizes that such investment might have an adverse effect on productivity and wage growth for the following reason: when firms possess the ability to credibly threaten to move their operations to another country, perhaps one where worker protections are less binding, they have the power to keep wages relatively low. In turn, low compensation can reduce pressure for firms to reduce costs by introducing productivity-enhancing technologies. Finally, lower productivity further reduces the ability of firms to grant pay increases.

Seguino attempts to test this possibility using data on 37 semi-industrialized economies for the period 1970–2000. She examines the role in wage growth of a number of variables, including inflation, the size of the labor force, the deviation of GDP from its trend rate of growth, the proportion of the population with a secondary education, and finally the variable of interest for her study, the level of FDI. She looks separately at the effects of "inward" and "outward" foreign direct investment as well as the sum of the two. The exact definition of foreign domestic investment was the increase in the equity position of a foreign firm that holds more than 10 percent of the shares of a host country firm.

Seguino finds that the impact of FDI on wages is negative and too large to be due to chance. However, the size of the impact varies somewhat, depending upon details of the model's construction. Both inward and outward FDI, considered separately, have a negative effect.

Seguino then turns to the determinants of productivity growth, taking into account the effects of the growth rate of GDP and factors unique to a given time period or economy. It turns out that total FDI, measured as the sum of the absolute values of inward and outward investment, has a negative effect on productivity growth. When the role of inward and outward FDI are estimated separately, no strong effect could be discerned in either a positive or negative direction.

Levy Institute News

New Program Codirector and Senior Scholar

The Levy Institute welcomes Caren A. Grown as senior scholar and codirector of its Gender Equality and the Economy program. Grown is director of the Poverty Reduction and Economic Governance team at the International Center for Research on Women, where she leads research on the impact of multilateral and national economic policies on gender equality as well as asset accumulation and women's property rights. From 1992 to 2001, Grown was a senior program officer at the John D. and Catherine T. MacArthur Foundation in Chicago. Her responsibilities included managing a collaborative research competition on governance challenges in the global economy, conceiving and implementing a five-year foundationwide initiative to award grants for research, graduate training, and communication/application of new ideas in economics; and establishing the Fund for Leadership Development, which supported individuals working on new approaches to population problems in Mexico, Brazil, Nigeria, and India.

Before joining the MacArthur Foundation, Grown was an economist with the Center for Economic Studies at the U.S. Census Bureau. In the 1980s, she consulted with the Ford Foundation's Developing Countries and Rural Poverty Programs. She is the lead author of *Taking Action: Achieving Gender Equality and Empowering Women,* published by Earthscan and the UN Millennium Project. She has guest coedited three special issues of *World Development,* on macroeconomics, international trade, and gender inequality, and coauthored, with Gita Sen, *Development, Crises and Alternative Visions: Third World Women's Perspectives* (Monthly Review Press, 1987). Grown holds M.A. and Ph.D. degrees in economics from the New School University and a bachelor's degree in political science from UCLA.

Upcoming Events

Conference: Unpaid Work and the Economy: Gender, Poverty, and the Millenium Development Goals
October 1–3, 2005
Annandale-on-Hudson, New York

The focus of this conference is on unpaid work, including unpaid care work, and its significance for economic analysis and social policy. It is jointly organized by the Bureau for Development Policy, United Nations Development Program, and The Levy Economics Institute and will be held at Blithewood, the Levy Institute's research and conference center on the campus of Bard College, Annandale-on-Hudson, New York. During this event, participants from around the world will share their experiences, research methodologies, and policy perspectives on women's unpaid work.

Time allocated to unpaid work has received increased attention in economic and policy circles during the last decade, and several countries now collect time use data and construct satellite accounts. Yet, nonmarket work has not been taken sufficiently into account in the formulation of public policies and pro-poor alternative macroeconomic strategies. Unpaid work is currently receiving renewed attention, as it is especially important in the context of achieving the United Nations's Millennium Development Goals, one of which calls upon nations to "promote gender equality and empower women."

This timely conference will draw on the growing body of time use research and economic modeling that incorporates unpaid work, thus contributing to a dialogue among policy analysts, economists, practitioners, and statisticians concerned with these issues.

Conference: Time Use and Economic Well-Being
October 28–29, 2005
Blithewood
Bard College
Annandale-on-Hudson, New York

See page 16 for conference program.
Registration information will soon be available at www.levy.org.

Conference

Time Use and Economic Well-Being

October 28–29, 2005

Conference organizers: Edward N. Wolff and Ajit Zacharias

Program

Friday, October 28

8:30–9:00 a.m.

BREAKFAST AND REGISTRATION

9:00–9:15 a.m.

WELCOME AND INTRODUCTION

Dimitri B. Papadimitriou, President, Levy Institute

9:15–11:00 a.m.

SESSION 1

Determinants of Household Production I

"'What Gives' When Mothers Are Employed?" **Suzanne M. Bianchi**, University of Maryland.

"Time to Eat: Household Production under Increasing Income Inequality." **Daniel S. Hamermesh**, University of Texas at Austin, National Bureau of Economic Research (NBER), and Institute for the Study of Labor (IZA).

Discussant: **Susan Himmelweit**, Open University, UK

11:00–11:30 a.m.

BREAK

11:30 a.m. – 1:00 p.m.

SESSION 2

Determinants of Household Production II

"Where Do They Find the Time? A Time-Diary Analysis of How Working Parents Preserve Their Time with Children." **Lyn Craig**, Social Policy Research Centre, University of New South Wales.

"Parental Child Care in Single Parent, Cohabiting, and Married Couple Families: Time-Diary Evidence from the United States and the United Kingdom." **Charlene Kalenkoski**, Ohio University; **David Ribar**, The George Washington University; and **Leslie Stratton**, Virginia Commonwealth University.

Discussant: **Jean Kimmel**, Western Michigan University

1:00–2:30 p.m.

LUNCH

2:30–4:00 p.m.

SESSION 3

Labor Market Developments and Workers' Time-Allocation Patterns

"Working Hour Arrangements and Income Inequality: An Earnings Treatment Effects Approach by Fragmentation and Timing of Work." **Joachim Merz**, University of Lüneburg; Research Institute on Professions (Forschungsinstitut Freie Berufe, FFB); Center for Research in Entrepreneurship, Professions and Small Business Economics; and IZA.

"Time Allocation of Employed Population in Russia." **Irina Soboleva**, Center for Labor Market Studies, Institute of Economics, Russian Academy of Sciences.

Discussant: **Irina Paley**, Brown University

4:00–4:30 p.m.

BREAK

4:30–6:00 p.m.

SESSION 4

Time Use, Macroeconomic Modeling, and Social Policy

"From National Satellite Accounts of Household Production to Macroeconomic Modeling in African Countries." **Alfred Latigo** and **Omar Abdourahaman**, United Nations Economic Commission for Africa; **Ismaël Fofana**, **Bernard Decaluwe**, and **John Cockburn**, University of Laval.

"The Temporal Welfare State: A Cross-national Comparison." **Robert E. Goodin** and **James M. Rice**, Australian National University.

Discussant: **Marzia Fontana**, University of Sussex

6:00–9:00 p.m.

RECEPTION AND DINNER

Keynote Address: Nancy Folbre, University of Massachusetts, Amherst

Saturday, October 29

8:30–9:15 a.m.

BREAKFAST

9:15–11:00 a.m.

SESSION 5

Measurement Issues in Time-Use Research

"Using Auxiliary Data to Compensate for Noisy Time-Use Data." **N. Anders Klevmarken**, Uppsala University.

"Examining the Dynamics of Child Care Using the American Time-Use Survey and USA Heritage Time Use Data Sets." **Jonathan Gershuny**, **Muriel Egerton**, and **Kimberly Fisher**, Institute for Social and Economic Research, University of Essex.

Discussant: **Diane Herz**, U.S. Bureau of Labor Statistics

11:00–11:30 a.m.

BREAK

11:30 a.m. – 1:00 p.m.

Session 6

Household Production and Economic Inequality

"Household Production and the Distribution of Economic Well-Being in the United States." **Ajit Zacharias**, Levy Institute.

"How Does Nonmarket Production Affect Earnings Inequality? Evidence from the American Time-Use Survey." **Harley Frazis** and **Jay Stewart**, U.S. Bureau of Labor Statistics.

Discussant: **Frank Stafford**, University of Michigan

1:00–2:30 p.m.

LUNCH

2:30–4:00 p.m.

SESSION 7

Well-Being and Deprivation: Subjective and Objective Measures Utilizing Time-Use Data

"Time, Money, and Satisfaction." **Jens Bonke**, **Mette Deding**, and **Mette Lausten**, The Danish National Institute of Social Research, Copenhagen.

"Developing Poverty Indicators Using Time-Use Statistics: A Study in India." **Indira Hirway**, Central Statistical Organization, Government of India, and Center for Development Alternatives.

Discussant: **Lars Osberg**, Dalhousie University

4:00–4:30 p.m.

BREAK

4:30–6:00 p.m.

SESSION 8

International Comparisons of Time Allocation

"International Differences in Market Work and Household Production." **Richard B. Freeman**, Harvard University and NBER; and **Ronald Schettkat**, Bergische Universität Wuppertal.

"Elderly Time Allocation and Well-Being: What Changes after Retirement? An International Comparison." **Elsa Fontainha**, ISEG (Technical University of Lisbon).

Discussant: **Younghwan Song**, Union College

6:05–9:00 p.m.

RECEPTION AND DINNER

Recent Levy Institute Publications

LEVY INSTITUTE MEASURE OF ECONOMIC WELL-BEING

Economic Well-Being in U.S. Regions and the Red and Blue States
EDWARD N. WOLFF and AJIT ZACHARIAS
March 2005

How Much Does Public Consumption Matter for Well-Being?
EDWARD N. WOLFF, AJIT ZACHARIAS, and ASENA CANER
December 2004

How Much Does Wealth Matter for Well-Being? Alternative Measures of Income from Wealth
EDWARD N. WOLFF, AJIT ZACHARIAS, and ASENA CANER
September 2004

POLICY NOTES

Imbalances Looking for a Policy
WYNNE GODLEY
2005/4

Is the Dollar at Risk?
KORKUT A. ERTÜRK
2005/3

Manufacturing a Crisis: The Neocon Attack on Social Security
L. RANDALL WRAY
2005/2

The Case for an Environmentally Sustainable Jobs Program
MATHEW FORSTATER
2005/1

PUBLIC POLICY BRIEFS

The Fed and the New Monetary Consensus
The Case for Rate Hikes, Part Two
L. RANDALL WRAY
No. 80, 2004 (Highlights, No. 80A)

The Case for Rate Hikes
Did the Fed Prematurely Raise Rates?
L. RANDALL WRAY
No. 79, 2004 (Highlights, No. 79A)

STRATEGIC ANALYSES

How Fragile Is the U.S. Economy?
DIMITRI B. PAPADIMITRIOU, ANWAR M. SHAIKH, CLAUDIO H. DOS SANTOS, and GENNARO ZEZZA
March 2005

Prospects and Policies for the U.S. Economy: Why Net Exports Must Now Be the Motor for U.S. Growth
WYNNE GODLEY, ALEX IZURIETA, and GENNARO ZEZZA
August 2004

WORKING PAPERS

Is More Mobility Good? Firm Mobility and the Low Wage–Low Productivity Trap
STEPHANIE SEGUINO
No. 423, May 2005

The Disutility of International Debt: Analytical Results and Methodological Implications
GREG HANNSGEN
No. 422, April 2005

A Simplified Stock-Flow Consistent Post-Keynesian Growth Model
CLAUDIO H. DOS SANTOS and GENNARO ZEZZA
No. 421, April 2005

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