The Levy Economics Institute of Bard College

Summary

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Contents

INSTITUTE RESEARCH

Levy Institute Measure of Economic Well-Being

4 EDWARD N. WOLFF, AJIT ZACHARIAS, and ASENA CANER, Levy Institute Measure of Economic Well-Being: United States, 1989, 1995, 2000, and 2001

Strategic Analysis

6 DIMITRI B. PAPADIMITRIOU, ANWAR M. SHAIKH, CLAUDIO H. DOS SANTOS, and GENNARO ZEZZA, Is Deficit-Financed Growth Limited? Policies and Prospects in an Election Year

Program: Distribution of Income and Wealth

8 STEPHANIE A. BELL and L. RANDALL WRAY, The "War on Poverty" after 40 Years: A Minskyan Assessment

9 EDWARD N. WOLFF, Changes in Household Wealth in the 1980s and 1990s in the United States

Program: Financial Markets and Monetary Policy

10 CONFERENCE: The 14th Annual Hyman P. Minsky Conference on Financial Structure, "Can the Recovery Be Sustained? U.S. and International Perspectives"

23 JÖRG BIBOW, Investigating the Intellectual Origins of Euroland's Macroeconomic Policy Regime: Central Banking Institutions and Traditions in West Germany after the War

Program: Federal Budget Policy

24 WILLEM THORBECKE, Inflation Targeting and the Natural Rate of Unemployment

25 L. RANDALL WRAY, Those "D" Words: Deficits, Debt, Deflation, and Depreciation

Explorations in Theory and Empirical Analysis

26 GENNARO ZEZZA, Some Simple, Consistent Models of the Monetary Circuit

27 CLAUDIO H. DOS SANTOS, Keynesian Theorizing during Hard Times: Stock-Flow Consistent Models as an Unexplored "Frontier" of Keynesian Macroeconomics

INSTITUTE NEWS

28 New Board Members: LAKSHMAN ACHUTHAN; J. EZRA MERKIN

28 New Levy Institute Book

29 Upcoming Event: Conference, The Distributional Effects of Government Spending and Taxation, October 15–16

PUBLICATIONS AND PRESENTATIONS

32 Publications and Presentations by Levy Institute Scholars

34 Recent Levy Institute Publications

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 issues that profoundly affect the quality of life in the United States and abroad.

The *Summary* is published three times a year (Winter, Spring, and Fall) and is intended to keep the academic community informed about the Institute's research. To accomplish this goal, it contains summaries of recent research publications and reports on other activities.

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LETTER FROM THE PRESIDENT

To our readers:

This issue begins with an analysis of economic well-being in the United States by Senior Scholar Edward N. Wolff and Research Scholars Ajit Zacharias and Asena Caner. The authors compare various measures of well-being and find that the official measures have average values lower than the Levy Institute measure, but all measures show that the distribution of well-being was more unequal in 2001 than in 1989.

A strategic analysis by Senior Scholar Anwar M. Shaikh, Research Scholars Claudio H. Dos Santos and Gennaro Zezza, and me finds optimistic official views about the near-term prospects for U.S. growth and employment, in spite of the sharp rise in government and current account deficits. We believe that the U.S. economy will become unstable if present monetary and fiscal stances persist, and recommend that, as a means of reducing the deficit, it is better to rescind tax cuts than to curtail government expenditures.

A working paper by Stephanie A. Bell and Senior Scholar L. Randall Wray under the distribution of income and wealth program uses a Minskyan assessment to review the track record of the "War on Poverty" government program. They find that the program failed because it was based on economic theories that misunderstood the nature of poverty and it lacked a critical component—a government commitment to full employment. A working paper by Senior Scholar Edward N. Wolff finds that there has been a marked improvement in average family wealth despite the slow growth in income over the 1990s, but that the racial disparity in wealth holdings widened between 1998 and 2001, possibly due to low stock ownership among blacks and Hispanics.

The program on financial markets and monetary policy begins with the 14th annual Hyman P. Minsky conference, held at the Levy Institute in April. A common observation among participants was the atypical business cycle pattern associated with the 2001 recession: strong GDP growth and very little job growth. Many queried whether economic growth would continue after the presidential election in light of a possible consumer-led recession (if interest rates rise) and a series of shocks that have heightened uncertainty and diminished confidence in the economy. Some suggested that there has been a structural shift in the labor market and that the public sector must be relied upon to sustain growth and rebuild employment. In spite of positive sentiments about a dynamic and flexible U.S. economy, the majority foresaw serious problems for policymakers as a result of inaccurate forecasts, economic vulnerabilities, globalization, trends in financial risk management, the outlook for profits, increasing household debt burdens, higher inflation, the wars on terrorism and in Iraq, and corporate malfeasance. There was nearly unanimous recognition that Minsky's theses about debt dynamics and financial cycles were relevant, and that increasing private risks in a deregulated financial system pose a threat to the economy.

A working paper by Research Associate Jörg Bibow investigates Germany's postwar monetary history and finds that the government and central bank were positioned as antagonists, and that contemporary economic theory did not impact the country's emerging monetary order. Rather, historical accidents and peculiar personalities molded public perceptions in line with political interests.

Two policy notes are included under the program of federal budget policy. Research Associate Willem Thorbecke reviews the natural rate hypothesis advanced by Friedman and recommends that the Federal Reserve continue its dual mandate of price stability and full employment. Senior Scholar L. Randall Wray reviews the dangers faced by the U.S. economy and concludes that fears about debt deflation, inflation, and depreciation of the dollar should not be taken seriously. He agrees with Minsky that a direct job-creation program can provide full employment and supports a low-growth strategy, which mitigates against financial instability.

Two working papers are included under explorations in theory and empirical analysis. Research Scholar Gennaro Zezza investigates the implications of models associated with the Theory of the Monetary Circuit using corresponding sets of stock-flow accounting, and determines that some hypotheses on investment decisions may be inappropriate. Research Scholar Claudio H. Dos Santos determines that the three main Keynesian "schools of thought" converged to a similar view of (closed) monetary capitalist economies with developed financial markets, and that a "financial Keynesian" view is an unexplored frontier of Keynesian thought that can only be rigorously evaluated with the help of stock-flow consistent accounting frameworks.

As always, I welcome your comments and suggestions.

Dimitri B. Papadimitriou, *President*

Levy Institute Measure of Economic Well-Being

Levy Institute Measure of Economic Well-Being: United States, 1989, 1995, 2000, and 2001

EDWARD N. WOLFF, AJIT ZACHARIAS, and ASENA CANER
Levy Institute Measure of Economic Well-Being, May 2004
http://www.levy.org/pubs/limew/limew0504.pdf

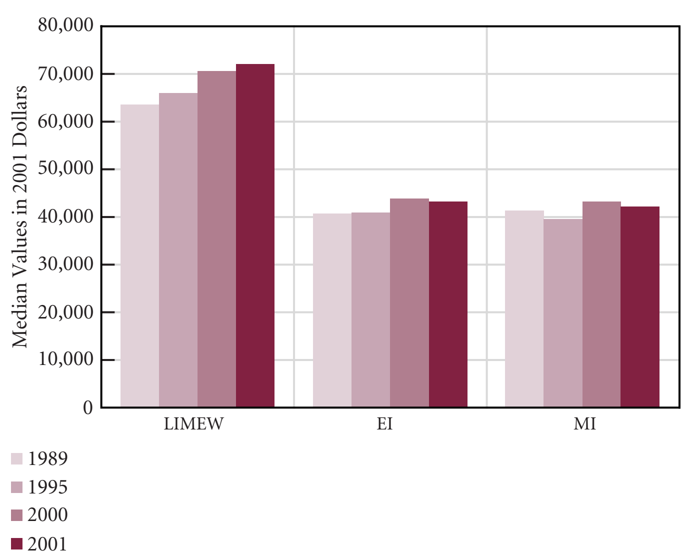
The most widely used official measure of economic well-being is gross money income (MI). The U.S. Census Bureau has supplemented this measure with a more comprehensive measure, which is referred to here as extended income (EI). According to Senior Scholar Edward N. Wolff of New York University and Research Scholars Ajit Zacharias and Asena Caner, the most comprehensive measure of a household's command over commodities is the Levy Institute Measure of Economic Well-Being (LIMEW) because it includes such components as public consumption and household production. The authors expand their previous research of well-being by including data from 1995 and 2001 in their analysis. A comparison of various measures of well-being in 1989, 1995, 2000, and 2001, including the LIMEW less the value of household production and public consumption (LIMEW–C) and the LIMEW less the value of household production (PFI, a "post-fiscal income" measure), shows that the picture of economic well-being differs substantially according to each measure's individual components and the manner in which the components are incorporated in the measure. The official measures have average values lower than the LIMEW, and the rates of change vary among the different measures (*see* Figure 1). All measures, however, indicate that the distribution of economic well-being, as measured by the Gini coefficient, was more unequal in 2001 than in 1989 (*see* Figure 2).

The authors' data are drawn from the public-use version of the data files used by the Census Bureau to construct MI and EI. Additional information from Federal Reserve System surveys on household wealth, national surveys on time use, the National Income and Product Accounts (NIPA), and several government agencies is integrated into the data files. The resulting document provides estimates of the LIMEW for all households in the United States, for households in some key demographic groups, and for overall economic inequality.

According to the LIMEW, U.S. households were 13.2 percent better off economically in 2001 as compared to 1989. In contrast, the official measures were 6.0 percent (EI) and 2.1 percent (MI). The authors note that the reported increase in economic well-being was accompanied by a considerable increase in annual hours of work (238 hours). According to the LIMEW, racial disparity in 1989 was notably higher than in 2001, but the official measures show a much smaller difference. Similarly, the disparity between families with a single female householder and those with a married couple is less, according to the LIMEW, than the official measures. This is mainly due to the more comprehensive accounting of government expenditures in the LIMEW, as well as public consumption. Other household groupings, by age or income, show that economic disparity differs substantially among the various measures.

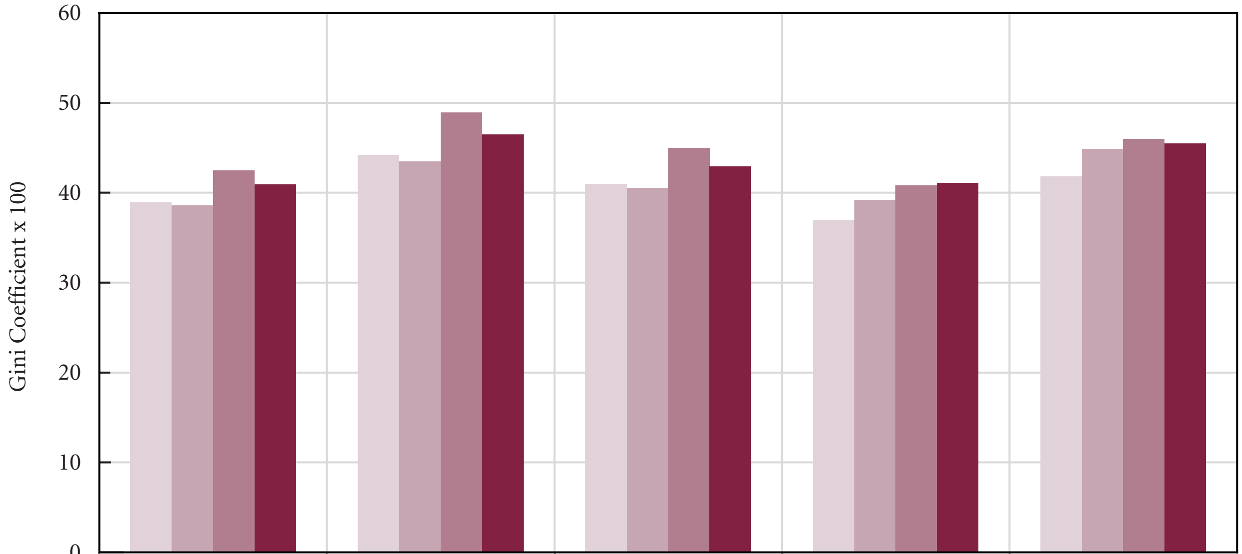
While MI suggests that inequality hardly changed in the second half of the 1990s, the other measures point toward an increase in inequality. The authors find that the official measures may understate inequality in the distribution of command over commodities. Since public consumption and household production are relatively more equally distributed,

Figure 1 **Economic Well-Being by Income Measure**



Source: Authorsí calculations

Figure 2 **Economic Inequality by Income Measure, 1989 to 2001**



	LIMEW	LIMEW-C	PFI	EI	MI
1989	38.9	44.2	41.0	36.9	41.8
1995	38.6	43.5	40.5	39.2	44.9
2000	42.5	48.9	45.0	40.8	46.0
2001	40.9	46.5	42.9	41.1	45.5

Source: Authors' calculations

their inclusion in an income measure generally lowers the degree of inequality. MI overstates inequality because it is a pretax measure that does not fully account for government transfers and excludes public consumption and household production. The degree of inequality between the LIMEW and EI is similar in 1995 and 2001, but quite different in 1989 and 2000. The reason is that the base-income and income-from-wealth components have strikingly different incremental effects on inequality.

Base income has a large positive effect on inequality in EI and a small negative effect in the LIMEW. The difference suggests that to consider economic inequality as primarily shaped by earnings inequality may be misleading. Wealth inequality also plays an important role. Income from wealth has a large positive effect on inequality in the LIMEW and a much smaller effect in EI. The two measures treat nonhome wealth differently (a lifetime annuity on net worth in the LIMEW versus current realized income from assets in EI), so the inequality-enhancing effect of imputed income from nonhome wealth in the LIMEW is twice that in EI. Net government expenditures considerably reduce the overall level of inequality in the LIMEW and EI.

The authors calculate a set of estimates that give a concrete picture of the level, composition, and distribution of public consumption and household production. The information base allows them to perform sensitivity analyses of alternative assumptions, and the results of these analyses, including their investigation of the forces behind the disparities among age groups and households grouped by income, will be reported in future publications.

Strategic Analysis

Is Deficit-Financed Growth Limited? Policies and Prospects in an Election Year

DIMITRI B. PAPADIMITRIOU, ANWAR M. SHAIKH, CLAUDIO H. DOS SANTOS, and GENNARO ZEZZA

Strategic Analysis, April 2004

www.levy.org/pubs/sa/stratan-apr-04.pdf

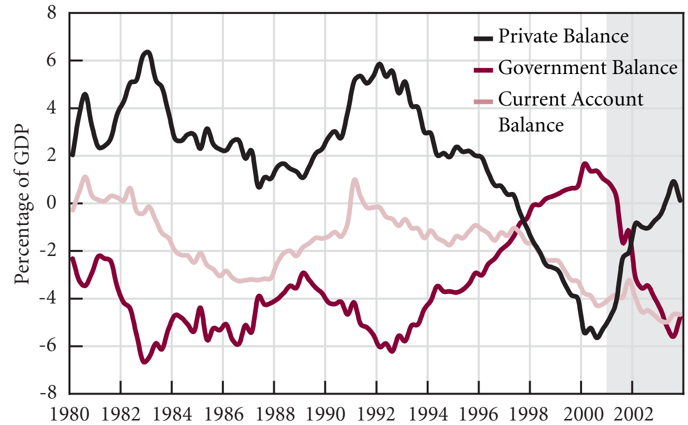
Colleagues at The Levy Economics Institute have long argued that government deficits would be necessary to sustain economic growth when private sector borrowing reached its limits. This recourse also has limits, however, because deficits are linked to debts. According to President Dimitri B. Papadimitriou, Senior Scholar Anwar M. Shaikh of New School University, Research Scholar Claudio H. Dos Santos, and Research Scholar Gennaro Zezza of the University of Cassino, Italy, official views seem optimistic about the near-term prospects for U.S. growth and employment, and are not overly concerned about the near-term consequences of the sharp rise in government and current account deficits. The authors find, however, that the U.S. economy will become unstable if present monetary and fiscal stances are maintained because government and foreign debt would rise steadily relative to GDP, even under the assumption of constant interest rates. They examine two alternative means of reducing the government deficit by half over five years and recommend that it is better to rescind tax cuts than to curtail government expenditures.

The authors note that real GDP growth, profits, and productivity responded dramatically to the rise in government deficits. They also note that employment and wage incomes have lagged far behind and that new jobs increasingly encompass low-quality, low-wage employment. They further note that there is continuing dispute over the actual number of jobs created in light of the two different methods employed by the Bureau of Labor Statistics (the payroll and household surveys).

The authors review the current state of the U.S. economy and find the return of large and growing fiscal deficits. The government deficit now mirrors the current account deficit and the private sector balance has been rapidly reversing itself toward surplus, a trend that was projected in previous Strategic Analysis reports (*see* Figure 1). Expectations that the unemployment rate would fall when job growth was positive were not necessarily correct, they say, because population growth and immigration tend to swell the pool of those looking for work. Large fiscal deficits have pumped up growth and profits, but have left employment and wage income moribund.

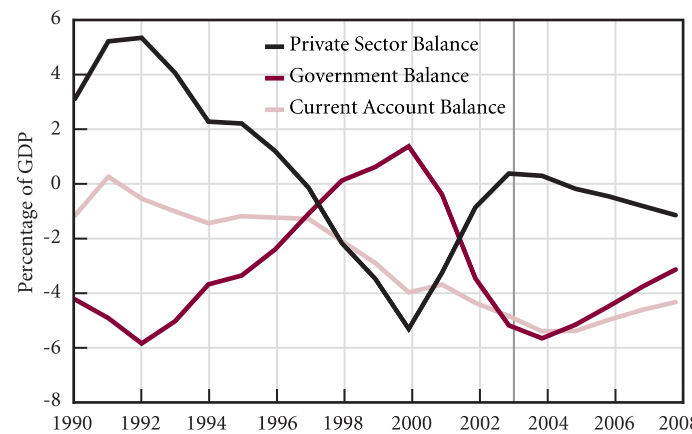
According to the Federal Reserve, debt service payments at the end of the third quarter of 2003 accounted for 13.1 percent of disposable income, which is close to the record high (13.3 percent in 2001). The Fed's broader measure (the financial obligations ratio) peaked at an all-time high of 18.7 percent of disposable income in the last quarter of 2002 and remained above 18.3 percent in the third quarter of 2003. Interest rates are near all-time lows, while debt and debt service burdens are near

Figure 1 **Three Financial Balances in Historical Perspective**



Sources: BEA and authors' calculations (last observation 2003:4)

Figure 2 **Main Sector Balances: Cutting Government Expenditures or Rescinding Recent Tax Cuts**



Sources: BEA and authors' calculations all-time highs, giving rise to an unprecedented record of consumer bankruptcies. The authors warn that further increases in debt burdens could sharply increase debt service burdens and accelerate bankruptcies. The official view that the household sector seems to be in good shape misses the point, they say. The authors are more concerned about a possible drop in demand for U.S. assets by foreign creditors, such as China and Japan, than renewed inflationary pressures and rising interest rates.

The authors find that while present monetary and fiscal policies are likely to lead to robust growth and improved employment, this would come only at the expense of high government deficits, record foreign deficits, and rising ratios of government and foreign debt relative to GDP—an unsustainable scenario. They examine the medium-term consequences of curtailing government spending (Scenario I, the path favored by the present administration) and rolling back recent tax cuts (Scenario II).

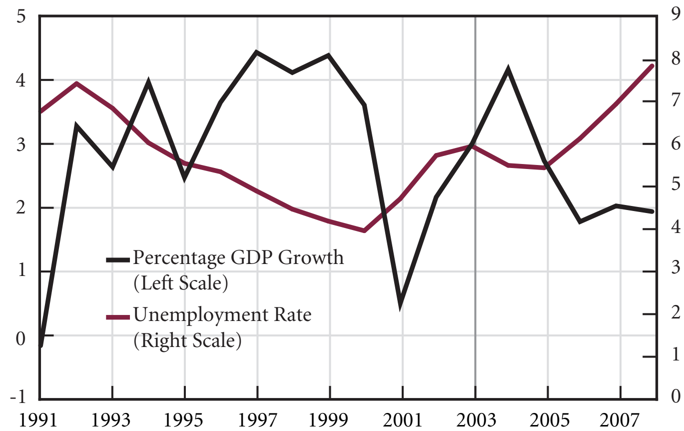
The baseline scenario projects the consequences of present economic policy using Congressional Budget Office projections of government spending. The government deficit rises from 5.2 percent of GDP in 2003 to 5.8 percent in 2004, the same level as the current account deficit. Accelerated export growth would be counterbalanced by accelerated import growth and real GDP growth would jump from 3.1 percent in 2003 to above 4.0 percent thereafter. Unemployment falls steadily to about 4.4 percent by 2008. This rosy scenario, however, is unstable. Because relative government and foreign deficits would be higher than the growth rate of GDP, government and foreign debt would rise steadily, relative to GDP, and lead to a growing interest burden.

Halving the deficit to a target level of 2.6 percent of GDP in five years by cutting government spending (under the same assumptions as the baseline scenario) leads to a decline in the foreign deficit from 5.0 percent to 4.2 percent (*see* Figure 2). This path, however, requires a decrease in the level of real government spending, not merely a reduction in its growth rate, so real GDP growth slows to 2.6 percent in 2005 and 2.0 percent thereafter (*see* Figure 3). Unemployment rises to 8.0 percent in 2008, the private sector falls back into increasing deficits and debts, and the foreign debt continues to rise relative to GDP. What looks good in terms of structural balances turns out to be bad for growth and employment.

If the personal tax rate returns to its pre-tax cut level, the three sector balances are very similar to Scenario I, but there is a substantial difference regarding growth and unemployment. Real GDP growth falls very little from the projected high of 4.1 percent in 2004 (to 3.2 percent in 2008) and the unemployment rate is modestly reduced (to 5.5 percent in 2008) (*see* Figure 4). Foreign and government debt burdens are less troublesome because of higher growth rates.

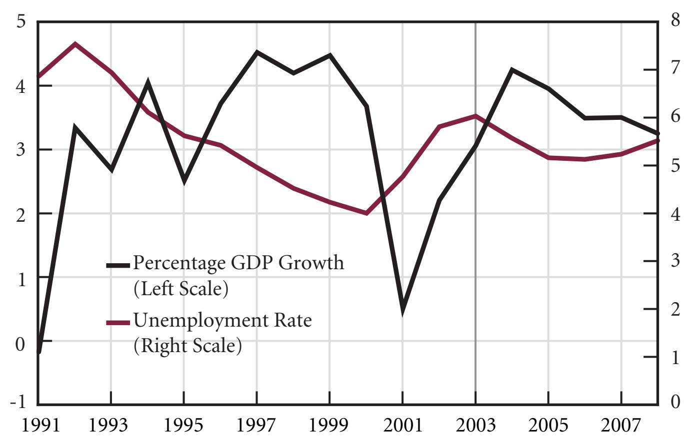
The results of the model imply that the sharp rise in actual GDP growth from 2001 through 2003 had more to do with the jump in government spending than with the reduction in tax rates. Furthermore, if interest rates rise in the future, the prospects of the U.S. economy would worsen significantly.

Figure 3 Real GDP Growth and Unemployment Cutting Government Expenditures



Sources: BEA and authors' calculations

Figure 4 Real GDP Growth and Unemployment Rescinding Tax Cuts



Sources: BEA and authors' calculations

Program: Distribution of Income and Wealth

The "War on Poverty" after 40 Years: A Minskyan Assessment

stephanie a. bell and l. randall wray
Working Paper No. 404, April 2004
www.levy.org/pubs/wp/404.pdf

An unconditional war on poverty (WOP) was declared in Lyndon B. Johnson's first State of the Union address 40 years ago and submitted to Congress as the Economic Opportunity Act. Stephanie A. Bell and Senior Scholar L. Randall Wray from the University of Missouri–Kansas City review the track record of the WOP in terms of Hyman Minsky's early criticisms of the program. They find that the WOP has failed because it was based on economic theories that misunderstood the nature of poverty. The critical component missing today was also missing in 1964; i.e., a government commitment to full employment. According to the authors, only a targeted jobs program that pays decent wages will successfully fight poverty among the non-aged in a politically acceptable manner.

The authors note that the Johnson administration sought to change poor people by emphasizing education and job training rather than changing the system that leads to their impoverishment. Minsky's suggestion was to create jobs suited to the people's existing educational and skill levels so that it would be possible to reduce, rather than redistribute, poverty. He surmised that joblessness, insufficient hours of work, and low pay combined to create poverty among the able-bodied and therefore insisted that a comprehensive jobs program together with an effective and adequate minimum wage would go a long way toward eliminating poverty. Minsky called for "tight full employment," with a 2.5 percent unemployment rate.

In the post–WWII era, the preferred means for generating fiscal expansion was to shift resources to private consumption and investment (with the exception of defense spending). Policies were designed to stimulate investment spending by increasing after-tax profits. Policymakers also tried to increase the certainty of capital income by using government contracts with guaranteed profits, such as those granted to the defense, transportation, and housing industries. Minsky argued that this kind of investment strategy tended to exacerbate income inequality and generate inflation, and could lead to a debt-financed investment boom, thereby undermining the stability of the financial system. His proposed alternative approach stressed policies that favored high consumption and increased wages and incomes at the bottom of the income distribution. He believed that the government should play a major role in generating growth (and become an employer of last resort), because growth relying on private sector deficits was ultimately unsustainable. Minsky expected that a tight-labor-market strategy would eliminate poverty that was due solely to joblessness, increase the number of workers per family, and improve the distribution of income by raising wages of low-income workers faster than high-income workers. He argued in 1965 that achieving tight full employment would generate more than enough additional production to bring all Americans out of poverty (an argument tested by the authors, who found it still true today).

Minsky believed that welfare and other "transfers" raised income and aggregate demand without increasing output. Hence, an inflationary bias was built into the system and hurt the weakest groups who could not get their incomes indexed. To avoid an inflationary rise in prices and wages, Minsky envisioned effective profit and price constraints along with tight full employment. Bell and Wray note that inflation is not much of a concern in today's global economy as a result of substantial deflationary wage and price pressures and floating exchange rate regimes. The primary barrier to attaining and sustaining tight full employment is political will, they say.

In sum, Minsky's fundamental argument is that poverty is largely an employment problem, tight full employment improves income at the bottom of the wage spectrum, and a program of direct job creation is necessary to sustain tight full employment. He believed that tight full employment should be followed by programs to upgrade workers rather than the reverse sequence, which characterized the poverty campaign of the WOP.

Changes in Household Wealth in the 1980s and 1990s in the United States

EDWARD N. WOLFF

Working Paper No. 407, May 2004
www.levy.org/pubs/wp/407.pdf

While most measures traditionally focus on well-being in terms of income, household wealth is a broader measure because owner-occupied housing provides services directly to the owner, wealth is a source of consumption when assets are converted into cash, and financial assets provide liquidity in times of economic stress. Moreover, the distribution of power is often related to the distribution of wealth. However, the only segment of the population that has experienced large gains in wealth since 1983 is the richest 20 percent of households.

In earlier studies, Senior Scholar Edward N. Wolff of New York University presented evidence of increasing household wealth inequality between 1983 and 1998 in spite of increases in mean and median wealth. An extension of his research to 2001 shows that there was marked improvement in the wealth position of average families despite the slow growth in income over the 1990s. Mean and median net worth and financial wealth grew briskly in the late 1990s, while the inequality of net worth leveled off and that of financial wealth showed a marked decline. Indebtedness fell substantially during the late 1990s, so the overall debt-equity ratio in 2001 was lower than in 1983, but the racial disparity in wealth holdings widened between 1998 and 2001.

The data source for the Wolff study is the Federal Reserve's Survey of Consumer Finances (SCF), which consists of a core representative sample combined with a high-income supplement from the Internal Revenue Service's Statistics of Income data file. In some cases, Wolff modifies the weights that are used to meld the high-income supplement with the core sample to conform to the size distribution of income. He presents his results based on his adjustments to the original asset and liability values in the surveys in order to compare changes in mean wealth by asset type. The principal wealth concept used by the author is marketable wealth, or net worth, which is defined as the current value of all marketable or fungible assets less the current value of debts. This measure reflects wealth as a store of value and therefore a source of potential consumption.

Wolff notes that wealth experienced robust growth during the 1990s, while household income stagnated for the average household. The growth rates of mean and median household wealth, as well as financial wealth, fluctuated over the period, but were greater in 2001 than in 1989 by 16 percent, 44 percent, and 53 percent, respectively. Wealth inequality remained unchanged, however, despite an explosive increase in the number of very rich households due to the surge in stock prices. Income inequality, meanwhile, increased sharply between 1982 and 1988, and between 1997 and 2000.The richest one percent of the population received about one-third of the total gain in marketable wealth, and the top quintile accounted for 89 percent of growth over the period from 1983 to 2001, a pattern similar to that for financial wealth. Despite the stability of net worth inequality and the decrease of financial wealth inequality during the 1990s, growth in the economy was concentrated in a surprisingly small part of the population.

A notable trend in the composition of household wealth includes an increase in pension accounts, which is largely offset by a decline in total liquid assets (households substituted tax-free pension accounts for taxable savings deposits). Additionally, gross housing wealth remained almost constant, homeownership rates increased to 67.7 percent, and net equity in owner-occupied housing fell to 18.8 percent in 2001. Homeowner mortgage debt increased to 37 percent in 1998 before falling back to 33 percent in 2001. The author finds that families have been using tax-sheltered mortgages and home equity loans to finance normal consumption rather than consumer loans and other forms of consumer debt. He also finds that there are marked differences in the ways middle-class and rich families invest their wealth, and striking differences in the wealth holdings of different racial and ethnic groups. Progress among African American and Hispanic households was mixed. A disturbing finding is that the wealth gap between African Americans and Hispanics and non-Hispanic whites (ratios of 12–17 percent) was still much greater than the corresponding income gap (ratios of 50–55 percent).

The cross-sectional age-wealth profiles for the 1983–2001 period followed the hump-shaped pattern of the lifecycle model. Wolff considers the relative wealth positions of families defined by age and parental status and finds that childless families were much wealthier than families with children and families with female-headed households. However, the relative wealth position of married couples with children has improved since the early 1980s. The debt-equity ratio grew sharply among female heads with children and was lowest among the elderly.

The average wealth of the poorest 40 percent of the population declined by 44 percent between 1983 and 2001, falling to only $2,900 by 2001. Since 1989, wealth has shifted in relative terms away from young households (under age 55) toward households in the 55–74 age group. The racial disparity in wealth holdings, after stabilizing during most of the 1990s, widened between 1998 and 2001. This trend is traceable to the much lower rate of stock ownership among black and Hispanic families than among whites. Despite overall gains in stock ownership, only slightly more than half of all households had any stake in the stock market in 2001, and most stock ownership was in the hands of the rich and upper-middle classes.

Wolff notes that although the wealth news seems very good for the 1998–2001 period, the results must be interpreted cautiously. A large part of the story is the erosion of traditional Defined Benefit (DB) pension plans (not included in net wealth) and the substitution of Defined Contribution (DC) plans (included in net wealth). In a forthcoming paper, the author shows that when DB pension wealth is included in the wealth measure, there is virtually no growth in median wealth and an increase in wealth inequality between 1989 and 2001.

Program: Financial Markets and Monetary Policy

The 14th Annual Hyman P. Minsky Conference on Financial Structure

Can the Recovery Be Sustained? U.S. and International Perspectives

As part of its research program on financial markets, the Levy Institute organized a conference, held on April 23 and 24 at Blithewood in Annandale-on-Hudson, New York, to examine previous public discussions at Minsky conferences in the context of current economic trends and their implications for the U.S. and world economies. Topics included fiscal and monetary policies for the expansion of national economies as well as the global economy; exchange rate misalignments resulting from "brutal" gyrations in the currency markets, along with their possible cures; and trade and capital flows as they might impinge upon the conduct of monetary and fiscal policies. The role of the United States was examined in view of the current international economic climate. Summaries of the speakers' remarks are given here.

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

The session was moderated by Levy Institute President DIMITRI B. PAPADIMITRIOU. Presentations were made by LAKSHMAN ACHUTHAN, Managing Director, Economic Cycle Research Institute; Senior Scholar JAMES K. GALBRAITH of the University of Texas at Austin; and JAMES W. PAULSEN, Chief Investment Strategist, Wells Capital Management.

In his introduction, DIMITRI B. PAPADIMITRIOU noted that the purpose of the conference—to assess the many cheerful yet cautionary forecasts that good times are here again—reflected Hyman Minsky's insight about the economy as expressed in a tribute by Leon Levy in his book *The Mind of Wall Street*: " . . . prosperity leads to its own decline by ultimately producing speculative excesses." Papadimitriou further noted that recovery from the short-lived recession and future stabilization is unlikely to regain the GDP and employment growth rates of the 1990s.

Papadimitriou outlined the results of the latest Levy Institute Strategic Analysis report (*see* page 6 for details). The April 2004 report shows that fiscal policy has made a swift and significant comeback in terms of deficit spending, which contributed to real GDP growth rates of 8.2 percent and 4.1 percent in the third and fourth quarters of 2003. While profits and productivity soared, growth in employment and wage income lagged far behind. Total job creation in the period between December 2003 and March 2004 was behind by 77,000 jobs in terms of absorbing workforce growth, and increasingly encompassed low-quality, low-wage employment. The weakness of the labor market also shows up in the stagnation of hourly earnings and employee compensation.

Papadrimitriou stated that the return of large and growing fiscal deficits was the first striking element of recent times. Moreover, twin deficits (current account and government) are back as unprecedented private sector deficits recede. This event has generated growth, enhanced profitability, and pulled the economy out of the 2001 downturn. The consensus view expects moderate productivity growth in the near future, along with an improvement in employment and total wage income. The current average rate of growth and productivity is close to the historical average (1.6 percent), which defines the medium-term growth rate needed to maintain the current level of unemployment.

While the Federal Reserve is optimistic about higher growth and lower unemployment in 2004, as well as the prospects for sustained expansion of the U.S. economy, Papadimitriou stated that the concerns at the Levy Institute are somewhat different. He noted that Levy scholars have argued for some time that the pace of consumer spending cannot continue in light of near record debt-service payments (13.1 percent of disposable income) and debt and debt-service burdens (in spite of low interest rates), a record financial obligations ratio, and an unprecedented number of consumer bankruptcies. There is a significant danger of higher debt-service burdens and bankruptcies now that interest rates have bottomed out, a point that is missing from the official view, Papadimitriou said. The Institute is more concerned about a possible drop in demand of U.S. assets by foreign creditors, such as China and Japan, than large government deficits, inflationary pressures, and rising interest rates.

Papadimitriou outlined the results of the medium-term consequences of three alternative policy scenarios. The authors of the report found that rolling back tax cuts is preferable to curtailing government expenditures in terms of growth and employment. This result suggests that the sharp rise in actual GDP growth from 2001 to 2003 was the result of government expenditures rather than a reduction in tax rates.

Continued devaluation of the dollar after 2004 would improve the current account balance and accelerate growth if interest rates did not rise. On the other hand, rising interest rates would cause the U.S. economy to worsen significantly as a result of rising interest burdens for the private sector and higher government deficits (i.e., larger cutbacks in government spending and higher tax rates would be required to keep the budget deficit in line). Papadimitriou concluded with a quote by Distinguished Scholar Wynne Godley: "A chronic balance-of-payments deficit will make it impossible to balance the budget. Either the target of the budget must be changed or effective steps must be taken to improve the balance of payments."

LAKSHMAN ACHUTHAN noted that his comments were rooted in a cyclical worldview. He acknowledged that there were noncyclical (abnormal) things happening today and that a sea change was under way. Achuthan pointed out that manufacturing accounted for 11 percent of U.S. jobs but 134 percent of net job losses since the beginning of the last recession. The pattern is decidedly different from past recession and recovery periods, and from the rest of the world, which suggests a structural shift. From 1995 to 2002, China lost 15 percent of its manufacturing jobs even as the U.S. economy was adding them; since 2001, the United States has lost 15 percent of its manufacturing jobs.

Following the initial conflict in Iraq, some people expected continued weakness in the U.S. economy, while others expected a return to strong GDP and job growth. However, a lopsided recovery unfolded—strong GDP growth and very little job growth. Achuthan presented examples of similar trends in South Africa and New Zealand during periods of structural change. In South Africa, as GDP grew from 1994 to 2003, industries shed workers who were no longer deemed "productive" enough to employ under the higher wage schemes promoted by the Mandela government in an effort to close the apartheid wage gap. In New Zealand, the loss of major agricultural exports to the United Kingdom in the early 1970s resulted in sharply rising unemployment accompanied by rising GDP. These patterns can also apply to larger market economies. Periods of structural change can show a divergence between things that we think should move together, like output and jobs.

There are two basic reasons for the divergence: a subpar recovery and a period of structural change. The evidence points to a story of unintended consequences, suggested Achuthan. Longer-term trends, such as the Federal Reserve's success in fighting inflation and globalization, overlapped the 2001 recession, which also affected inflation. A business that lacks pricing power has to cut costs through productivity gains and outsourcing, or profits will be hurt. The insistence that productivity growth is the primary culprit for the lack of job growth, however, misses the point because nobody really knows the precise number of jobs lost to productivity gains. Achuthan suspected that job losses stemmed from a greatly accelerated structural change. The 2001 recession was global and came at a time of virtual price stability, which resulted in deflationary pressures for tradable goods. The manufacturing sector ramped up productivity growth through cheap financing, record low interest rates, and tax incentives, but it also had more options than before. China was integrating into the global supply chain and there was a newfound wealth of credible Indian firms. These events helped to cut costs in the wake of the 2001 recession. Rather than a cyclical or exaggerated cycle of some sort, there was a structural shift.

The implications for the United States are that intellectual property is going to play a critical role in the longer term (things that require local and highly specialized knowledge cannot be outsourced). Achuthan expected that comparative advantage, which might be defined in increasingly more fine-grained terms as tasks are broken down and redistributed globally, was essentially driving the economic shift, and he noted that globalization brings both opportunities and threats. Wage growth will slow in the West, particularly in manufacturing, and the supply of employees will rise in the service sector, which implies some downward pressure on wage growth. The United States is best suited to be a center of operations in the new global world as it will continue to attract the best and the brightest individuals. The challenge is to own intellectual property, speak a number of different languages, and have a highly integrated system of managing production and clients. The United States is in a good position for that challenge, but it is going to take a long time to play out, observed Achuthan.

According to JAMES K. GALBRAITH, it is no surprise that military purchases and restocking of equipment following the Iraq war have resulted in a growing economy. Poor job performance, however, is a surprise. He then posed the following questions. Will jobs pick up and will the economic expansion continue after the presidential election?

Galbraith believes that there are a number of reasons to be cautious. One reason is that we are in the turbulent wake of the largest private sector boom and bubble in modern times, so we should not expect an ordinary recovery of the business cycle. This reason is reinforced by a fairly low level of capacity utilization, particularly in such sectors as telecommunications. A second reason is that household debt burdens have continued to rise in a period of recession, in spite of extraordinarily low interest rates, so households are unlikely to drive the next phase of economic expansion. A third reason is the fiscal difficulties of state and local governments, which are adding an extra drag on the economy. A fourth reason is the future of interest rates, which are likely to rise in the face of pressure from internal and external sources and current signals from Alan Greenspan. A fifth reason is that the United States faces a cumulative decline in its trade performance that puts its current account and (full) employment in a worse position than at any time in U.S. history. The trade deficit impedes a strong expansion and induces policies that may generate restraint or contraction. The final and most intangible reason is fear and uncertainty in response to the international situation (e.g, the war on terror and uncertain progress in Iraq). The Bush administration has not been forthcoming about the extent of future budget demands for Iraq, and preoccupation with these matters will interfere with the decisions of private U.S. businesses related to long-term investments, particularly in new areas.

Galbraith stated that it was not prudent to assume, as does the administration, that there will be a smooth recovery based upon existing policies or that a program of deficit reduction will generate an expansion. He noted that interest rates rose following the enactment of a deficit reduction package in 1993. The banking sector, which was in a position of very low deposit rates and very high interest rates on government bonds, was able to borrow from the public and lend to the government at essentially no risk and cover its costs and rebuild its balance sheets. The sector was pushed by the rise in deposit rates to seek riskier customers (an explanation that would likely please Minsky). Commercial and industrial loans grew almost immediately following the rise in interest rates in February 1994, suggesting that willing borrowers existed at that time. We do not face this situation today, Galbraith said, because there are few dissatisfied borrowers and the problem is a general uncertainty about the prospects for profitability and the expansion of private business. The bubble in housing prices is much more likely to unravel than accelerate, so private credit cannot be relied upon for an economic expansion.

The Iraq war may continue to have some positive effect on spending in the short run, but it may also generate some inflationary consequences for our economy, surmised Galbraith. Little attention has been directed to this consequence, but it is historically characteristic of warfare as a result of profiteering and bottlenecks in specific sectors. The supply and price of oil may be affected because war is import intensive and tends to draw resources away from sectors that feed growth, such as advanced technology. Wars tend to put upward pressure on pricing and downward pressure on the international financial position of the country, and the effects should be feared.

Galbraith agreed with Papadimitriou that prudent policy to sustain growth and rebuild employment must rely on the public sector. He proposed that we think in terms of a public strategy with a significant medium-term economic objective aimed at building a new climate of security so that the private economy can regain its confidence. This strategy should include public leadership in the fields of energy diversification, conservation, housing, and alternative transportation in order to reduce our vulnerability in the world economy and the peculiar geopolitics of oil. He also proposed that we address our enormous dependence on a strong financial sector to preserve our position in the world as the supplier of currency reserves and the consumer of last resort. One step is to broaden and deepen our technological base and improve a range of industries that serve the domestic market and can be competitively exported. We should also slow the growth of certain imports and consider the strategic orientation of trading policy, such as buying steel from the domestic market. Galbraith highly recommended a policy strategy that mobilizes our resources and is not subordinate to arbitrary financial objectives.

According to JAMES W. PAULSEN, the developed world is facing a long-term, deflationary-biased environment. However, in the next few years of the business cycle, he expects inflation to be a central issue, especially in light of surprising strength in the U.S. economy. He foresees three years of higher optimism and a return to a policy-tightening stance, likely followed by serious economic problems.

Paulsen noted that nobody bought into the good news during the current recovery cycle, in spite of one of the best economies in the last 15 years. He surmised that the traumatic experiences of the past three to four years have changed the way we approach and evaluate the same data and information. He further surmised that cautiousness and doubt were huge positives for the future because the Fed and other policy officials have stayed "over easy," which could result in more growth later on. Moreover, the U.S. economy will benefit from such stimuli as accelerated money growth, wide lending margins, a massive fiscal stimulus, a weak dollar, and low mortgage rates. No one is stepping on the brakes in the United States, he observed, and there is growth in China and Japan.

Paulsen combined all policies as a percent of GDP and reviewed the results historically. He found that this technique explained the major economic expansions and contractions in terms of policy. He believed that lack of pricing has been the main problem for the past seven years, and noted that pricing has started to rise. Corporations, then, have some flexibility again, the stock market has recovered, capital spending is back, jobs are emerging, inventories have started to rise, and the Fed is no longer impotent. Although the consumer is the weakest link, Paulsen expected consumer spending to be adequate in 2004. Jobs will replace the stimulants of refinancing and real wage increases, and the composition of spending will change from durable to nondurable goods, and from housing to services, which will generate more jobs. If interest rates rise, the vulnerabilities of the household sector related to debt will become troublesome in about three years and will probably lead to a consumer-led recession.

Paulsen produced evidence of higher inflation throughout the economic system. Within the last 18 months, every index changed from year-on-year deflation to inflation, and core consumer prices have risen. He noted that much of the character of the 1990s has changed, and he expects that our number one obsession—deflation—will be solved by policy. He further noted that our other obsessions—jobs and the war on terror—call for massive policy ease. He expects that these obsessions will be solved in the next few years, but with some unintended consequences.

In the United States, money grew slower than nominal activity from the mid-1980s to mid-1990s, a trend that produced deflation. In the last three to four years, however, the money supply grew faster than nominal activity, a trend that is a recipe for inflation. Paulsen found the same inflationary trends in terms of fiscal policy, the value of the dollar, real yields, debt growth, and industrial capacity.

Paulsen observed that the decade of the 1990s was the only economic expansion in the postwar period in which supply led demand. The situation today, however, resembles the economic expansions of old, where demand led supply. In addition, global competition is much less significant today because of the decline of the dollar, which had risen 50 percent between the mid-1990s and 2002, a period when we imported international price competition. A significant amount of deflationary pressure came from high traded durable goods, but durable prices may flatten out as the dollar continues to weaken, he said. For the first time in a long time, Paulsen expected positive manufacturing job growth in May.

Speaker: MICHAEL H. MOSKOW

The output gap—the difference between actual and potential output—was the frame of reference used by Michael H. Moskow, president of the Federal Reserve Bank of Chicago. He noted that the output gap summarizes the effect of numerous frictions in the economy that can slow the adjustment of aggregate demand and productive resources to a sustainable equilibrium. A positive output gap (underutilization of resources, which describes our recent environment of excess capacity and higher unemployment rates) decreases inflationary pressures, while a negative output gap (demand exceeds long-run, sustainable productive capacity) increases them. He further noted that since the output gap cannot be measured with precision and must be supplemented with judgment, monetary policy has to be formulated in an environment of uncertainty.

Moskow observed that the impressive growth of economic output in the past nine months has narrowed the output gap. The Fed's policy challenge is to accommodate economic activity and to close the remaining gap without overshooting the level of potential output and generating inflationary pressures. He further observed that monetary policy is a very blunt instrument that is incapable of addressing imbalances in individual sectors, so policymakers must consider the risks that imbalances pose to the economy at large.

Moskow attributed the current output gap to the recent recession (March to November, 2001) when real GDP declined as businesses cut back on capital investments and inventory spending. He noted that the mild recession (a quarter of the average decline of recessions since 1960) was followed by a moderate recovery as a result of a series of shocks (e.g., the war on terrorism, corporate malfeasance, and the Iraq war), which led to heightened uncertainty and diminished confidence about the economy. Although the economy stopped shrinking at the end of 2001, the output gap did not narrow. However, real GDP increased at an annual rate of more than 5.5 percent in the past three quarters, a trend that implies significant progress in narrowing the output gap.

In line with other presentations, Moskow reiterated that job growth has been the missing link for much of the recovery. He noted that in spite of recent gains, payrolls are still below the level reached when the recession ended and that analyst explanations for the jobless recovery include unusually high sectoral reallocation (e.g., a sharp decline in manufacturing employment and outsourcing to other countries). Moskow pointed out that the U.S. economy is very dynamic and the monthly job numbers do not reflect the fact that, on average, more than 2.5 million new jobs are created each month and approximately the same number of jobs are destroyed (308,000 new payroll jobs in March reflected the net change in employment). Since the rates of job creation and destruction are relatively low today, the current pace of job reallocation is not high. Moreover, the decline in manufacturing and the increase in international outsourcing appear to be consistent with long-run trends and usual changes over the business cycle, so the situation is not a case of heightened reallocation. According to an estimate from Goldman Sachs, only 300,000 to 500,000 jobs have been lost due to outsourcing since 2000, and this number is not large relative to the size of the U.S. economy.

Moskow maintained that the United States has been challenged by growing competition over the past 50 years, but that our economy has been remarkably flexible (it generated over 80 million net new jobs). Technological advances, for example, often give rise to new industries that replace the jobs lost to foreign competition, but jobs resulting from unforeseeable innovations in technology are impossible to predict. The impact of job losses in terms of human costs must be dealt with by easing the transition (e.g., financial assistance, retraining programs, or other efforts), and dynamic changes in the economy are important if we are going to continue to increase overall incomes and our standard of living.

Moskow suggested that weak employment growth could be explained by new employment practices. There has been a rapid increase in "just-in-time" hiring, such as temporary health services (now 2.0 percent of employment compared to 0.5 percent 20 years ago) and the consulting industry. Moreover, temp agencies now provide more light industrial and technical workers. Temporary workers allow firms to vary the scale of their operations and to have greater flexibility when hiring. These options suggest a structural change in the labor market. However, a more fundamental explanation is that employment growth will be slow if aggregate demand is weak relative to gains in productive capacity.

Moskow noted that aggregate demand languished in 2002 and early 2003, while firms successfully exploited advances in technology and took advantage of capital investments in the late 1990s. Productivity increased rapidly, so potential productive capacity likely advanced much more sharply than demand. Since mid-2003, however, aggregate demand has outpaced the growth rate of potential output, leading to an increase in employment. Moskow believes that economic growth will remain solid, so employment should accelerate in light of productivity gains, fiscal stimulus, accommodative monetary policy, replacement demand for capital equipment,and improving conditions abroad.

Moskow concurred with the Federal Reserve's February forecast of a real GDP growth rate of 4.5 to 5.0 percent in

2004. In spite of such risks as inflation and imprecise output gap measures, he noted that consumer price inflation is still very low, so he was not worried about an increase in inflation at the macro level. Unit labor costs have been falling for the past two years, thanks to strong sustained productivity growth, and this trend should help contain overall cost pressures. As the output gap narrows, we must remain vigilant, cautioned Moskow, who maintained that the real federal funds rate would have to rise to a more compatible level with long-run sustainable economic growth.

In conclusion, Moskow was encouraged by the growth outlook for 2004 (disinflation has subsided) and he did not foresee any broad-based inflationary pressures. The U.S. economy has begun to meet the challenge of a jobless recovery in light of its entrepreneurial culture, market-based principles, and technological advances. He expected solid growth and price stability in the years ahead.

Session 2. The Macroeconomic Prospects for the U.S. Economy

The session was moderated by Resident Research Associate GREG HANNSGEN. There were presentations by ROBERT Z. ALIBER of the University of Chicago; ROBERT W. PARENTEAU of RCM; and Senior Scholar L. RANDALL WRAY of the University of Missouri–Kansas City.

ROBERT Z. ALIBER noted that he became aware of the real estate bubble in Asia during a business trip to Hong Kong and Bangkok in March 1997. His subsequent forecast of exchange rates was correct, although his prediction for asset prices was not. The theme of his remarks focused on the transfer problem and asset prices.

Aliber concluded that we have lived through 30 of the most tumultuous years in international finance in the last two centuries. As evidence, he noted the highest peacetime inflation rate in the 1970s, the very large swings in commodity prices, the overshooting and undershooting of real exchange rates, the massive collapses of national banking systems, and the fact that the United States was the world's largest creditor country in the 1980s and its largest debtor country by 2000. He also noted that the Japanese bubble caused other real estate bubbles, and that the robust change in current account balances in Asia was reflected in the U.S. credit accounts (when the trade deficit increased by $150 billion). He argued that part of the U.S. asset and stock price bubble was associated with a surge in capital inflows—the transfer problem.

Aliber outlined shocks on both sides of the balance sheet. On the asset side, a predominant shock was financial liberalization, which explained much about the Japanese and Scandinavian cases. He observed that Brady bonds formalized the bankruptcy proceedings of developing countries and made them eager recipients of foreign capital. There were good news shocks from the point of view of Mexico, Brazil, and Argentina, when the U.S. money supply and growth rate surged and there was rapid growth in offshore dollar deposits that could be used by banks as a resource for loans. Mexican government policy (privatization, macrostabilization, and liberalization) led to tremendous growth in Latin American investments, but some countries developed high current account deficits (7 percent of GDP). When the inflow of hard capital ceased, these countries did not have the funds to finance their trade deficits. On the liability side, these monetary shocks caused debt growth rates that were 2.5 times the interest rate, so countries resorted to Ponzi finance.

In Japan, when industry demand for loans eased, the banks competed for prime real estate and stock loans. There was also a surge in foreign banking. When banks made loans to generate income and cover operating expenses, they focused on real estate. When the Bank of Japan began to limit economic growth and real estate loans in the early 1990s, it was bad news for Japan but marvelous news for Asia. The slowdown in the rate of growth led to a real appreciation of the yen, so Japanese firms invested in other parts of Asia. Very rapid direct investment supported the Japanese banking system and caused a surge in capital inflows for other Asian countries, which developed very large current account deficits and overvalued currencies.

Aliber noted that good news shocks for one country might be bad news shocks for another (e.g., the surge in demand for hard assets and a significant real depreciation of the dollar in the 1970s was good news for Americans interested in a low inflation rate, but bad news for banks in the U.S. farmland and Mexico). In many cases, a very rapid growth in the supply of credit to a particular group of borrowers induces an exceptional increase in the rate of growth of the monetary base. Although countries do very well when they secure foreign capital, a large part of the increase in productivity is due to the terms of trade effect. Real appreciation of currencies only makes it appear that national productivity rates have shifted.

Aliber noted that speculation in currencies can be destabilizing and he suggested that real exchange rates are endemic as long as there are variable cross-border flows of capital. Therefore, the market exchange rate has to change in order to affect the current account. Macrofunds can be momentum craters and international equity traders are essentially coattail riders, he said. He further noted that transitory phenomena can have very large permanent effects.

In terms of the transfer problem, Aliber outlined the process that countered his 1997 forecast of asset prices in Asia. The change in the current account ($150 billion) resulted in a change in the capital account. When their currencies depreciated, Asians bought $150 billion of U.S. dollar securities from Americans, who in turn bought securities from other Americans, which resulted in asset price escalation. Wealth increased, so Americans reduced their savings out of current income. In the adjustment process, asset prices have to increase enough so that the increase in the household consumption rate as a percentage of income (or a decrease in the domestic saving rate) is more or less equal to the increase in the inflow of foreign savings. Asset prices continue to increase until the domestic saving rate declines. This process was responsible for massive bank failures in many countries (with the exception of Japan), where domestic borrowers were on an unsustainable borrowing trajectory. Shocks such as a change in interest rates, capital inflows of stocks, or currency depreciations caused the banking system to collapse.

Aliber explained the change in the U.S. international investment position by noting that our external payments position is unique because it adjusts passively to events in other countries. Domestic credit growth is highly correlated with the real exchange rate; the transfer problem stems from cross-border flows of capital (e.g., China experienced capital inflows in the past year in anticipation of revaluation gains from its currency).

ROBERT W. PARENTEAU focused on the household sector and warned of real problems following the removal of policy steroids or during the onset of another recession, as policymakers would be faced with difficult containment problems. He believes that the Washington consensus view is to let a bubble run its course, unless it threatens price stability, and to inject liquidity into the economic system if the bubble bursts. He noted that the reasons behind the very shallow recession in 2001 include the presence of a very resilient financial system and the distribution of risk through new financial instruments. In addition, the fiscal response (tax cuts) helped Wall Street, as did greater government surveillance and transparency. However, the consensus view suggests that the fiscal deficit is the only worry—ignoring the accumulation of household debt or the current account deficit—and that policy should monitor inflation risks and the output gap.

Parenteau outlined three flaws in the consensus view: (1) the financial balance equation shows that the private sector balance will widen and return to deficit if the fiscal deficit is reduced before the current account deficit has improved (the sequencing problem must be recognized); (2) the private sector has adjusted on the business side, but the household sector has persistently engaged in deficit spending, which is very unusual; and (3) the flow of funds data suggests that households have grossly exceeded debt accumulation expectations and that they have managed finances like a hedge fund operation.

After the bubble burst in 2000, the household saving rate and the trade deficit did not meet Parenteau's expectations and he was puzzled by three things: (1) Why did the business sector restrict its expenditures while the household sector continued its deficit-spending behavior? (2) Why did household debt explode relative to its financing gap? and (3) Why is there an enormous gap among changes in household debt, total debt, and the externally financed sector? The collapse in the equity market did not result in a rebound in the gross saving rate and a decline of net debt. Parenteau observed that 78 percent of the U.S. economy is now accounted for by personal consumption and residential investment (a record high).

Parenteau believes that U.S. government policy was designed to keep the consumer in play (e.g., multi-year tax cuts and low mortgage rates). Since corporate bond yields did not decline until 2003, there was a difference in the cost of capital between the two components of the private sector (household and corporate). He proposed that the components had different expenditure behaviors in response to policy. The household debt-to-income ratio is significantly off trend, noted Parenteau, and he asserted that proposals of balance-sheet adjustments in the household sector miss the point.

Two possible explanations for the increase in household debt are that households may have leveraged their real estate holdings in order to reposition their financial assets, or that there have been large intrasectoral flows between creditor and debtor households (highly concentrated equity and bond ownership suggest that upper-income households may have successfully raised their saving rate, while middle-income households have increased their debt). He noted that some monthly data give a sense of liquidity-preferred shifts on the margin. Parenteau was not comfortable with these explanations because, in his view, households should not act as hedge funds nor should the middle-income household sector greatly increase its debt.

Parenteau foresaw some risk associated with the Washington consensus's asymmetric response to a bubble because it may recreate a bubble in another asset class that could burst and create a larger problem. A variety of private agents seem to be gaming the Fed's policy response, an action that could lead to exit strategy problems for policymakers. There is a moral hazard, he noted, when policymakers are perceived to place a floor on financial asset prices or to encourage risk taking within the private sector. What appears to be stabilization in the post-bubble period has been bought with a Faustian bargain, he asserted, since households are encouraged to act abnormally and change their portfolio behavior (the "Greenspan doctrine" may have distorted investor behavior). There is likely to be some financial market rockiness when it becomes clear that the Fed is heading toward a more normal federal funds rate.

L. RANDALL WRAY outlined his views of the "D" words that are notable in today's economic literature—deficits, debt, deflation, and depreciation. A summary of his presentation appears as Policy Note 2004/2 on page 25.

Session 3. Financial Instability in a Global Economy

The session was moderated by Institute Professor PHILIP ARESTIS. There were presentations by ILENE GRABEL of the University of Denver and DOREEN ISENBERG of the University of Redlands.

Under the assumption that it is in the interest of developing countries to curtail financial risk, ILENE GRABEL proposed a system of trip wires and speed bumps that reduce risk, as well as the frequency and depth of financial crises. Trip wires measure the types of financial risk that confront individual economies, while speed bumps are narrowly targeted and gradual changes in policies and regulations that are activated whenever trip wires reveal economic vulnerabilities. Grabel noted that her system is very strongly indebted to Minsky's understanding of the root causes of financial instability and is much better than early-warning models, such as the International Monetary Fund special data dissemination standard, that fail to predict crises in the developing world.

Grabel outlined various early-warning models in the public and private sectors, especially the Goldstein/Kaminsky/Reinhart model. These models were based on the idea that financial crisis prevention required both good predictors that fill in the information gaps and an open, liberalized regime, so that agents (self-regulating actions of rational private actors) could reallocate portfolios in response to apparent problems. She noted that the empirical performance of these models has been dismal.

Grabel outlined six underlying problems of early-warning models: (1) they depend on the availability and accuracy of information; (2) they presume that the interpretation of predictors is a science rather than an art; (3) they are predicated on the false notion that financial crises in all developing countries have the same root causes; (4) model refinements assume that crises are a consequence of informational inadequacy rather than a fundamental feature of liberalized financial environments; (5) economists often fail to predict economic turning points, and developing economies cannot afford the cost of failed efforts; and (6) we do not know whether investors will respond to predictions in a manner that is market stabilizing or destabilizing.

The trip wire approach tries to target particular financial risks by country and it recognizes that national policymakers are in the best position to design trip wires for their unique economic vulnerabilities. Grabel outlined various financial risks and ways to identify them. For example, currency risk could be revealed by the ratio of official reserves to short-term external obligations, or by the ratio of official reserves to the current account deficit. Fragility risks are associated with shocks that jeopardize the ability of private and public borrowers to meet current obligations (e.g., maturity or location mismatches). She suggested that financial regulators in developing countries should consider banning the use of off-balance sheet activities, since their economies cannot afford to bear the risk of nontransparent financial activities.

Flight risks include lender flight risk (e.g., the ratio of official reserves to private and multilateral foreign currency-denominated debt) and portfolio investment flight risk (e.g., the ratio of total accumulated foreign portfolio investment to gross equity market capitalization). Cross-border contagion risk (falling victim to instability in another country) was another risk that had a great deal of empirical relevance given recent events in the developing world. Grabel proposed trip wires activated in one country in response to crises or speed bumps implemented in another, and she recommended that national policymakers establish and periodically revise appropriate trip-wire thresholds that account for particular characteristics, vulnerabilities, and technical capacities.

Grabel also recommended that speed bumps should be modestly transparent, implemented gradually, and designed so that they govern inflows rather than outflows (to reduce investor panic). She noted the advantages and disadvantages of automatic versus discretionary speed bumps, and concluded that there was no ideal single strategy that could be applied to all developing countries. She suggested that speed bumps should be mainly automatic, but did not rule out the use of discretion by regulators. An important difference between the trip wire/speed bump approach and the Goldstein/Kaminsky/Reinhart model is that a successful approach does not depend, to the same extent, on the adequacy of information.

DOREEN ISENBERG focused on the transformation in banking regulations and the United States' financial stability in a globalizing economy as a result of the new Basel 2 capital accord. She outlined the recent history of financial restructuring, which promoted an increase in price competition among different types of financial institutions by allowing them to offer the same services and a level financial playing field. She argued that Basel 2 was the next big step in global transformation of financial markets and noted that it was actively supported by the United States. Basel 2 proposes to transform the current supervisory and regulatory structure of depository institutions worldwide, as Basel 1 did in 1988. Basel 2 also proposes to alter the capital adequacy requirements, increase regulatory flexibility, and promote a greater reliance on market decision making and discipline. Part of the process involves moving toward reliance upon risk management models, she said.

Isenberg's presentation focused on credit risk management, expected changes in macroeconomic financial stability, and the question of whether Basel 2 would pass a Minskyan test of financial stability. She noted that Basel 1 induced banks to hold more capital and was considered to be a very successful transformation. She further noted that the objectives of Basel 1 and Basel 2 appear to be the same—to level the international playing field and promote greater financial stability in the international arena. However, Basel 2 approaches its goal of stability from a very different perspective: it accepts risk taking rather than moving away from riskier activities and assets. The objective of supervision is to assist the management of risk, and the focus of Basel 2 is to strengthen the regulatory capital framework for large, internationally active banking organizations.

Isenberg outlined three pillars of Basel 2: credit and operational risk management, the supervisory process, and market discipline as regulation. She noted that the standardization of credit risk targets small banks, while the foundation and internal risk-based (IRB) approaches are aimed at very large banking institutions. She further noted that Basel 1 resulted in regulators providing the information, while Basel 2 targets banks for more information. The Basel Committee for Banking Supervision (BCBS), however, will continue to provide data and information in order to assist small banks.

Using the foundation approach, the probability of default is provided by banks, while the supervisory values are provided by the BCBS. In the advanced IRB approaches, banks provide information. Isenberg wondered what would happen to credit-risk weights, which are associated with different kinds of debts and assets and are very important as lending incentives derived from this kind of structure. She observed that Basel 1 had its biases so that there were privileged debts, such as short-term debts and the debts of OECD borrowers. She further observed that the transformation of incentives in Basel 2 would be positive because longer-term debt would be given a lighter weight than short-term debt, and non-OECD borrowers would not necessarily be assigned a 100-percent-risk weight. These changes are better from the perspective of developing countries.

According to Isenberg, the real controversy is the adoption of the advanced IRB approaches, whose rate group includes banks with assets in excess of $250 billion or total foreign expenditures of $10 billion or more. In the United States, there are 10 banks in this group and they represent 99 percent of foreign assets and more than 65 percent of total assets held by U.S. banks. She expected an additional 10 banks to adopt the IRB approach, and other banks to follow over time.

If the first pillar (credit and operational risk management) passed, Isenberg foresaw four possible sectoral and macroeconomic effects in terms of cost reduction, sectoral concentration, procyclical lending, and regulators as managers. A significant reduction in the minimum capital requirements for large banks—without sacrificing risk ratings—would place small banks at a competitive disadvantage, she said. A Fed study showed that the reduction would result in a 33 percent lowering of marginal costs, which would, initially, accrue only to large banks. Moreover, as the innovations in risk management that lie at the heart of Basel 2 are very costly, small and medium-sized banks are not expected to adopt them. This response would result in eventual failure or merger with larger institutions and even greater concentration in the financial sector. What will happen to the markets that are served by small banks, asked Isenberg?

Banking is a procyclical industry, but financial regulations have helped to counter the boom/bust banking cycle. Isenberg noted that risk management programs and external credit rating agencies are implicated in the amplification of the procyclical nature of Basel 2. She further noted that the best practices arising from Basel 2 would encourage banks to develop and use better risk management techniques, so the unique element of Basel 2—an internal risk-based approach—would therefore encourage regulators to rely on industry for valid approaches and new insights. There is increased pressure for regulators to insure that the banks' actions and decisions are correct, stated Isenberg.

In the Minkyan perspective, Isenberg noted, financial relations are an integral part of capitalism, which is defined as a web of uncertainties held together with a series of promises, and the capital system is driven by profits, which depend on investing. Market restructuring is important, since one set of regulations does not always apply, particularly in light of the evolution of risk perceptions that change over time. Therefore, in terms of Basel 2, the adoption of a sound, internally determined banking system, without regard for its external, industry-wide connections, is a problem. Isenberg pointed out that risk is not readily identifiable, categorically consistent, or quantifiable, but econometric models are used to manage risk. She further noted that, according to Minsky, increasing bank size and concentration within the sector would be destabilizing. Moreover, a small fracture in one part of a highly concentrated banking sector could amplify the impact on the entire financial system.

Session 4. The Changing Role of Fiscal Policy

The session was moderated by Senior Scholar THOMAS L. HUNGERFORD. There were presentations by Institute Professor PHILIP ARESTIS, Senior Scholar L. RANDALL WRAY of the University of Missouri–Kansas City, and Research Associate STEVEN M. FAZZARI of Washington University in St. Louis.

In a coauthored study with Senior Scholar Malcolm Sawyer of the University of Leeds, PHILIP ARESTIS noted that macroeconomic policy has focused on monetary policy rather than fiscal policy. He disagreed with economic theories such as the "new consensus" that suggest fiscal policy has a limited role to play in influencing aggregate demand. Fiscal policy should be reinstated as a tool of macroeconomic policy, an action with which Minsky would agree, asserted Arestis. A summary of the coauthored paper appears as Working Paper no. 381 on page 15 of the Fall 2003 *Summary*.

In a coauthored paper with Stephanie A. Bell of the University of Missouri–Kansas City, L. RANDALL WRAY outlined a Minskyan assessment of the War on Poverty after 40 years. A summary of his presentation appears as Working Paper no. 404 on page 8.

In a coauthored paper with Piero Ferri of the University of Bergamo, Italy, and Edward Greenberg of Washington University in St. Louis, STEVEN M. FAZZARI presented a cycle model that focuses on the financing of investment and formalizes a part of Minsky's theory. The model links two themes: the Minsky cycle (the macroeconomic cycle is driven by finance) and the linkage between investment and finance (the microeconomic empirical evidence). The engine of the first theme is finance and the accumulation of debt, so one objective was to find out how this process is relevant in the current U.S. economy. The second theme is central to Minsky's theory of financial instability and cyclical analysis. The microeconomic analysis looks at the impact of financial constraints, cash flows, and financial effects on investment at the level of the firm.

Fazzari summarized the Minsky financial cycle and noted that each cycle has its own special characteristics and is specific to a particular historical period. He also noted that firms with more internal funds will invest more, but that this commonsense idea was difficult to show empirically and was not a focus of mainstream economists. He further noted that the empirical challenge was to identify the financial implications of cash flows and profits as a proxy for investment opportunities and demand, and that research has successfully shown the effects of financing. Approximately $0.35 of every dollar of cash flow goes toward fixed capital investment and, since firms also engage in inventory adjustment and working capital, the effects are significant.

According to Minsky, today's investment generates a set of financial commitments over time that impose an inherent dynamic in the economic system. The main question for the authors was whether or not a formal model would generate economic cycles, and a key aspect was linking interest rates with the cycle. The central dynamic is that higher interest rates in a boom raise debt-service costs and squeeze cash flows, so the model's purpose was to determine how this dynamic comes about.

Key features of the model include an investment function calibrated to recent empirical results and embedded in a Keynesian macroeconomic model in which cash flow is determined endogenously. The basic dynamic process is driven by: (1) the Phillips curve effect of unemployment on inflation; (2) the effect of changing inflation on inflation expectations and nominal interest rates; (3) the impact of nominal interest rates on debt service; and (4) the effect of debt service on cash flow and investment. A careful accounting of debt dynamics is difficult from a technical point of view, Fazzari noted, so it is important to pay attention to the stock-flow relationships in order to correctly forecast debt. Since debt dynamics generate certain nonlinearities in the model, simulations were applied to analyze and predict macro behavior. Therefore, the authors chose some realistic parameter values and linked the analysis with solid empirical work, especially on the investment side. They were careful to match the Phillips curve inflation/interest rate dynamics with the empirical evidence so that their model design was realistic.

The authors found that their set of basic investment-cash flow relationships generated well-defined, cyclical output fluctuations (Minsky-style cycles), which were empirically robust and very persistent. They also found that the cash-flow term in the investment function (the internal finance effect on investment) generated the cycles. Interest rates and debt service costs are key, said Fazzari, and debt levels also followed the Minsky pattern. Contrary to the notion that frictions are the problem (i.e., if prices were more flexible, things would be fine), a quicker response of prices and wages to unemployment (larger values for the slope of the Phillips curve) increased the model's volatility because it accelerated inflation/interest rate/debt service dynamics. This finding contrasted sharply with the New Keynesian macroeconomic perspective. Consistent with the conclusion that debt and financial effects on investment generate the cycles of the model, an increase in the real interest rate made the economy more volatile and shortened the cycle period.

The authors also found that the amplitude and frequency of the cycles depend on how nominal interest rates respond to stages of the business cycle. The dynamic process identified a fundamental non-neutrality of money and monetary policy operating through the financing of investment. If investment depends on cash flow, nominal interest rates drive real investment. Endogenous aggregate cycles are driven by demand-side rather than supply-side factors, which are emphasized in real business cycle models. Fazzari noted that the cycles do not rely on stochastic shocks.

The implications of these findings are that Minsky's debt dynamics are relevant and that setting interest rates procyclically is destabilizing. Fazzari expressed an interest in gaining insight into how financial factors spill over onto the consumption side, which seems to be increasingly important in the current economic situation. The authors' observations suggest important possible extensions of their work to the analysis of the monetary transmission mechanism and monetary policy.

Speaker: MARTIN SHUBIK

According to Martin Shubik of Yale University, the problem of forecasting relates to context. Once context is set up, the rest of the world appears as exogenous variables. He noted that the forecasting business is good at two types of forecasts: (1) short-term forecasts based on linear extrapolation, which are embedded in the reality of the world around us (although exogenous events, such as terrorist activities, can blow a hole in macro projections); and (2) long-term forecasts in small areas with a well-defined, ongoing physical process and a long (pipeline) delay.

Shubik made the point that there is a divide among useful business economics, useful macroeconomics, and basic microeconomic theory. The relationship between basic micro theory and operating macro theory should complement each other, he said, but one must realize that they have completely different time scales. His fundamental question was, "What are the invariants in an economy with respect to both money and financial instruments?"

Shubik was adamant that the question comes first and a useful simulation should then be built in three steps: (1) the question and selection of input in view of the time scale; (2) the building of a formal model; and (3) the selection and interpretation of output. He stressed that it was paramount to design the inputs and outputs before building the model. There is no such thing as a general purpose simulation, but there is a good ad hoc simulation directed to the question at hand.

According to Shubik, another major hangup of micro- and macrotheorists is the concept of rational behavior in economics. He believes that rational behavior should be applied with some important modifications, such as a belief in political economy rather than economic theory, per se. His concern was "context rational behavior," but he asserted that modern financial theory has been dominated by mathematicians who disconnect theory from context. A danger is that mathematical finance tends to regard common stock as lottery tickets, without regard to the underlying businesses or real connections between paper ownership and the businesses themselves. He finds that mutual funds are intervening mechanisms that dominate over half of the market, which means that people are actually buying lottery tickets on lottery tickets. Modern finance is dominated by balanced portfolios and fancy instruments rather than by security analysis, he said.

Shubik noted that while behavioral finance is reputed to have been invented about four or five years ago, there has always been a reinvention cycle. He also noted that he and Hyman Minsky were particularly interested in economic dynamics and coherence since all degrees of freedom in a dynamic economy are used up by the equilibrium condition (e.g., money and financial institutions disappear because they are not necessary). A domain of disequilibrium, however, results in a completely different array of degrees of freedom.

Shubik recounted his association with Minsky and stated that Minsky had great skepticism about how far one could push mathematical economics. Selecting the correct and relevant variables was much better than statistical econometric technology, suggested Shubik. Minsky's observations stressed the appreciation of mechanisms in understanding economic dynamics. An example of an invariant in a good economy is Social Security, but its institutions have changed markedly over time. Shubik recommended an approach encompassing what he called "mathematical institutional economics," which goes beyond formal equilibrium theory.

Due to his background in simulation game theory and experimental gaming, Shubik believes all viable economic models should be built as simulations capable of being played as a game. In the transition from equilibrium theory to a playable game, one goes from a single point in space, which has already lost dimension owing to the equilibrium conditions placed on it, to the whole-state space of behavior (and action), which requires specification of the rules of the game that are carriers of the process (the instruments and institutions of society). And micro details of modeling are extremely important when dealing with macro and disequilibrium phenomena. Good policy applied in an inappropriate manner or time period may be worse than no policy, he noted. According to Shubik, when you try to build process models, even at the level of general equilibrium theory, you start to invent every financial instrument.

Evaluating an economic system in terms of the whole-state space of behavior and economic dynamics must address the questions: "What is the tradeoff between prediction and control, and what is the role of flexibility?" Macroeconomists should be interested in control, noted Shubik. His discussion with Minsky about the size of government in a "reasonable" democratic state (they determined that 20–30 percent of GNP should flow through the government) is not often presented in textbooks, he observed. He further noted that a decent stochastic multivariate model of the real world is currently beyond our capabilities. Moreover, the job of government is to control the economy, not to predict things that cannot be predicted.

Speaker: MAURICE HINCHEY

According to Congressman Maurice Hinchey (D-NY), the current economic recovery has been characterized by unprecedented and seemingly contradictory economic indicators, and accompanied by fiscal policy that is radically different from that of the 1990s. He contended that it was necessary to examine what has transpired on the economic landscape since President George W. Bush took office in order to judge whether the U.S. economic recovery can be sustained.

Hinchey noted that the call for $2 trillion worth of tax cuts was based on federal surpluses during the presidential campaign, but based on a slowing economy and federal deficits thereafter. Although the economy has been in recovery and has grown since the fourth quarter of 2001, Americans have not felt the benefits, he said. Historically, this is one of the most painful recoveries on record for the lower- and middle-income classes, as well as the working poor. Hinchey warned that the economy is built like a house of cards that is likely to collapse in light of unyielding neoconservative ideology and economic modeling after that of the Reagan administration. The current predicament is a jobless recovery accompanied by debt-laden economic expansion. Hinchey noted that 2.4 million jobs have been lost since the start of the Bush administration and 8.4 million people are unemployed. The long-term unemployment rate is 9.9 percent if you include people who gave up looking for a job and people working part time because they can't find full-time work. According to Hinchey, Bush has the worst job creation record of any modern president.

The distressing news also includes a significant drop in median household income in 2001 and 2002 (typical household income is down $1,400 since Bush took office) and a rapidly growing disparity between rich and poor. Poverty has increased for the first time in six years (by 1.3 million), with 33 million Americans (12 percent of the population) now living in poverty. Moreover, more than 4 million people have lost their health insurance since 2001. Under President Bush, the country went from record budget surpluses to record budget deficits, and the $5.6 trillion surplus projected over 10 years has turned into a $2.9 trillion deficit, due mostly to nearly $3 trillion in tax cuts. Hinchey gave Bush's economic record failing grades across the board. He noted that Canada had added a million jobs since 2001, while the United States lost more than 2 million jobs. The disparity could be traced to differences in economic policy, he said, pointing out that Canada's tax-cut package was directed to lower- and middle-income households and its national healthcare system removed health coverage as an impediment to hiring.

Although consumer spending and housing have fueled economic growth, personal income is not keeping pace with inflation. Consequently, people are tapping home equity and increasing their credit card debt. Record high home ownership rates (69 percent) are accompanied by record high mortgage ($6.82 trillion) and other debt ($2 trillion). The record level of personal and federal debt is creating a debt bubble, which will crowd out funds for private investment and lead to a rise in long-term interest rates. As debt payments increase and disposable income declines, Americans will not be able to spend at the same pace and the foundation of the house of cards (consumer spending) will crumble, Hinchey warned.

Hinchey noted that tax cuts at the federal level have led to tax increases at the local and state level for the majority of citizens, so people are paying greater net taxes than before the Bush tax cuts. Moreover, states and localities are forced to pay for an increasing number of federal mandates (e.g., Medicaid services and educational programs), which has resulted in cuts to state and local programs and services, combined with a rise in local taxes. With higher interest payments on the national debt, this situation effectively amounts to a debt tax of $2,109 for a family of four (58.7 percent of the income tax liability for a median income family of four). By 2008, the numbers are expected to amount to $3,705 and 71 percent. Moreover, the alternative minimum tax (AMT) affected 1 million taxpayers in 1999, but will affect 33 million taxpayers by end of this decade (97 percent of families with annual incomes between $75,000 and $100,000). This needs to be fixed, stated Hinchey, but it would be costly ($780 million), and increased borrowing would increase the debt tax. Bush has no plan to deal with these economic problems and his budget makes these conditions worse, he said. Hinchey was concerned about the state of the U.S. economy in both the short and long term, and expected that Bush's failure to address many of the problems would lead to massive economic distress as early as the second quarter of 2005.

Session 5. Money, Risk, and Policy

The session was moderated by Resident Research Associate W. RAY TOWLE. There were presentations by Research Scholar CLAUDIO H. DOS SANTOS, Resident Research Associate GREG HANNSGEN, and ROBERT PRASCH of Middlebury College.

According to CLAUDIO H. DOS SANTOS, models associated with the formal Minskyan literature present underdeveloped financial structures and treat financing issues with oversimplified hypotheses that do not do justice to the richness of Minsky's analyses. A summary of his presentation appears as Working Paper no. 403 on page 14 of the Spring 2004 *Summary*.

GREG HANNSGEN used Minsky's financial fragility hypothesis and financial theory of the business cycle to formulate a model and study the effects of monetary policy, while simultaneously omitting those elements that Minsky's critics find objectionable. He found that it was possible to adhere to Minsky's theory of investment even if one assumes that many of the critiques of his post-Keynesian antagonists are correct.

A summary of Hannsgen's paper appears as Working Paper no. 384 on page 18 of the Fall 2003 *Summary*.

After 25 years of privatization and deregulation, Americans are left with an increasingly risky economic structure, asserted ROBERT PRASCH. He presented a number of recent examples that showed that we, as consumers, employees, and savers, are forced to accept ever-increasing quantities of price and quality risk. For example, the senior executives of Delta Airlines quietly funded a special account to ensure that their own pensions would be completely protected in the event of bankruptcy. Who are the risk takers, he asked, and are they being compensated with additional rewards for the increased risks that they routinely undertake?

Prasch noted that in the event of unequal bargaining power, legalized protection, and asymmetric information, there is a tendency to separate risk from reward. He expected that the systemic shifting of risk toward those who cannot afford, control, or want it will continue (e.g., deregulation of the electricity market), and that this trend is contributing a higher sense of insecurity among middle- and working-class Americans. He also noted that deregulation, particularly financial deregulation, is valued by its beneficiaries, partly because of the ability to separate risk from reward.

Prasch outlined four main reasons why risk is shifted toward smaller parties and less informed stockholders, customers, and the general public. One reason is that decision makers in the U.S. capitalist system enjoy legal protection from full responsibility for the risks that they generate (e.g., legal limited liability). This tendency has been exacerbated by the limited liability partnership, which has been adopted by the law and accounting professions. For example, former Arthur Andersen partners, who were in a position to understand and act on the developing crisis at Enron, were fully protected, while company shareholders, pensioners, and creditors were left in penury.

A second reason relates to asymmetric information, which occurs when one party ("insiders") has privileged access to the specific characteristics of a situation, while another party ("outsiders") does not. Insiders can create new risks without the knowledge or understanding of outsiders. For example, financial products and markets have misrepresented the qualities of overly risky assets in order to sell them to customers. Prasch believes that theoretical and policy conclusions derived from such premises as free entry and exit, perfect information, and costless mobility—all of which lie behind the ideal situation (i.e., markets ensure a linkage between risks and rewards)—should be viewed with some skepticism.

A third reason is externalities, such as contagion or the shifting of risk to third parties who are not a party to the original contract. Prasch questioned whether decision makers account for the full impact of their actions, in terms of the level of systemic risk, when they act (e.g., purchase or sell assets, or increase leverage). He noted that markets reflect the private calculation of risk, but that they tend to underprice the risk faced by society as a whole. He observed that past ideas and laws that protected the general public have been deemed outdated without reason or argument. Totally free financial markets induce risks that pose a threat to the economy, asserted Prasch.

A fourth reason is that security might be a normal good. Since the wealthy are the decision makers in our largely deregulated financial markets, they could be presumed to make arrangements for a substantial degree of economic security for themselves. Moreover, they could be expected to use this security to generate more than the socially desirable quantity of risk for the market as a whole. Markets tend to concentrate risk in the hands of those who cannot afford it, so an increase in private risks contributes to passing along the full cost of risk to society as a whole. Prasch concurred with Minsky's observation that in a deregulated financial system risk has a tendency to shift to those least able to handle it, all things being equal.

Investigating the Intellectual Origins of Euroland's Macroeconomic Policy Regime: Central Banking Institutions and Traditions in West Germany after the War

JÖRG BIBOW

Working Paper No. 406, May 2004

www.levy.org/pubs/wp/406.pdf

Germany's postwar monetary history illustrates the evolution of central banking institutions and traditions within an intricate political power struggle. Many German economists hold that "ordoliberalism," the dominant economic theory of the time, shaped the new monetary economic order (social market economy) of West Germany. Research Associate Jörg Bibow investigates central banking in West Germany after 1945 and the legal status of the central bank that was enshrined in the Bundesbank Act of 1957. He finds that ordoliberalism did not impact the country's emerging monetary order, which included an early emphasis on an independent central bank and a stability orientation in monetary policy. Rather, historical accidents and peculiar personalities, who were able to mold public perceptions to fit political interests, appear to have been more important.

The author revisits the Allies' role in resurrecting a central banking system in West Germany and the conflicting views of central bankers and the Adenauer government on the issue of their relationship in economic policy development. Although Allied decentralization policy had a lasting impact on the federal structure of West Germany's central banking system, central bank independence was of German origin and design, observes Bibow. The Bank deutscher Länder (BdL), forerunner of the Deutsche Bundesbank, pushed for an extreme form of independence compared to prevailing international trends. From the BdL's viewpoint, it was unacceptable to have its discretion overruled by some "referee" (under government control), while the federal government's finance minister, Fritz Schäffer, found it equally unacceptable that the bank should be in a position to oppose the government.

The German tradition of central bank independence, established by the interim law in 1951, featured a vaguely defined remit for the bank together with its obligation to support the government's general economic policy. The federal government was forced to focus its leverage on the appointment of the bank's leadership, a route that conflicted with the vested interests of the Länder governments, notes Bibow.

Bibow reviews how central bank independence fits into the ordoliberal view of a sound economic order. He finds that the liberal ideas of Eucken and Friedman show a common conviction that the authorities should not be able to intervene at whim in the market process. They also agree that the fundamental issue is the role of the rate of interest as equilibrium market mechanism. Bibow's analysis of the Freiburg School confirms the notion that central bank independence is not compatible with ordoliberalism, which supports the establishment of a monetary order that does not involve interventions in the market process. Empowering some monopolist who is independent of political control with the right to fiddle with interest rates is not sound "ordnungspolitik," observes Bibow. He believes that interest rate policies that are currently practiced by central banks are ongoing interventions in market processes. The quest is on, he says, for a monetary order in which the determination of interest rates would be left to the self-control of markets.

The Bundesbank Act was passed in a year of federal elections, observes Bibow. The bank's position was bolstered by public opinion, and its role was legalized, making it a public authority of executive powers that could oppose the government at its own discretion, but without accountability to anyone. The flaw in this monetary structure is that it risks setting the incentives and interests of two players on a collision course, since the government and central bank are positioned as antagonists rather than partners in the pursuance of common goals. Bibow notes that exchange-rate issues have turned out to be a bone of contention on many occasions and he believes that the recession of 1966–67 was deliberately engineered by the Bundesbank.

The Bundesbank Act left the substance of the bank's independence essentially undefined, so the relationship and balance of power between the government and the central bank were left to be determined in due course—an outcome that would largely depend on public perceptions. In the BdL's first 10 years, its success in maintaining price stability won substantial praise from a society enjoying the benefits of economic success. Since the Bundesbank's independence was untouchable, the brief phase of Keynesianism, which allegedly began in Germany in 1967, did not include monetary policy, observes Bibow.

Bibow suggests that a task for future research is to investigate the extent to which Germany's monetary traditions may have contributed to its past economic performance and whether some peculiar setting might be replicable at the European level.

Program: Federal Budget Policy

Inflation Targeting and the Natural Rate of Unemployment

WILLEM THORBECKE
Policy Note 2004/1
www.levy.org/pubs/pn/pn04_1.pdf

Inflation targeting has become a common strategy of monetary policy, but it has not been adopted in the United States, despite the advocacy of some economists, including members of the Federal Reserve. Research Associate Willem Thorbecke of George Mason University reviews the natural rate hypothesis, upon which the case for inflation targeting is based, and recommends that the Fed continue to focus on its dual mandate—price stability and full employment. His recommendation is based on the fact that the natural rate theory has been a poor guide for policy making over the last 10 years and that macroeconomic performance under the Fed's dual mandate has been splendid.

Thorbecke reviews the Phillips curve models and the natural rate theory advanced by Friedman, who argued that there was a natural, market-determined rate of unemployment and that any attempt to use monetary policy to keep unemployment below the natural rate would produce accelerating inflation. Thorbecke notes that the natural rate theory predicted events well in the late 1960s and early 1970s, but not in the 1990s. Inflation did not pick up as unemployment fell below estimates of the natural rate. Part of the reason for this pattern lies in changes to the structure of the U.S. economy, says the author.

Thorbecke outlines the changes, which include a decrease in the bargaining power of workers (many of the unemployed were low-skilled workers), a decrease in the pricing power of firms, and an increase in productivity growth. Specifically, firms did not need to raise prices to cover higher labor costs, international and domestic competition limited the ability of firms to raise prices, advances in information and communications technology increased labor productivity and reduced unit labor costs, and increases in aggregate demand may have contributed to reducing the natural rate. These changes in the structure of the economy imply that monetary policy stimulation will be less inflationary and that contractionary policy will be less potent in quelling inflation. Rather, large swings in unemployment might be necessary to produce changes in inflation, observes Thorbecke. Therefore, if the Fed were to adopt inflation targeting, there would be more volatility in unemployment, which would adversely affect such groups as low-skilled workers, minorities, and single mothers.

Thorbecke does not support the idea that the Fed should announce current and target levels of the optimal long-run inflation rate (OLIR) or the nonaccelerating inflation rate of unemployment (NAIRU) because their measurement is imprecise and there have been massive forecasting errors. Specified numbers might take on a palpable reality that is undeserved, he says. Recent experience with falling unemployment suggests that the slack in labor markets should also be a focus for policymakers, since falling unemployment does not automatically lead to rising inflation. Indeed, long-lasting gains for low-skilled workers might ensue if workers become more productive when they are trained on the job.

Those "D" Words: Deficits, Debt, Deflation, and Depreciation

L. RANDALL WRAY

Policy Note 2004/2

www.levy.org/pubs/pn/pn04_2.pdf

Economic commentary has recently described the dangers faced by the U.S. economy in terms of deficits, debt, deflation, and depreciation. Senior Scholar L. Randall Wray of the University of Missouri–Kansas City reviews the dangers and takes exception to many of the concerns and arguments. Wray emphasizes that from the vantage point of the U.S. economy as a whole, imports are a benefit while exports are a cost (net imports mean that we consume more than we produce). The claim that the United States needs foreign savings in order to finance its persistent trade deficit makes no sense for a sovereign nation operating on a flexible exchange rate, he says. Wray concludes that current relationships among the three sectoral balances of the U.S. economy are more sustainable now than in 2000, and that the government's deficit- and debt-to-GDP ratios are not high compared with past ratios, or those achieved in other nations.

Wray examines the "triple threat" of U.S. deficits—private sector, federal budget, and trade deficits—and notes that an expansion driven by private deficits is unsustainable. He warns that a simple return to the historical average for private sector balances (a surplus of 2–3 percent of GDP) would lead to an aggregate demand gap of $300–$400 billion and a deep recession with double-digit unemployment. He further notes that there is no purely objective way to gauge whether the ratios related to the level of debt (the portion of income flows required to service outstanding debt and the ratio of debt-to-income flows) or the debt ratios for the federal government (government interest payments or sovereign debt relative to GDP) are excessive. Things are no clearer when it comes to external debt, he says, but two distinctions should be made: (1) there is a difference between public sector and private sector debt; and (2) it matters whether the external debt is denominated in the domestic currency. The second distinction does not apply to the United States because all federal government debt and almost all private sector debt are denominated in dollars.

Wray believes that deflationary pressures at home and abroad are real and that falling prices and wages can quickly generate rising debt burdens. He does not believe that the likelihood of a 1930s-style debt deflation process is high or that fears about the dangers of inflation and uncontrolled depreciation of the dollar should be taken seriously.

The author argues that the government budget balance is, to a large extent, nondiscretionary and that the best indicator of the necessary budget adjustment is involuntary unemployment. By this measure, the Clinton budget surplus was less restrictive at the peak of the economic boom than Bush's current deficit at 5 percent of GDP. He advocates that direct job creation that puts people to work doing useful things can add to national output and raise living standards without generating much inflationary pressure (as opposed to a stimulus package that promotes "hiring off the top"). High employment can be maintained with lower levels of government spending and lower aggregate demand, he says. Wray agrees with Hyman Minsky that a direct job-creation program can provide full employment, even in a low-growth economy, and he supports a low-growth strategy because a high-growth strategy favors private investment and generates growing financial fragility and instability.

Wray recommends that future tax cuts target lower-income families; therefore, he supports a reduction of the payroll tax. Since the types of spending programs by government matter (e.g., direct job creation, such as public service employment programs, create more jobs for the buck than alternative programs), policymakers should consider the fact that government spending and tax policies can be distortional when formulating fiscal stimulus programs. The best policy response to a trade deficit is to create jobs, not to block imports. When the rest of the world decides that it has sufficient stock of dollar assets, then the U.S. trade deficit will disappear, he adds. Wray advocates a substantial increase in federal funding for state and local governments (by as much as $150 billion per year) with a countercyclical component, since the federal government can spend without regard to its revenues.

A further recommendation by Wray is that the U.S. government reassure its senior citizens about its support of them during retirement. Otherwise, in a climate of uncertainty, private savings can never be high enough, and a reluctance to spend or invest depresses economic growth, as exemplified by Japan.

Explorations in Theory and Empirical Analysis

Some Simple, Consistent Models of the Monetary Circuit

GENNARO ZEZZA

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A puzzle within the Theory of the Monetary Circuit (TMC) is the determination of aggregate profits within a single period of production, when firms have to pay interest on an initial bank loan. Research Scholar Gennaro Zezza of the University of Cassino, Italy, shows that the profit paradox disappears when one postulate of the TMC (the initial loan required to start the production process is equal to wages) is dropped in favor of another (the initial loan covers interest payments, as well as wages). A household's demand for bank deposits implies that consumption and saving decisions depend on accumulated wealth, so the analysis of a single production process is inappropriate, says Zezza. He shows that the TMC can be reconciled with Keynesian and Kaldorian approaches, as well as with the post-Keynesian stock-flow approach that has been adopted by such economists as Distinguished Scholar Wynne Godley.

Zezza investigates the implications for the TMC models using corresponding sets of stock-flow accounting. He notes that most contributors to the TMC literature fail to properly take into account how bank profits can be spent in the goods and financial markets. By ignoring the accounting and behavioral implications of interest payments, TMC models are usually characterized by a "paradox of profits;" i.e., in a credit economy and a single production period, firms pay back the principal but they do not have enough liquidity to pay the interest. In Zezza's view, this result depends on interest payments disappearing from income, or stock-flow accounting, and he shows how simple TMC models can be made consistent in this respect.

The author considers the simplest model of the TMC (a single production period in a pure credit economy and no government), where real wages are paid in advance and firms are required to have enough liquidity prior to production. At the end of the period, firms have enough liquidity to pay back the initial loan but not enough liquidity to pay the interest. Zezza does not find a satisfactory proposal to solve the profit paradox. He proceeds toward a simpler solution by treating interest payments consistently and assumes that any level of undistributed profits by the banking sector is used to purchase equities. The end-of-period increase in the stock of loans exactly matches the end-of-period increase in the stock of bank deposits. If households' demand for new bank deposits is zero, firms' receipts from sales are sufficient to pay back the initial loan plus interest. The initial loan covers both the wage bill and interest payments (monetary profits equal investment). In Zezza's approach, deposits determine loans in a way that is entirely different from the conventional view, where the bank is allowed to lend money only when it has collected deposits from households. While the conventional view is true for a single bank, it cannot be true for the banking system as a whole. He suggests that most circuitists fail to see that interest payments on loans constitute a source of income for banks.

The simple model implicitly adopts the assumption that consumption and saving decisions are based on current income. Current consumption decisions, however, are based on current income and accumulated savings, notes Zezza. Moreover, one should assume an initial stock of wealth for some sectors; banks, for example, should be able to appropriate the current production or the stock of wealth of firms. The author proceeds to drop the assumption that supply equals demand and to assume that households unexpectedly save part of their income in the form of bank deposits. At the end of the period, the firms' bank debt has increased exactly by the increase in household deposits and equals the (unexpected) increase in inventories. This result shows the similarity between the TMC approach to credit and the approach adopted in the works of Godley, where the demand for bank loans is assumed to depend on changes in the stock of inventories.

Zezza also uses a neo-Kaleckian approach and splits firms into sectors producing consumer and capital goods. If households spend all of their income, firms in the consumer goods sector will recover enough liquidity to pay back the initial loan plus interest and still have profits to invest. However, investment in the capital goods sector remains undetermined, so the assumption that firms in this sector invest all of their profits is inappropriate, and investment must remain exogenous in order to determine profits. At the end of the production period, the increase in the stock of bank deposits will equal the increase in the outstanding debt of firms, as in the simple model. If firms are allowed to issue equities to finance investment, the result is the same as the simple model (firms will not recover the initial loan plus interest), unless bank behavior is modified and banks are allowed to increase their demand for equities in line with any increase in deposits. The results of the two-sector model show that some hypotheses on investment decisions in the TMC literature may be inappropriate, says Zezza.

The author surmises that a more complex model, which includes a central bank and the government sector, is entirely compatible with the major features of the TCM approach and the maintenance of the endogeneity of money.

Keynesian Theorizing during Hard Times: Stock-Flow Consistent Models as an Unexplored "Frontier" of Keynesian Macroeconomics

CLAUDIO H. DOS SANTOS

Working Paper No. 408, May 2004

www.levy.org/pubs/wp/408.pdf

Research Scholar Claudio H. Dos Santos believes that the stock-flow consistent (SFC) approach to macroeconomic modeling is a natural outcome of the path taken by Keynesian macroeconomics in the 1960s and 1970s. He shows that the three main Keynesian "schools of thought," as represented by the views of Paul Davidson and Hyman Minsky (American Post-Keynesian), Wynne Godley (British Post-Keynesian), and James Tobin (Neoclassical Keynesian), converged to a similar view of (closed) monetary capitalist economies with developed financial markets. This "Financial Keynesian" view is very different in nature from textbook descriptions of Keynesianism because it puts a much greater emphasis on the role of monetary and financial institutions in dynamically determining (path dependent) "real outcomes."

According to Dos Santos, the financial Keynesian view, which is a relatively unexplored frontier of Keynesian thought, can only be rigorously described and analyzed with the help of SFC accounting frameworks. The author proposes a simplified accounting framework and, following the structuralist tradition, phrases the views of the authors in question as different behavioral "closures" to the system implied by the (ex post) accounting identities.

Dos Santos concludes that the rich messages of the "old" but not well known and relatively underdeveloped financial Keynesian models—in particular, the broad normative Minskyan message about the importance of keeping sectoral balance sheets "healthy"—are largely neglected in modern mainstream models of the so-called "New Keynesian Consensus."

INSTITUTE NEWS

New Board Members

The Institute is pleased to welcome LAKSHMAN ACHUTHAN, managing director of the Economic Cycle Research Institute (ECRI), to its Board of Governors. ECRI is an independent organization that focuses on business cycle research and forecasting in the tradition established by Geoffrey H. Moore. Achuthan plays a key role in helping asset managers, corporate strategists, and policymakers use cyclical forecasts in their decision-making processes. He is the managing editor of ECRI's publications and participates regularly in a wide range of public economic discussions on television and radio and in the financial press. He is coauthor of *Beating the Business Cycle*, published by Doubleday in May; a member of *Time* magazine's board of economists and the New York City Economic Advisory Panel; and treasurer of the Downtown Economists Club. Achuthan earned a B.S. degree in economics and finance from Fairleigh Dickinson University and an M.B.A. in international business from Long Island University.

The Institute is also pleased to welcome J. EZRA MERKIN, managing partner of Gabriel Capital Group, to its Board of Governors. Merkin manages four funds with total assets approaching $3 billion. He was previously associated with Halcyon Investments and the law firm of Milbank, Tweed, Hadley & McCloy. He graduated from Columbia College, magna cum laude, and Harvard Law School, and is a member of Phi Beta Kappa. He also served on the faculty of the Benjamin N. Cardozo School of Law. Merkin is chairman of the Investment Committee of UJA-Federation of New York and of the Investment Committee of Yeshiva University, serves on the boards of several other leading charitable endowments, and is responsible for allocating approximately $2 billion of charitable assets. He is a member of the Board of Visitors of Columbia College.

New Levy Institute Book

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

EDWARD N. WOLFF, ed.

Cheltenham, U.K., and Northampton, Massachusetts: Edward Elgar Publishing Limited and The Levy Economics Institute, 2004

Throughout the 1990s the United States expanded its lead over other advanced industrial nations in terms of conventionally measured per capita income. However, it is not clear that welfare levels in America have grown concomitantly with per capita income, nor that Americans are necessarily better off than citizens of other advanced countries. The contributors to this volume investigate the extent to which welfare has increased in the United States over the post-WWII period and provide a rigorous examination of conventional measures of the standard of living, as well as more inclusive indices.

The chapters cover such topics as race, home ownership, and family structure; the status of children; the consumer price index; a historical perspective on the standard of living; and worker rights and labor strength in advanced economies. In addition, they explore and compare two economic systems for delivering goods—the free enterprise system of the United States and the European social welfare state.

Wolff has included essays by Dimitri B. Papadimitriou; Ajit Zacharias; David S. Johnson; Christopher Jencks, Susan E. Mayer, and Joseph Swingle; Dean Baker; Lars Osberg and Andrew Sharpe; Timothy M. Smeeding and Lee Rainwater; William J. Collins and Robert A. Margo; Seymour Spilerman and Florencia Torche; Richard H. Steckel; Thomas L. Hungerford and Maria S. Floro; Robert Buchele and Jens Christiansen; and Daphne T. Greenwood.

This provocative and accessible volume answers the intriguing question posed by the title and will be of interest to economists, sociologists, policymakers, and policy analysts, as well as students of these fields.

The publication of this collection of essays is the direct outgrowth of a 2001 Levy Institute conference organized by Wolff under the Institute's distribution of income and wealth program. The purpose of the conference was to better understand the many economic aspects of well-being that help define the "quality of life."

Upcoming Event

CONFERENCE

The Distributional Effects of Government Spending and Taxation

October 15-16, 2004
Blithewood
Annandale-on-Hudson, New York

Registration and program information is posted on the Levy Institute website.

PROGRAM

FRIDAY, OCTOBER 15

8:30–9:00 a.m. CONTINENTAL 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
International Comparisons
CHAIR: **Dimitri B. Papadimitriou**, President, *Levy Institute*
Michael Förster, *European Centre Vienna* and *OECD,* and **Pierre Pestieau**, *University of Liege*, *CORE, CEPR,* and *Delta*
"The Generosity of the Welfare State toward the Elderly"
Jonathan Schwabish and **Timothy M. Smeeding**, *Maxwell School, Syracuse University*; **Lars Osberg**, *Dalhousie University*; **Michael Eriksen** and **Joseph T. Marchand**, *Maxwell School, Syracuse University*
"Income Distribution and Social Expenditures: A Cross-national Perspective"
DISCUSSANT: **Amy Ellen Schwartz**, *New York University*

11:00–11:30 a.m. BREAK

11:30 a.m. – 1:00 p.m.

SESSION 2

Cross-national Comparisons within Europe

CHAIR: **Edward N. Wolff**, *Levy Institute* and *New York University*

Holly Sutherland, *University of Cambridge, University of Essex,* and *DIW Berlin*

"The Effects of Taxes and Transfers on Household Incomes in the European Union"

Irwin Garfinkel, *Columbia University*, **Lee Rainwater**, *Harvard University*, and **Timothy M. Smeeding**, *Maxwell School, Syracuse University*

"Patterns of Economic Well-being: Full Income Distribution and Income Packages in Rich Countries"

DISCUSSANT: **Marc Lee**, *Canadian Centre for Policy Alternatives*

1:00–2:30 p.m.

LUNCH

2:30–4:00 p.m.

SESSION 3

Distributional Effects of Taxes and Government Spending in the U.S.

CHAIR: **Asena Caner**, *Levy Institute*

Edward N. Wolff, *Levy Institute* and *New York University*, and **Ajit Zacharias**, *Levy Institute*

"An Overall Assessment of the Distributional Consequences of Government Spending and Taxation in the U.S., 1989 and 2000"

Leonard E. Burman, *Urban Institute*, **William G. Gale, Matthew Hall,** and **Peter R. Orszag**, *The Brookings Institution*

"Distributional Effects of Defined Contribution Plans and Individual Retirement Arrangements"

DISCUSSANT: **Sourushe Zandvakili**, *University of Cincinnati*

4:00–4:30 p.m.

BREAK

4:30–6:00 p.m.

SESSION 4

Distributional Effects in Other Countries I

CHAIR: **Ajit Zacharias**, *Levy Institute*

Ann Harding, **Rachel Lloyd**, and **Neil Warren**, *NATSEM*, Canberra, Australia

"The Distribution of Taxes and Government Benefits in Australia"

Kwang Soo Cheong, *Johns Hopkins University*

"Distributional Effects of Personal Income Taxation in Korea"

DISCUSSANT: **Lars Osberg**, *Dalhousie University*

6:00–9:00 p.m.

RECEPTION AND DINNER

KEYNOTE ADDRESS: **David Cay Johnston**, *New York Times*

"The Stealth Tax"

SATURDAY, OCTOBER 16

8:30–9:15 a.m. CONTINENTAL BREAKFAST

9:15–11:00 a.m. SESSION 5

Distributional Effects in Other Countries II

CHAIR: TBA

Leon Podkaminer, *The Vienna Institute for International Economic Studies (WIIW)*
"Distributional Effects of Evolving Spending and Tax Policies in Post-Socialist Poland"

Markus Jäntti, *Abo Akademi University*, Finland
"The Distribution of the Tax Burden in Finland, 1985–2001"

DISCUSSANT: **Steve Davies**, *Colorado State University*

11:00–11:30 a.m. BREAK

11:30 a.m. – 1:00 p.m. SESSION 6

Distributional Effects at the Sub-national Level

CHAIR: TBA

Harvey Cutler, *Colorado State University*
"The Impact of Local Government Decisions on the Distribution of Income"

Howard Chernick and **Paul Sturm**, Hunter College, CUNY
"Explaining State/Local Fiscal Redistribution"

DISCUSSANT: **Elissa Braunstein**, *Political Economy Research Institute (PERI), University of Massachusetts*

1:00–2:30 p.m. LUNCH

2:30–4:00 p.m. SESSION 7

Distributional Effects of Public Education and Social Security

CHAIR: TBA

William R. Johnson, *University of Virginia*
"Are Public Subsidies to Higher Education Regressive?"

Barbara A. Butrica, *Urban Institute*, **Howard M. Iams**, *Social Security Administration*, and **Karen E. Smith**, *Urban Institute*
"The Changing Impact of Social Security on Retirement Income in the U.S."

DISCUSSANT: **Teresa Ghilarducci**, *University of Notre Dame*

4:00 p.m. RECEPTION

PUBLICATIONS AND PRESENTATIONS

Publications and Presentations by Levy Institute Scholars

PHILIP ARESTIS *Institute Professor of Economics*

Publications: "European Union Must End the Stability and Growth Pact and Reform the European Central Bank" (with M. C. Sawyer), *Ekonomia*, Vol. 6, No. 1, Summer 2003; "Dollar Weakness is the Key Driver" (with E. Karakitsos), *Financial Times*, March 3; "Threshold Effects in the U.S. Budget Deficit" (with A. Cipollini and B. Fattouh), *Economic Inquiry*, Vol. 42, No. 2, April; "Regime de Metas de Inflação Ainda Divide Especialistas," interview and debate with Frederic Mishkin, Columbia University, on inflation targeting, published in the Brazilian newspaper *Folha De S. Paulo*, May 24; "Financial Globalisation and Regulation" (with S. Basu), *Research in International Business and Finance*, Vol. 12, No. 1, July; "Can Monetary Policy Affect the Real Economy?" (with M. C. Sawyer), *European Review of Economics and Finance*, Vol. 3, No. 3, July; "Financial Sector Reforms in Developing Countries with Special Reference to Egypt," in R. Arena and N. Salvadori, eds., *Money Credit and the Role of the State: Essays in Honour of Augusto Graziani*, Ashgate Publishing Limited, 2004; "El BCE y el Pacto de Estabilidad son culpables del bajo crecimiento de la UE," interview by Ana Barandiaran published in the Spanish newspaper *El Correo*, July 17.

Presentations: "New Consensus Monetary Policy: A Critique" (with M. C. Sawyer), On the "New" Monetary Policy: Implications and Relevance conference, Cambridge Centre for Economic and Public Policy, Cambridge, U.K., March 18–20; "Current Trends in Macroeconomic Theory and Policy," State University of New York (SUNY) seminar at New Paltz, April 22; "Reinstating Fiscal Policy" (with M. C. Sawyer), The Changing Role of Fiscal Policy session at the 14th Annual Hyman P. Minsky Conference on Financial Structure, The Levy Economics Institute of Bard College, Annandale-on-Hudson, New York, April 23–24; "Inflation Targeting and Asset Bubbles" and "Does Financial Structure Matter?" at the Federal Reserve Leadership Education Programme conference organized by the Financial Markets Center, Maritime Institute for Technology and Graduate Studies, Linthicum Heights, Maryland, May 14-15; "Inflation Targeting: A Critical Appraisal" (with M. C. Sawyer), New Macroeconomics and Monetary Policy session, "Financial Liberalization and Poverty: Channels of Influence" (with A. Caner), Finance session, and "Does Financial Structure Matter?" (with A. Luintel and K. Luintel), Growth session, at the International Conference of the Department of Applied Economics V, coorganized by the University of the Basque Country and the Cambridge Centre for Economic and Public Policy, Bilbao, Spain, July 15–16.

ASENA CANER *Research Scholar*

Presentations: Organized and chaired, Poverty and Wealth: Measurement and Gender Issues session, and Savings of Low-Income Households session, annual meeting of the Eastern Economic Association, Washington D.C., February 20–22.

GREG HANNSGEN *Resident Research Associate*

Presentations: "Borrowing Alone: The Theory and Policy Implications of the Commodification of Finance," World Congress of Social Economics, Albertville, France, June 8–11; "Minsky's Acceleration Channel and the Role of Money," Money, Risk, and Policy session at the 14th Annual Hyman P. Minsky conference, The Levy Economics Institute of Bard College, Annandale-on-Hudson, New York, April 23–24.

DIMITRI B. PAPADIMITRIOU *President*

Presentations: Interview with Jim McTague regarding the Bush/Kerry economic proposals and their effects, *Barron's*, March 8; interview with Ron Fink regarding bank regulation in the wake of Enron, *CFO*, March 9; interview with Greg Robb regarding the jobless recovery, *CBS MarketWatch*, March 9; interview with Bill Atkinson regarding the future of the consumer, *Baltimore Sun,* April 20; interview with Jim Picerno regarding the limitations of deficit-financed growth, Bloomberg, June 1; discussant and session moderator at the International Conference on Gender, Macroeconomics, and International Economics, Salt Lake City, Utah, June 20–22; interview with Michael E. Kanell regarding what bank mergers say about the broader economy, *Atlanta Journal-Constitution*, June 23.

JOEL PERLMANN *Senior Scholar*

Publication: "Intermarriage Then and Now: Race, Generation, and the Changing Meaning of Marriage" (with M. C. Waters), in Nancy Foner and George M. Fredrickson, eds., *Not Just Black and White: Historical and Contemporary Perspectives on Immigration, Race and Ethnicity in the United States*, New York: Russell Sage Foundation, 2004.

Presentations: "The New Race Question and the 1910 Census: The 'List Of Races and Peoples,' 1898–1910," U.S. Census Bureau conference, March 4; invited speaker, Radcliffe Institute seminar on immigration, past and present, March 26.

MALCOLM SAWYER *Senior Scholar*

Publications: "European Union Must End the Stability and Growth Pact and Reform the European Central Bank" (with P. Arestis), *Ekonomia*, Vol. 6, No. 1, Summer 2003; "Can Monetary Policy Affect the Real Economy?" (with P. Arestis), *European Review of Economics and Finance*, Vol. 3, No. 3, July; "La Private Finance Initiative nel Regno Unito: una lettura critica," *Economia Publica*, Vol. 34, No. 2, 2004.

Presentations: "Alternative Macroeconomic Policies for EMU," University of Maastricht, Netherlands, April 5; "The Private Finance Initiative in the U.K.: A Critical Appraisal," Università degli Studi di Roma, La Sapienza, Rome, April 16; "An Economic Evaluation of Alternative Arrangements for Retirement Pensions," University of the Basque Country, Bilbao, Spain, May 26.

EDWARD N. WOLFF *Senior Scholar*

Publications: "Racial Differences in Patterns of Wealth Accumulation" (with M. Gittleman), *Journal of Human Resources*, Vol. 39, No. 1, Winter 2004; "What Has Happened to the Leontief Paradox?" in Erik Dietzenbacher and Michael L. Lahr, eds., *Wassily Leontief and Input-Output Economics*, Cambridge: Cambridge University Press, 2004; "Stakeholding and Inheritances," *Politics and Society*, Vol. 32, No. 1, March 2004; *What Has Happened to the Quality of Life in the Advanced Industrialized Countries?* Cheltenham, U.K., and Northampton, Massachusetts: Edward Elgar Publishing Limited and The Levy Economics Institute, 2004.

Presentations: "The Transformation of the American Pension System, 1983–1998," Sloan Conference on Work Options for Mature Americans, University of Notre Dame, Indiana, December 7–8, 2003; "Recent Trends in Living Standards in the United States," Columbia Seminar on Full Employment, Social Welfare, and Equity, Columbia University, December 15, 2003; "The Transformation of the American Pension System," National Academy of Social Insurance Conference, In Search of Retirement Security, Washington, D.C., January 22; interview with Steve Barrows, KNZZ NewsRadio, Grand Junction, Colorado, November 19, 2003; interview with Judy Martin, NPR *Marketplace Morning Report*, December 9, 2003 and January 8, 2004; interview with Bob Smith, WXXI Radio, February 20; "The Devolution of the American Pension System," Bard College seminar, April 8; discussant, Conference on Puerto Ricans on the Island and in the Mainland: New Directions in Social Science Research, Russell Sage Foundation, New York, May 21–22; *Dolan's Unscripted*, CNNfn, June 23; "Household Wealth, Public Consumption, and Economic Well-being in the United States," SSHRC International Conference on Index Number Theory and the Measurement of Prices and Productivity, Vancouver, British Columbia, June 30 – July 3.

L. RANDALL WRAY *Senior Scholar*

Publications: "The Adverse Economic Impact from Repeal of the Prevailing Wage Law in the State of Missouri" (with M. Forstater, K. Pinkham, and M. Kelsay), *Ingram's magazine*, April; "Loanable Funds, Liquidity Preference, and Endogenous Money," C*redit and State Theories of Money: The Contributions of A. Mitchell Innes*, Cheltenham, U.K.: Edward Elgar, 2004.

Presentations: "When are Interest Rates Exogenous?" Eastern Economic Association annual meeting, Washington, D.C., February 20-22; "International Aspects of Current Monetary Policy," University of Cambridge, Cambridge, U.K., March 20; "Credit and State Theories of Money," CFEPS conference on The Nature, Origin, and Role of Money, University of Missouri-Kansas City, March 30 - April 1; "Social Security," the Shepherd Center, Kansas City, April 9; "Those 'D' Words: Deficits, Debt, Deflation, and Depreciation," State University of New York, New Paltz, April 22; "The 'War on Poverty' after 40 Years: A Minskyan Assessment," The Changing Role of Fiscal Policy session and "Those 'D' Words: Deficits, Debt, Deflation, and Depreciation," The Macroeconomic Prospects for the U.S. Economy session at the 14th Annual Hyman P. Minsky Conference on Financial Structure, The Levy Economics Institute of Bard College, Annandale-on-Hudson, New York, April 23-24; "Currency Solvency and the Possibility of Full Employment," "Can Interest Rate Hikes Stimulate the Economy?" (with L. Tauheed), and "International Aspects of Monetary Policy," Eighth International Post-Keynesian Workshop, Kansas City, June 16-24.

AJIT ZACHARIAS *Research Scholar*

Publication: "Introduction" in Edward N. Wolff, ed., *What Has Happened to the Quality of Life in the Advanced Industrialized Countries?* Cheltenham, U.K., and Northampton, Massachusetts: Edward Elgar Publishing Limited and The Levy Economics Institute, 2004.

Presentation: "Accumulation and Gender Disparities in Paid Work in the United States" (with M. Mahoney), International Conference on Gender, Macroeconomics, and International Economics, Salt Lake City, Utah, June 20–22.

Recent Levy Institute Publications

Levy Insitute Measure of Economic Well-Being
United States, 1989, 1995, 2000, and 2001
EDWARD N. WOLFF, AJIT ZACHARIAS, and ASENA CANER
May 2004

Levy Institute Measure of Economic Well-Being
Concept, Measurement, and Findings: United States, 1989 and 2000
EDWARD N. WOLFF, AJIT ZACHARIAS, and ASENA CANER
February 2004

Levy Institute Measure of Economic Well-Being
United States, 1989 and 2000
EDWARD N. WOLFF, AJIT ZACHARIAS, and ASENA CANER
December 2003

POLICY NOTES

Those "D" Words: Deficits, Debt, Deflation, and Depreciation
L. RANDALL WRAY
2004/2

Inflation Targeting and the Natural Rate of Unemployment
WILLEM THORBECKE
2004/1

The Future of the Dollar: Has the Unthinkable Become Thinkable?
KORKUT A. ERTÜRK
2003/7

Is International Growth the Way Out of U.S. Current Account Deficits? A Note of Caution
ANWAR M. SHAIKH, GENNARO ZEZZA, and CLAUDIO H. DOS SANTOS
2003/6

Deflation Worries
L. RANDALL WRAY
2003/5

Pushing Germany Off the Cliff Edge
JÖRG BIBOW
2003/4

Caring for a Large Geriatric Generation: The Coming Crisis in U.S. Health Care
WALTER M. CADETTE
2003/3

Reforming the Euro's Institutional Framework
PHILIP ARESTIS and MALCOLM SAWYER
2003/2

The Big Fix: The Case for Public Spending
JAMES K. GALBRAITH
2003/1

PUBLIC POLICY BRIEFS

The War on Poverty after 40 Years
A Minskyan Assessment
STEPHANIE A. BELL and L. RANDALL WRAY
No. 78, 2004 (Highlights, No. 78A)

The Sustainability of Economic Recovery in the United States
The Risks to Consumption and Investment
PHILIP ARESTIS and ELIAS KARAKITSOS
No. 77, 2004 (Highlights, No. 77A)

Asset Poverty in The United States
Its Persistence in an Expansionary Economy
ASENA CANER and EDWARD N. WOLFF
No. 76, 2004 (Highlights, No. 76A)

Is Financial Globalization Truly Global?
New Institutions for an Inclusive Capital Market
PHILIP ARESTIS and SANTONU BASU
No. 75, 2003 (Highlights, No. 75A)

Understanding Deflation
Treating the Disease, Not the Symptoms
L. RANDALL WRAY and DIMITRI B. PAPADIMITRIOU
No. 74, 2003 (Highlights, No. 74A)

Asset and Debt Deflation in the United States
How Far Can Equity Prices Fall?
PHILIP ARESTIS and ELIAS KARAKITSOS
No. 73, 2003 (Highlights, No. 73A)

What Is the American Model Really About?
Soft Budgets and the Keynesian Devolution
JAMES K. GALBRAITH
No. 72, 2003 (Highlights, No. 72A)

Can Monetary Policy Affect the Real Economy?
The Dubious Effectiveness of Interest Rate Policy
PHILIP ARESTIS and MALCOLM SAWYER
No. 71, 2003 (Highlights, No. 71A)

STRATEGIC ANALYSES

Is Deficit-Financed Growth Limited? Policies and Prospects in an Election Year
DIMITRI B. PAPADIMITRIOU, ANWAR M. SHAIKH, CLAUDIO H. DOS SANTOS, and GENNARO ZEZZA
April 2004

Deficits, Debts, and Growth: A Reprieve But Not a Pardon
ANWAR M. SHAIKH, DIMITRI B. PAPADIMITRIOU, CLAUDIO H. DOS SANTOS, and GENNARO ZEZZA
October 2003

The U.S. Economy: A Changing Strategic Predicament
WYNNE GODLEY
March 2003

WORKING PAPERS

Keynesian Theorizing during Hard Times: Stock-Flow Consistent Models as an Unexplored "Frontier" of Keynesian Macroeconomics
CLAUDIO H. DOS SANTOS
No. 408, May 2004

Changes in Household Wealth in the 1980s and 1990s in the United States
EDWARD N. WOLFF
No. 407, May 2004

Investigating the Intellectual Origins of Euroland's Macroeconomic Policy Regime: Central Banking Institutions and Traditions in West Germany after the War
JÖRG BIBOW
No. 406, May 2004

Some Simple, Consistent Models of the Monetary Circuit
GENNARO ZEZZA
No. 405, April 2004

The "War on Poverty" after 40 Years: A Minskyan Assessment
STEPHANIE A. BELL and L. RANDALL WRAY
No. 404, April 2004

A Stock-Flow Consistent General Framework for Formal Minskyan Analyses of Closed Economies
CLAUDIO H. DOS SANTOS
No. 403, February 2004

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