The Levy Economics Institute of Bard College

Report

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16th Annual Hyman P. Minsky Conference on the State of the U.S. and World Economies

GLOBAL IMBALANCES: PROSPECTS FOR THE U.S. AND WORLD ECONOMIES

On April 19 and 20, scholars, policymakers, and financial analysts gathered at the Levy Institute's headquarters in Annandale-on-Hudson, New York, to discuss the current state of the U.S. and world economies by exploring themes from the work of the late Levy Institute economist Hyman P. Minsky. Participants addressed a wide range of issues that would have been central to Minsky's concerns: stability and instability, the U.S. budget deficit, the state of the U.S. housing market, the analysis of the inflow of Asian funds into the U.S. economy and its consequences, and the effects of China's economic development policies on the U.S. economy.

Frederic S. Mishkin

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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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Dimitri B. Papadimitriou


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Conference *Continued from page 1*

Welcome and Introduction: Global Imbalances: The U.S. and the Rest of the World

DIMITRI B. PAPADIMITRIOU, LEVY INSTITUTE

Papadimitriou welcomed conference participants and began his introduction with a discussion of the U.S. trade in goods. He reviewed the latest data for the overall U.S. trade deficit, which rose in 2005–06; its value as a percentage of GDP; and its composition in terms of the United States' trading partners. He then discussed the Levy Institute macroeconomic model's projections for the U.S. economy over the next few years. To the Congressional Budget Office (CBO) projections of the U.S. government budget deficit between now and 2010 he added his projections for the current account deficit over the same period, based on the CBO's economic growth and inflation assumptions. The projected outcome indicated an improved current account deficit over the 2007–10 period. He then presented projections for the private sector deficit, using the Institute's three-sector accounting model, by deducting the government deficit from the current account deficit.

Papadimitriou noted that the CBO assumptions lead to private deficit projections, with implausible values for total spending far in excess of income, particularly in light of the recent subprime mortgage crisis. He highlighted this issue by offering some forecasts from the Institute's macro-model simulations after the first quarter of 2006, showing the rise in the ratio of debt to income required to fund the private sector deficit. Given the limited scope for lending, this exercise more plausibly indicates a leveling off of the debt-to-GDP ratio.

Addressing the appropriate policy responses to the projections obtained from the Levy macro-model, Papadimitriou contrasted two scenarios: a substantial depreciation of the dollar, and a significant rise in the budget deficit. He offered two reasons why reliance on the former adjustment mechanism would be unsafe: its inflationary consequences, and the unwillingness of China, as a principal trade partner, to accept currency appreciation. However, to achieve the CBO 2010 output level, the latter course would increase the deficit to 4.6 percent of GDP, compared to the 3.2 percent obtained from the dubious CBO baseline.

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

Chair: DIMITRI B. PAPADIMITRIOU, LEVY INSTITUTE

Speakers: LAKSHMAN ACHUTHAN, ECONOMIC CYCLE RESEARCH INSTITUTE; ROBERT W. PARENTEAU, RCM

Achuthan's presentation focused on the forecasting performance of business cycle models. He noted that forecasters often make large errors in the vicinity of cycle turning points, and that they are much better at analyzing past behavior than predicting future changes. He argued that it is possible to improve the accuracy of predicting real-time changes with forecasting models that do not fail across diverse economies and distinct time periods. Such indicators employ information coming from within the economy, referred to as endogenous influences, that affects the turning cycle points—for example, data on new orders can be used as a signal for an increase in production. Achuthan then examined the evidence that the use of such indicators leads to, demonstrating that the same indicators successfully forecast real-time turning points, both across time periods with many structural differences and across different economies. He argued against those economists who believe that recessions are triggered by external shocks (e.g., a flood); since these cannot be predicted, recessions are hard to forecast reliably. Achuthan maintained that it takes more than a shock to trigger a recession, that there must be existing weaknesses in the economy to make it vulnerable to shocks and that such weaknesses act as endogenous influences on the cycle. As an example, he noted that the attack on Pearl Harbor did not produce a recession, while in 1990 the proposed index of economic indicators peaked and turned down in advance of the recession "triggered" by Saddam Hussein's invasion of Kuwait.

Parenteau began with a discussion of the sustainability of household financial imbalances. He reviewed evidence showing an explosive rise in the household debt-to-income ratio. He also examined the loophole that would defuse the consequences of this outcome, namely, that if household assets are appreciating at a strong enough pace, it can sustain the private sector's deficit spending, and argued for the implausibility of such an outcome because it would require perpetual asset bubbles. Most of his presentation, however, was devoted to the view that the current U.S. growth path leads to a soft landing, and in this context, he examined some possible "delinkages" that would prevent a fall in consumer spending. One is a decoupling argument, in which consumers tap their housing equity even as housing starts decline; this view is contrary to the evidence showing that, since early 2006, the pace of mortgage equity withdrawal has slackened. Such outcomes suggest that the prospect of a hard landing should be taken seriously. Parenteau argued that the securitization of mortgage loans removed banks' incentive to be diligent on granting credit, since they do not hold securitized mortgages on the balance sheets any longer. In the current deregulated mortgage market, the Federal Reserve Board (Fed) cannot be blamed for excess liquidity, as the brokers and investment banks have generated and retained much more liquidity than the Fed.

Wolfgang Münchau

Keynote Speaker: WOLFGANG MÜNCHAU, FINANCIAL TIMES

Münchau focused on the ability of the Eurozone economies to isolate themselves from the effects of a U.S. recession. He discussed the case for decoupling, listing the reasons often suggested for its feasibility. The first among these is that the European stock markets are performing well because the Eurozone as a whole is trading less with the United States than with the United Kingdom alone. Secondly, the European economies of the 1990s were independent, while today many have common monetary and fiscal policies, making the Eurozone a single large, and relatively closed, economy, somewhat similar to that of the United States, and resistant to the external shock of a U.S. recession. Third, both economic growth forecasts (above 3 percent) and confidence indicators offer an improved medium-term assessment of Europe's economic performance. Finally, successful economic reforms are also cited as evidence of an economic regime change in Europe, though Münchau pointed out this is not the case with France, Italy, or even Germany, where successful reform has been the result of pay negotiations in the private sector, despite continuing labor market rigidity. Münchau then outlined the case against each decoupling argument. Even if trade with the United States is limited, the main transmission channel in Europe's case is finance. Research indicates that price movements in the U.S. stock market have a very strong impact on European stock markets, so an equity crash would immediately affect Europe. Next, statistics show that U.S. and European property markets are closely correlated, so just as reductions in U.S. interest rates

Torsten Slok

Robert Z. Aliber

have been responsible for rising house prices, and increases for falling house prices, European interest rates and home prices are likely to follow, with a delay, the same developments. Finally, there is the recent, historically high euro-to-dollar exchange rate, expected to lead, with some delay, to falling European exports and slower growth in the Eurozone.

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

Chair: GREG HANNSGEN, LEVY INSTITUTE

Speakers: TORSTEN SLOK, DEUTSCHE BANK SECURITIES, INC.; ROBERT Z. ALIBER, UNIVERSITY OF CHICAGO

Slok addressed the question of why low inflation and its targeting by central banks matters. Maintaining low rates of inflation expectations—referred to as inflation "anchoring"—matters because of their link to the future course of inflation. Moreover, a broader inflation target band leads to a rising inflation premium being added to long-term interest rates. However, inflation expectations have been low, and real interest rates have been trending downward during the last 10 years. The result has been a falling personal saving rate combined with rising asset prices. Slok also discussed a number of factors threatening the current low inflation environment. First, demand for rising nominal wages could lead to political opposition to inflation band targeting. Second, the aging of the U.S. population will lead to a decrease in labor market participation, lower output, and substantial increases in Social Security and health care costs. While the immediate result will be a massive fiscal deficit, this will eventually show up as increased inflation. Finally, there is the threat of global imbalances, in particular China's growing foreign exchange reserves. If China's economy were to overheat, higher inflation would produce a rise in U.S. prices through increased import prices, which are already climbing.

Aliber examined each of the four major asset price bubbles of the past two decades. The first began in Japan in 1985 after financial liberalization. The outcome was stock and real estate price increases in the late 1980s. This was essentially because individual Japanese borrowers secured loans in Japan to buy relatively cheaper property abroad. The second major asset price bubble occurred in the mid-1990s in South Asia (Thailand, Malaysia, and Indonesia), with sharp stock price increases culminating in the depreciation of the Thai baht and "the Asian crisis." The third was the U.S. stock price bubble of the late 1990s, which in turn pulled up stock prices in most of the countries that are part of the Organization for Economic Co-operation and Development. The fourth and most recent bubble occurred in U.S. residential real estate prices. In all four cases, the country or countries involved had a high rate of economic growth and, with the exception of Japan, a current account deficit, and the asset price bubble acted as a lure for the inflow of foreign funds.

Session 3. Financial Instability in a Global Economy

Chair: W. RAY TOWLE, LEVY INSTITUTE

Speakers: KORKUT A. ERTÜRK, LEVY INSTITUTE AND UNIVERSITY OF UTAH; JAN A. KREGEL, LEVY INSTITUTE AND UNIVERSITY OF MISSOURI–KANSAS CITY; L. RANDALL WRAY, LEVY INSTITUTE AND UNIVERSITY OF MISSOURI–KANSAS CITY

Ertürk offered a simple two-region framework for the examination of financial flows between Asia and the United States, with their deficits and surpluses adding up to zero. In this closed system, falling investment in one (industrializing) region would result in a glut of savings, leading to inflows of funds into the other (industrialized) region; this would in turn lower the latter's interest rate and expand its economic growth. The liberalization of capital flows has two effects in this framework: it not only expands the production capacity of the recipient region, but also leads to an asset price bubble and currency appreciation. The outcome is financial instability. However, should domestic spending rise and saving fall in the industrializing region, the surplus reserves would disappear. Ertürk noted that the Asian economies accumulated large reserves as protection against currency attacks after 1998, but the Asian investment collapse led to a glut of savings, which then found their way into the U.S. economy. Fear of a currency crisis is no longer an important constraint on spending in Asia, so dollar reserves have outlived their usefulness. Once Asian domestic spending rises, the savings glut ends and a dollar glut ensues. The U.S. economy would then face greater difficulty in attracting foreign savings to finance its current account deficit, implying higher interest rates and a significant curtailment of private consumption due to household indebtedness.

Kregel addressed the question of international imbalances as a part of the development process resulting from trade between countries at different levels of development, with the industrializing country capturing part of the manufacturing market of its advanced trading partner. Traditional development policy was based on positive net resource flows from developed to developing countries. By contrast, with a negative-net-resource-flows policy—the dominant postwar pattern—the movement is in the opposite direction, resulting in trade surpluses for the developing country. One aim of negative flows is to create export surpluses. In particular, China's negative flows can be seen as a means of creating employment sufficiently rapidly to retain government control over the development process. Indeed, negative flows are a feature common not only to Asia but also Europe and, for geopolitical reasons, the Organization of the Petroleum Exporting Countries. Without such flows, the United States would face recession; Europe, falling growth; and China, loss of control. Maintaining the system is therefore of common interest. Kregel noted that with a negative flows policy, export earnings always cover imports and debt service, so no balance of payment crisis is likely; too, large foreign reserves can cover any capital flight, thus preventing a financial crisis.

Wray pointed out the broad policy implications of Minsky's hypothesis that apparent stability alters expectations and behavior in a way that generates fragility. Institutions, including the government, achieve stability by introducing constraints into this environment, largely determining whether the path of the economy deteriorates or progresses over time. He also discussed the emergence of what Minsky called "money-manager capitalism," a product of the relative stability of the postwar period. However, the more recent developments undermined this stability. The Fed adopted a policy of lowering interest rates, thereby fueling the mortgage market; banks securitized the loans, thus dispensing with the need to hold them on their books. The result was a mortgage securities market bigger than the Treasury market and consumer debt that is currently growing many times faster than income. Wray argued that private sector Ponzi finance—that is, borrowing with the sole intent of paying the interest and principal on a loan—could not be relied on to keep the economy going; the fiscal stance is too tight, and it must be relaxed to prompt high consumption based on high income rather than on household borrowing. He concluded by asking whether the U.S. economy as a whole is an example of Ponzi finance, and suggested that while the description fits the private sector, it does not apply to the government, which can always service its debt.

Keynote Speaker: JAMES K. GALBRAITH, LEVY INSTITUTE AND UNIVERSITY OF TEXAS AT AUSTIN

The orthodox economic policy proposals of recent decades (e.g., a balanced budget) are based on the notion of a zero value as a highly desirable policy outcome. Galbraith offered a critique of such policies, beginning with the four components of early 1980s Reaganomics—monetarism, supply-side economics, deregulation, and balanced budgets—and the practical

James K. Galbraith

James W. Paulsen

record of each. Monetarism in the strict sense lasted about 18 months before bringing about the debt crisis and a crisis in global banking, and was abandoned in 1982. However, that interim period was pivotal, in that inflation as such disappeared from the system, and it has not returned since. The doctrine of supply-side economics maintained that taxation significantly affects the levels of saving and consumption, as well as the choice between work and leisure. Galbraith noted that taxes went down in the 1980s, but the only effect was an adjustment of the income distribution; deregulation was successfully applied to the aviation industry earlier in the decade, but it failed when applied to banking because it then proved difficult to stop the slide from sustainable to Ponzi finance. The doctrine of balanced budgeting owes its endurance to the fact that it faded so fast from the original policy portfolio that it never shared in the general discrediting of the Reagan program. These four pillars of the Reagan portfolio were later exported abroad (as the "Washington Consensus") by applying monetary and fiscal rigor to situations that required far more expansionary policies. That experiment ended in 1998 in Russia, and in 2001 in Argentina.

Galbraith went on to examine whether the goal of price stability means zero inflation. In its most recent version of inflation targeting, the Fed is supposed to control not actual but expected inflation. Galbraith argued against expected inflation targeting; since the public's expectations for inflation appear to be stable, there will not be any deviation of the expected inflation rate from the targeted rate, so all the Fed has to do is target unemployment. He also argued that the current global system, while fragile, has nevertheless been sustainable, and will endure as long as it serves the interests of its major participants, namely, the United States, Japan, and China. Galbraith noted that the current U.S.-China relationship serves the interests of both countries. Should the relationship receive an outside shock, however, such as an attack on Iran—a major supplier of energy to China—it would become unstable.

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

Chair: AJIT ZACHARIAS, LEVY INSTITUTE

Speakers: JAMES W. PAULSEN, WELLS CAPITAL MANAGEMENT; ROBERT J. BARBERA, ITG; JAMES E. GLASSMAN, JPMORGAN CHASE & CO.

Paulsen detailed the four characteristics unique to the current recovery cycle. First is the persistence, globally and within the United States, of excess liquidity dominating the behavior of economic agents. Second, bond yields and the long-term cost of capital have not risen during the recovery. Third, stocks are up but, relative to earnings, are very inexpensive. Finally, and most important, the main contributors to the global recovery are no longer the old G7 but the current G25, and the many developing economies with high growth rates. Paulsen noted a world GDP growth rate of above 5 percent for the sixth year running, despite a two-and-a-half-year period of tightening U.S. monetary policy. He also noted an average U.S growth rate of 3.3 percent for the current cycle, and attributed most of this growth to trade with developing countries—a substantial 51 percent as of 2005. Paulsen argued that the United States has lost the world's economic leadership mainly because 15 years' worth of U.S. trade deficits has been driving the growth of the emerging economies, resulting in dollar-based consumption in these economies that is far in excess of that in the United States. He concluded by suggesting that the United States could gain back this rapidly expanding consumer market through a long-term, sustained contraction of its trade deficit to revive domestic manufacturing.

Barbera focused on China in his presentation. His contention was that the next major monetary policy will be made in China, not in the United States, and that the current imbalances are largely the result of policy decisions made in Beijing. More specifically, he argued that the United States anticipated that a big decline in its interest rates would lead to a decline in the dollar and a shift in the trade balance. This only partially materialized: the dollar fell against the euro because the European Central Bank did not intervene, but not against the renminbi, the yen, and the other Asian currencies because Asia purchased roughly $3 trillion in U.S. Treasury notes to hold the dollar steady against their currencies. The alternative would be to allow the renminbi to appreciate. Barbera noted, however, that such a policy would raise the price of China's farm products, adversely affecting the living standards of its vast rural population, and was unlikely to be adopted. He further examined the breakdown of the U.S. Consumer Price Index (CPI) to demonstrate the relative lack of government control over inflationary pressures. He argued that the price of energy, food, manufactured goods, and even residential rent are all mainly determined by developments in the Asian economies, leaving only some 32 percent of the CPI consisting of services (e.g., stockbroking) that remain insensitive to Asian economic influences.

Glassman took a different view of the global imbalance from most other participants by arguing that it had nothing to do with the United States; rather, it was the result of Asian countries building a war chest against the possibility of hedge fund money being pulled out of their economies, as during the Asian crisis. The U.S trade deficits have been the result of different rates of development in the world, with the developing economies experiencing fast growth and the main trading partners of the United States, namely, Japan and Europe, experiencing slower growth. The latter, however, are now growing more rapidly, and the U.S. trade deficit is beginning to improve. Glassman argued that increases in net household wealth relative to income, due to increased real estate asset prices, reduced the need to save, resulting in falling saving rates. Regarding the U.S. housing market, he contended that the subprime market troubles have mainly affected the building business, not the broader sector; what is being observed in the rest of the housing market is a correction of mispriced credit. Glassman concluded by noting the end of an era of rising net household wealth and a reversion to normal asset gains with stabilized rather than falling interest rates, which will encourage household saving once again.

Keynote Speaker: FREDERIC S. MISHKIN, FEDERAL RESERVE BOARD

Mishkin, a governor of the Federal Reserve, delivered the final keynote speech of the conference. He began by noting that the economic expansion of the last five and a half years is currently slowing to a more moderate pace. However, much of his speech was devoted to a discussion of the risks and uncertainties ahead for the U.S. economy.

Mishkin observed that the ongoing cutbacks in new home starts are likely to persist for a while. He also drew attention to the sharp rise in delinquencies on variable-interest-rate loans to subprime borrowers, and the exit of some subprime lenders from the market. However, he argued that spillover to other segments of the financial markets is negligible because loans to subprime borrowers account for less than 10 percent of all mortgages, and risks on these loans, because of their securitization, are spread widely. He attributed a weakening in business investment in part to a fall in demand for investment in non–high tech industries, especially construction. Mishkin also suggested that recent survey evidence indicating a reluctance to invest reflects uncertainty about the outlook for sales and earnings, and noted that the continuation of a moderate expansion should, in due course, restore confidence. He then cited some data on short-term developments consistent with a moderate rate of expansion: gains in employment; the continuing growth of real disposable income, which is driving consumer spending; mildly stimulating fiscal policy, mainly due to increases in defense spending; and solid demand for U.S. exports, given the prospects for further expansion in Europe, Japan, and China.

The final segment of the governor's speech was devoted to the inflation outlook. He noted that the year-on-year change in the consumer price indices was higher in early 2007 compared to early 2006, mainly due to increases in market rents; further upward pressure is likely to come from gasoline prices. On the supply side, the jobless rate has been low and there are reports of labor shortages in some occupations, but the data provide only mixed signals on whether wage inflation is rising. Mishkin stated that the underlying rate of productivity growth is still close to the 2.5 percent prevailing since the mid-1990s. Stressing the importance of long-run inflation expectations, he also suggested that, given his current inflation estimates, the core inflation rate would slow to around 2 percent in the next few years.

New Strategic Analysis

The U.S. Economy: What's Next?

WYNNE GODLEY, DIMITRI B. PAPADIMITRIOU, AND GENNARO ZEZZA
www.levy.org/pubs/sa_apr_07.pdf

With the virtual collapse of the subprime segment of the mortgage market, it has become clear to most economists that the path of household borrowing will play a large role in the evolution of the U.S. economy over the next few years. In a new Strategic Analysis, Distinguished Scholar Wynne Godley, President Dimitri B. Papadimitriou, and Research Scholar Gennaro Zezza attempt to trace the likely trajectory of the U.S. economy under the plausible assumption that household borrowing, of which home equity loans are obviously one component, will stabilize through 2010.

The authors begin by examining the plausibility of forecasts by the Congressional Budget Office (CBO), which advises Congress on fiscal matters. They plug CBO numbers into a model of the three financial balances of the economy: those of the private sector, the government, and the current account. They find that the CBO's figures—in particular, its rosy forecasts for the government deficit and economic growth—imply that the household sector will continue to borrow at an increasing rate. The intuition behind this finding involves (1) the accounting relationship showing that the deficits of the private and public sectors must add up to the current account deficit, and (2) the fact that tax revenues tend to rise only after statutory tax increases or along with a growing economy.

The analysis of the CBO projections leads to a second set of projections that starts with a leveling off of household borrowing. The authors also assume lower output growth in the rest of the world. The model's projection based on these assumptions is a slowdown of growth to nearly zero by 2008, followed by a recovery toward healthier growth rates in 2009–10. Moreover, the economy would never make up for the lost ground, and the unemployment rate would rise significantly and indefinitely.

Finally, the authors consider possible policy alternatives. It seems plausible that the exchange rate will fall more rapidly than has been widely supposed. Unfortunately, even a relatively fast devaluation of the dollar would not suffice to revive the economy, according to the group's simulations. This would have to be accompanied by a government deficit reaching 4.6 percent of GDP by 2010, if GDP is to attain levels forecast by the CBO. The authors believe that this high-deficit scenario may well be the most likely one—not an undesirable outcome, considering the alternative outlined in the previous projection.

New Levy Institute Measure of Economic Well-Being Report

How Well Off Are America's Elderly? A New Perspective

EDWARD N. WOLFF, AJIT ZACHARIAS, AND HYUNSUB KUM
www.levy.org/pubs/lmw_apr_07.pdf

The United States faces many policy choices regarding programs for the elderly. A new Levy Institute Measure of Economic Well-Being (LIMEW) report by Senior Scholar Edward N. Wolff of New York University, Senior Scholar Ajit Zacharias, and Hyunsub Kum of Seoul National University examines the economic position of this group relative to younger Americans.

Years ago, the elderly in the United States faced very high rates of poverty. Social Security helped reduce this problem, but according to government statistics, the average elderly household's money income was still only 55 percent of that of the nonelderly in 2001.

Money income represents only one part of a household's economic well-being, however. The LIMEW is a broader measure that includes such aspects of well-being as net worth, government programs (including noncash transfers), and household production. All of these components are considered part of economic well-being because they permit access to the commodities that households consume.

The authors find that, indeed, the relative well-being of the elderly is greater when measured by the LIMEW than by the standard measure of gross money income. In fact, the mean LIMEW for the elderly was 9 percent higher than that for the nonelderly in 2001. Also, the mean and median values of the LIMEW for the elderly relative to those for the nonelderly rose from 1989 to 2001. The main reason the elderly fare better in the LIMEW than in narrower income measures is nonhome wealth. Nonhome wealth was also a key driver of another finding in the report: according to the Gini measure of inequality, the LIMEW is more unequally distributed among the elderly than among the nonelderly.

In light of the fact that the elderly are better off than the nonelderly, government policies that favor the elderly over the nonelderly are misdirected, the authors find. However, rather than cut Social Security or other benefits for seniors, the government should consider extending benefits such as universal health care to younger groups.

Workshop

From Unpaid Work to Employment Guarantee Policy: A Social Accounting Matrix Exercise

This workshop, held April 27–30 at the Levy Institute in Annandale-on-Hudson, New York, dealt with data and methodological issues relating to the research project "Impact of Employment Guarantee Programs on Gender Equality and Pro-Poor Economic Development." This project, coordinated by Research Scholar Rania Antonopoulos and generously supported by the United Nations Development Programme, has two aims. The first is to create a gender-informed analytical model that makes transparent the linkages between unpaid work and the monetized parts of the economy, based on a Social Accounting Matrix (SAM) incorporating unpaid work from time-use surveys. In this, it extends the earlier pioneering work of Research Scholar Marzia Fontana. The project's second aim is to make use of this empirical tool in order to assess the impacts of employment guarantee policies on the economy.

The workshop consisted of presentations and discussions for the pilot case studies of South Africa and a village in the state of Gujarat, India, in connection with three areas: (1) desired features of a gender-aware SAM structure, (2) combining time-use data with other survey data, and (3) modeling and simulations. The choice of these pilot studies has been based on the fact that both governments have current budgetary commitments for public guaranteed employment schemes, under the Expanded Public Works Programmes in South Africa and the National Rural Employment Guarantee Act in India.

In addition to Antonopoulos and Fontana, participants included Cecilia Punt, team leader of the Provincial Decision-making Enabling (PROVIDE) SAM model, Western Cape Department of Agriculture, South Africa; Kalie Pauw, formerly senior researcher at the Western Cape Department of Agriculture; Olagoke Akintola, an expert on the social impacts of HIV/AIDS home-based care in South Africa; M. R. Saluja, an expert in input-output techniques and social accounting matrices; Research Associate Indira Hirway, director of the Centre for Development Alternatives, Ahmedabad, India, who has written extensively on both time use and employment guarantee schemes in India; Rudi von Arnim of the New School for Social Research, who has considerable experience with SAMs and structural computable general equilibrium models; and Taun Toay, a research assistant to the project. Dimitri P. Papadimitriou, president of the Levy Institute, and Haider Khan of the University of Denver attended in an advisory capacity. The workshop proposed a gendered SAM, with household and production classifications suitable for examining a set of employment-based interventions and the distributional implications of such interventions by gender, income level, and urban/rural sector, as well as the indirect, "multiplier" effects resulting from newly created paid employment.

New Working Papers

Are the Costs of the Business Cycle "Trivially Small"? Lucas's Calculus of Hardship and Chooser-dependent, Non–Expected Utility Preferences

GREG HANNSGEN
Working Paper No. 492
www.levy.org/pubs/wp_492.pdf

In his presidential address to the American Economic Association in 2003, New Classical economist Robert E. Lucas made an astounding claim. He argued that the costs of the business cycle to U.S. residents amounted to the equivalent of only .05 percent of U.S. consumption. In a new working paper, Research Scholar Greg Hannsgen looks at this claim from the perspective of social economics.

What exactly did Lucas mean when he said that the "costs" of the business cycle were so small? Lucas was looking at the economy as if it were made up of one individual who consumes the same amount as the average U.S. consumer. He assumed a particular utility function (which gives consumer satisfaction or utility as a function of the amount of consumption) that he then used to calculate the utility of his hypothetical consumer using actual data on per capita consumption. Next, he compared this figure with the utility of the same consumer under the assumption that consumption follows a steady upward trend rather than fluctuating with the business cycle. For Lucas, the costs of the business cycle equal the percentage increase in the actual consumption amounts that would be required to bring utility up to the level it would have achieved if consumption had in fact followed the steady, nonfluctuating upward path.

Hannsgen examines the validity of using a consumer utility function—normally used to study the behavior of individual consumers—to make inferences about the appropriate priorities of public officials (e.g., whether taming the cycle is an important goal). To analyze this issue, he borrows from another Nobel laureate, Amartya Sen, the concept of "chooser dependent" preferences. The idea can be explained with an example used by Sen in a 1997 article. Suppose you were eating dinner at a friend's house, and you were offered a choice of two slices of cake from a plate. From the perspective of your own hunger, you might prefer the larger slice. Indeed, if the host were serving the slices, you might hope to be given the largest. But you might not select the larger piece off the plate, simply out of courtesy to the host and to avoid appearing "grabby." So which slice of cake you wind up with might depend on whether you or the host were making the choice.

It is not a huge leap from this example (and, indeed, Sen makes the same point in his article) to the notion that consumers might feel differently about choices they make for themselves and those made by policymakers. Hannsgen offers two principal arguments along these lines: (1) that policymakers might have "fiduciary" duties to avoid imposing risk on others; and 2) consumers might resent fluctuations in consumption more when they do not have some control over them, as they do when making personal decisions about saving or spending.

State, Difference, and Diversity: Toward a Path of Expanded Democracy and Gender Equality

RANIA ANTONOPOULOS AND FRANCISCO COS-MONTIEL
Working Paper No. 493
www.levy.org/pubs/wp_493.pdf

How can a democratic state remain true to its principles of respecting and protecting diversity in the identities and choices made by its citizens while preventing the development of inequalities that undermine those very principles? In this new working paper, Research Scholar Rania Antonopoulos and Francisco Cos-Montiel of the London School of Economics examine the relationship between diversity and inequality in a democratic state, with a view toward defining the public policies required to ensure that the exercise of democratic rights is equally available to all citizens within it, highlighting the particular case of gender inequality and its alleviation by pro-poor, pro-women policies as an important illustration of their approach.

The authors point out that, although individuals have many different identities, others may single out one of them at the expense of other dimensions. The denial of alternative identities leads, in turn, to discontent, and to group violence to counter this process. Antonopoulos and Cos-Montiel argue that the failure to take into account the interests of different groups when formulating policy is a primary source of such violence, and to redress it requires going beyond antidiscrimination laws to implement a broad range of redistributive policies. As an example, they point to the constitutional provisions for indigenous land rights in some Latin American countries, and yet the evidence suggests that despite immense regional diversity, Latin America has the deepest levels of inequality in the world, particularly in those countries with the highest shares of indigenous populations.

Turning to gender, the authors argue that one causal link between diversity and inequality is "invisible" production: unpaid and unprotected work that women regularly carry out, often within the household. As a result, there is much less time available for engaging in other dimensions of a woman's life that are important to her status as a citizen. Therefore, public policies addressing the issues of gender equality should be assessed in terms of whether they increase or reduce the inequality of the work-time burden on women. Antonopoulos and Cos-Montiel outline a two-track policy approach for this purpose: the allocation of public funds for improved infrastructure and social services delivery to ease the burden of working time on women and girls, and employment guarantee programs to bring into the labor market those willing but unable to work. Moreover, the two policy tracks must be coordinated to be effective. Thus, paid employment as a replacement for unpaid work in areas not adequately supplied by the public sector (e.g., providing health care to family members) would also improve social services. Finally, the authors stress that such policy programs should be long-term and permanent, acting to absorb labor surplus, enforcing a wage floor, and creating job skills.

Fiscal Policy in a Stock-Flow Consistent (SFC) Model

WYNNE GODLEY AND MARC LAVOIE

Working Paper No. 494

www.levy.org/pubs/wp_494.pdf

For John Maynard Keynes and his early followers, fiscal policy was at the center of macroeconomic policymaking. Many Keynesians and post-Keynesians still credit massive deficit spending during World War II with the final conquest of the Great Depression in the United States. Macroeconomics has changed a great deal since that time, and even many economists who draw their inspiration from Keynes focus on combating inflation and unemployment with monetary policy alone, not fiscal policy.

In a new working paper, Distinguished Scholar Wynne Godley of Cambridge University and Marc Lavoie of the University of Ottawa observe that part of the reason for the deemphasis of fiscal policy lies in the difficulty of quickly adjusting budget deficits and surpluses as conditions change. Various measures, such as employer-of-last-resort programs, have been proposed by heterodox economists to ensure that fiscal policy responds to the economy in a timely way. Moreover, using a stock-flow consistent model with a mix of standard and heterodox features, the authors show that fiscal policy can have the same stabilizing effect that central bankers claim for monetary policy. Moreover, together with the interest rate, fiscal policy can give policymakers a second policy "lever," allowing the simultaneous achievement of an inflation target and full employment. These results are illustrated with numerical simulations in which the government adjusts its deficit in response to changes in the rate of inflation. Still, the authors question this approach to containing inflation, as cuts in the inflation target result in a loss of output as fiscal policy tightens.

Another conventional belief challenged in the paper is the notion that the real interest rate must be less than the rate of growth of the economy if a nation's debt is to remain stable. In Godley and Lavoie's stock-flow consistent model, an increase in the real interest rate induces an increase in the steady-state, or equilibrium, debt-to-GDP and deficit-to-GDP ratios, but the relevant variables will adjust to these equilibria over time rather than growing without bound. These results hold even for extremely high real interest rates, and despite the fact that policymakers are assumed to keep the government deficit sufficiently high to maintain full employment at all times. Another simulation shows that an indebted country need not maintain a positive trade balance to stabilize its debt.

All of these results suggest that fiscal policy is in need of an intellectual rehabilitation, though governments continue to run large deficits in the face of opposition from most economists.

Gender Inequalities in Allocating Time to Paid and Unpaid Work: Evidence from Bolivia

MARCELO MEDEIROS, RAFAEL GUERREIRO OSÓRIO, AND JOANA COSTA

Working Paper No. 495

www.levy.org/pubs/wp_495.pdf

Changes in the household sexual division of labor are closely connected to how market employment affects the amount of time available for unpaid work. However, much can be learned from whether or not the paid/unpaid work trade-off results mainly in the substitution of one type of labor for another. In a new working paper, Marcelo Medeiros of the International Poverty Centre (IPC) and CSC/Cambridge University, and Rafael Guerreiro Osório and Joana Costa of the IPC and the University of Brasília employ a 2001 household time-use survey from urban Bolivia to examine the extent of such substitution, and to estimate within-gender differences in paid/unpaid work.

By decomposing the average total time at work into the proportion of the population in paid and unpaid work (incidence of work), and the average hours allocated to each (duration of work), the authors find that, on average, fewer Bolivians did paid work but allocated more of their time to it, while more did unpaid work but spent less time doing it. They then look at total workload inequalities between men and women by decomposing them into those between the two genders and those within each gender. They report a 10 percent higher average number of work hours per week for women as compared to men, which is explained by the combined paid and unpaid hours of work for women, or more specifically, by the duration of unpaid labor, which is more than three times higher among urban Bolivian women than among their male counterparts. The authors highlight such gender workload differences by providing some counterfactual simulations, suggesting that if men performed the same amount of unpaid work as women, average male unpaid work would rise by 21 hours per week (h/w), while the reverse would reduce the average unpaid work time of women by 24 h/w. They conclude that the duration of shifts in unpaid work is the principal factor affecting gender workload inequality in urban Bolivia. They also discuss workload inequalities within the urban male and urban female groups by a comparison of Lorenz curves of inequality for paid, unpaid, and total work for women and men separately. They report high levels of work-time inequality among both groups, an outcome that, as the authors admit, restricts any generalization based mainly on the unpaid/paid gender division of labor.

A better understanding of the role of gender in the time allocation of work can be gained from a decomposition of the overall work-time inequality into between- and within-gender inequalities by the application of the Theil index, commonly employed for this purpose. The results reveal that much of the total work-time inequality is within, not between, gender groups, possibly arising from differences in household demographic composition or social class structure.

Gender Disparities in Employment and Aggregate Profitability in the United States

MELISSA MAHONEY AND AJIT ZACHARIAS

Working Paper No. 496

www.levy.org/pubs/wp_496.pdf

The relationship between women's labor market participation and aggregate profitability in advanced capitalist economies is a relatively unexplored area in economic research. Melissa Mahoney of the Levy Institute and the New School for Social Research, and Senior Scholar Ajit Zacharias examine this relationship during two periods of boom in profitability in the United States, 1958–66 and 1982–97. The authors measure the changes in the economy-wide average profit rate as the ratio of profits to the value of capital; they then decompose this ratio into changes due to the profit-wage ratio and those due to the ratio of wages to capital. Their findings show that, while the driving force behind the rise in profitability over both periods was the rising ratio of wages to capital, the contribution of the profit-wage ratio was negligible in the former, but substantial in the latter.

To examine this outcome further, the authors contrast the sharp decline in the wage share (i.e., the decline in the proportion of wages to value added) during 1982–97 with its more stable pattern during 1958–66, suggesting that this decline was the force that sustained the profitability boom of 1982–97. They then consider the role played by women's incorporation into the labor market over the period. They attempt to explain this difference by an extension of their decomposition analysis to the effects of gender pay differentials and gender shares of employment on profitability growth. The decomposition of the wage shares into compensation and hours worked shows the former to be the same in both periods, while during 1982–97 there is a notable difference in hours worked between men and women due to the higher share of women's hours worked, suggesting the substitution of female for male labor. This evidence supports the view that the increase in female hours worked exerted a downward pressure on the wage share because of the lower average female wage rate. However, the authors also examine the evidence for a narrowing of gender pay differentials over the period, and conclude that, to some extent, the narrowing pay gap has modified the decline in the wage share, but this effect was not of sufficient magnitude to undermine the overall profitability boom.

Mahoney and Zacharias then consider changes in the sectoral composition of output, particularly the expansion of the service sector and the decline of manufacturing, as an alternative explanation for the decline in the wage share. They conclude that the wage share decline in the service sector was not accompanied by any degree of feminization of its labor force during the period.

Surveying American Jews and Their Views on Middle East Politics: The Current Situation and a Proposal for a New Approach

JOEL PERLMANN

Working Paper No. 497

www.levy.org/pubs/wp_497.pdf

In this new working paper, Senior Scholar Joel Perlmann addresses two issues related to American Jewish opinion surveys. One involves choosing a definition of a Jew that is likely to reflect the complexities and various strands of American Jewish opinion on Israel and the Middle East. The other is designing a survey that, while representative, avoids the huge cost associated with a random-sample survey. The author notes that intermarriage has resulted in a majority of young Jewish Americans of today having one Jewish-born parent, and for whom Jewishness is one among many other ethnic and religious identities. Existing surveys of American Jews do not fully reveal such a multifaceted identity. Such surveys are of two types: those conducted by local Jewish communities, and the more costly random surveys. The author argues that the former are of uneven quality because of differences in funding and expertise, that they cover limited regions, and that areas outside the major cities receive insufficient coverage. The National Jewish Population Survey (NJPS) included in their sample anyone born to a Jewish parent, or anyone who chose to join the Jewish people. Since there is evidence that many who think of themselves as Jews are not religiously observant, the NJPS is a truncated survey. The American Jewish Identity Survey (AJIS) was the second national survey specifically to account for the underrepresentation of secular Jews in the NJPS by including those who regard themselves as Jews but who are not observant. Perlmann argues that the absence of hard questions about the diversity of American Jewish opinion on Israeli foreign policy and American Middle East policy are particularly significant shortcomings of the existing surveys.

Perlmann suggests that a good guide is the monthly polling of the Israeli population by the Center for Peace Studies at the University of Tel Aviv, which does not shrink from reporting the rise as well as the fall of its monthly "Peace Index" based on both Jewish and Arab opinion. He further proposes to combine the strengths of the NJPS, the Peace Index, and the U.S. Current Population Survey. The government's survey adds new subsamples of the population to a panel of respondents each month and rotates older subsamples out of the sample after 18 months. Adopting its method for a Jewish opinion survey has some advantages. The huge screening out of the non-Jewish population—98 percent of the population total—is spread out over time, since the survey requires a much smaller number of new respondents after the first year. Another is that keeping the respondents on the panel over a period of months allows sampling of their political outlooks as conditions change. Perlmann concludes by recommending that such a survey be based in an academic center rather than a local community to enhance its authority.

Employment Guarantee Programs: A Survey of Theories and Policy Experiences

FADHEL KABOUB

Working Paper No. 498

www.levy.org/pubs/wp_498.pdf

In a new working paper, Fadhel Kaboub of Drew University outlines the conceptual and practical history of employment guarantee programs, as well as their contemporary applications. The first U.S. program—Franklin Roosevelt's New Deal—was enacted in 1933, when unemployment reached 25 percent. Due to business opposition, the New Deal did not, however, provide an infinitely elastic demand for labor, but World War II labor shortages soon restored full employment. Price stability was also achieved by combining this outcome with consumer rationing and price ceilings, set by the Office of Price Administration, for most food items. Kaboub details the contributions of American economists in this field, among them, John Philip Wernette. Wernette proposed financing full employment through the creation of new money, a government mechanism that can be used to support the budget deficit. In this scheme, the purpose of federal taxation was to prevent inflation, not to finance public expenditure. The Keynesian economist Abba Lerner earlier formulated this principle of "functional finance" by arguing that money is created when the government spends, and is destroyed when it levies taxes. The paper also discusses the later work of Hyman P. Minsky in relation to employment guarantees. According to Minsky, "Since only the government can divorce the offering of employment from the profitability of hiring workers, the infinitely elastic demand for labor must be created by government." For him, the size of the deficit and the amount of national debt required to maintain full employment were irrelevant, as the logic of government finance differs radically from that of the household.

Kaboub examines the employer-of-last-resort (ELR) experiences of two developing countries, Argentina and India. After an unsuccessful period of free-market policies, Argentina adopted an employment guarantee program in 2002. Known as Jefes, the program is confined to household heads with children, and offers a monthly payment for a minimum of four hours of daily work, mostly on community projects but also on the repair of roads and bridges. By 2005, the program had had a notable impact on poverty, at an overall cost of less than 1 percent of GDP. Moreover, by 2005, some 60 percent of the participants were woman. India passed a law in 2005 that guarantees every household 100 days of employment per year on rural public works projects. Estimated at a cost of 1.3 percent of GDP, the program targets labor-intensive work in the field of environmental conservation and restoration, creating assets such as regenerated land.

ELR-led Economic Development: A Plan for Tunisia

FADHEL KABOUB
Working Paper No. 499
www.levy.org/pubs/wp_499.pdf

An earlier version of this paper was presented at the Levy Institute conference "Employment Guarantee Policies: Theory and Practice," October 13–14, 2006. It is summarized on p. 8 of the January 2007 *Report*.

Economic Perspectives on Aging

DIMITRI B. PAPADIMITRIOU
Working Paper No. 500
www.levy.org/pubs/wp_500.pdf

In this new working paper, Levy Institute President Dimitri B. Papadimitriou surveys the literature on the economics of aging, with an emphasis on government spending on the aged. The U.S. Bureau of the Census projects that the elderly will account for 16.3 percent of the total population by 2020, an increase of 3.8 percent over 2002. Many pundits warn of a coming "generational storm," as the young and middle-aged incur higher and higher taxes to pay for Social Security and medical benefits for retired baby boomers. The situation calls for a set of clear ideas about the dimensions of the emerging problem and the uncertainties surrounding the government's projections.

People are inclined to be conservative in making forecasts about such serious problems, but Papadimitriou argues that even minor adjustments to assumptions about life expectancies and other variables lead to radically different estimates of the financial soundness of Social Security and Medicare. Commentators often confuse the need for providing actual goods in the future with a need for financial provision, in the form of a stock of securities such as the Social Security Trust Fund. Perhaps more important than the fund balances for various programs are the resources that have been set aside by the soon-to-retire. Estimates by the Federal Reserve show that during the 1990s, the debt burden of the elderly grew substantially, and the percentage of the elderly that own their own home outright declined.

One controversial question about retirement security programs is whether the overall tax and benefit system is progressive or regressive. The answer to this question depends on

Social Security law as well as the life expectancies of different socioeconomic classes. Differing life expectancies also affect the impact of policies for the aged on different genders, races, and ethnicities.

Doubts about the solvency of federal retirement programs have unjustifiably drawn attention away from the massive shift of private pensions from defined benefit to defined contribution programs. This trend will undermine the retirement security of many moderate-income U.S. seniors who simply failed to accumulate sufficient balances in their retirement accounts. Similarly, many firms have cut health benefits for their retired workers. Ultimately, the health care costs of these retirees may come out of the public purse.

The paper concludes with a summary of *Government Spending on the Elderly,* a new book of contributed chapters edited by Papadimitriou.

Two National Surveys of American Jews, 2000–01: A Comparison of the NJPS and AJIS

JOEL PERLMANN

Working Paper No. 501

www.levy.org/pubs/wp_501.pdf

In a new working paper, Senior Scholar Joel Perlmann compares two national surveys of American Jews, the National Jewish Population Survey (NJPS) and the American Jewish Identity Survey (AJIS), to highlight the problems they reveal in understanding the American Jewish identity, and the survey modifications needed to resolve them.

Both surveys cover 2000–01 and are based on the same four screening questions: What is your religion, if any? Was your mother or father Jewish? Were you raised Jewish? Do you consider yourself Jewish for any reason? The author notes that the NJPS does not include anyone on the basis of the fourth screening question alone; therefore, respondents answering "yes" to this question should be excluded from the AJIS to allow comparison between the two surveys. Given this, the samples generally agree on the basic demographic features and education of the respondents and measures of cultural orientation (e.g. political party support or attachment to Israel). The most notable difference between them is a strikingly higher proportion of households with a total annual income of above $100,000 in the AJIS. Perlmann's examination of economic data from the 2004 General Social Survey shows it to be decidedly closer to the AJIS data. Another difference is that the proportion of people regarding themselves as Jewish by religion is notably higher in the NJPS than in the AJIS.

The single most important insight of these surveys is the demonstration of the high rate of Jewish intermarriages since 1970; in both samples, a large fraction of those interviewed classified themselves as having only one Jewish parent. In the NJPS, respondents were given a choice of two classifications, those having one Jewish parent and those having two, while the AJIS included a third classification, that of "other" (e.g., those who converted to Judaism). Perlmann's comparison between the two surveys has to ignore this difference, although he finds that the excluded group is more similar to that reporting one Jewish-born parent. Indeed, the AJIS includes more people of Jewish origin who do not identify themselves as Jewish by religion. The author concludes that it is important for capturing the diversity of American Jewish opinion that all respondents who did not declare themselves Jewish by religion be asked whether they consider themselves Jewish in any way.

Levy Institute News

New Board Member

The Levy Institute is pleased to announce the appointment of Bruce C. Greenwald to its Board of Governors. Greenwald is the Robert Heilbrunn Professor of Finance and Asset Management, Columbia University, and academic director of the Heilbrunn Center for Graham & Dodd Investing. A recipient of the Columbia University Presidential Teaching Award for educational excellence, he is an authority on value investing, with additional expertise in productivity and the economics of information.

Greenwald holds M.S. and M.P.A. degrees from Princeton University, and a B.S. and Ph.D. from the Massachusetts Institute of Technology.

New Appointments

Feridoon Koohi-Kamali is a research associate and editor of the Levy Institute's *Report* and other publications. He studied economics in the U.K. He has taught economics at Oxford University, and worked as a consultant and as an economic and financial journalist for a number of years. Koohi-Kamali's broad research field is consumption and analysis of household budget in developing economies, including topics such as welfare, poverty, and demographics; gender bias and expenditure patterns; price behaviors in tight food markets; and consumption in war economies. He holds a D.Phil. in economics from Oxford University.

Willis Walker has joined the Levy Institute as librarian, with responsibility for all books, journals, and databases in the Institute's collection. Walker was previously a librarian at the Kilmer Library, the primary economics and business library at Rutgers University. He came to librarianship and information management after a career in professional and reference publishing, including marketing and editorial work for publishers such as McGraw-Hill, Van Nostrand Reinhold, and John Wiley & Sons. Walker received his B.A. from Columbia University and his M.L.I.S. from Rutgers.

Candidates Sought: Research Scholar, Gender Equality and the Economy

The Levy Economics Institute of Bard College invites applications for the position of resident research scholar in the Gender Equality and the Economy program. The scholar will collaborate with a team of economists on extending current research in this program area, with an emphasis on gender and macroeconomics, gender and international economics, and gender and poverty. Given the nature of our research agenda, a wide variety of interests can be complementary. A completed Ph.D. is required, although candidates expecting to receive the degree in the immediate future will also be considered. The successful candidate will have a background in macroeconomics, feminist economics, and other heterodox approaches to economics; solid quantitative skills; and a strong interest in policy issues. Please submit a letter of interest and current CV, references, and sample papers to: Human Resources 1707, Bard College, PO Box 5000, Annandale-on-Hudson, NY 12504-5000, or fax to 845-758-7826. AA/EOE.

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