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# Summary

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

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

The *Summary* is a quarterly publication of The Jerome Levy Economics Institute of Bard College intended to keep the academic community informed about the Levy Institute's research. To accomplish this goal, it contains summaries of recent research publications and reports on other activities.

*Editors:* Karl Widerquist, Ajit Zacharias  
*Text Editor:* Judith Kahn

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## Letter from the President

*To our readers:*

*This issue of the Summary begins with Senior Scholar Edward N. Wolff's report on his new research project. Wolff is conducting an in-depth empirical examination of the long-term effects of technological change on earnings, inequality, and employment in the United States.*

*The program on the distribution of income and wealth includes four working papers. Resident Scholar Jamee K. Moudud and Resident Research Associate Ajit Zacharias provide a critique of the neoclassical rationale for the welfare state and the mainstream analysis of the macroeconomic effects of social expenditures. Andrew Glyn, of Oxford University, and Wiemer*

*Salverda, of the University of Groningen, examine the employment disadvantage faced by the least-educated workers and differences in the disadvantage among the OECD countries. Resident Scholar Michael J. Handel addresses the so-called skills crisis by analyzing trends in job skill requirements and relative wages. Edward N. Wolff uses the framework of a Marxian perspective to scrutinize the recent rise in profitability in the United States.*

*Three working papers and a public policy brief in the program on financial markets and monetary policy are summarized. Visiting Senior Scholar Jan A. Kregel analyzes the recent Brazilian crisis from a Minskian perspective and characterizes it as a debt deflation process originating in the public sector. In another paper, he argues that Paul Krugman's interpretation of the Keynesian liquidity trap is flawed and that this misinterpretation produces a policy prescription ill suited for restoring growth in Japan. Visiting Senior Scholar Philip Arestis, of the University of East London; Kevin McCauley, of the University of East London; and Visiting Senior Scholar Malcolm Sawyer, of the University of Leeds, outline the serious limitations of the European Union's Stability and Growth Pact and propose a Keynesian alternative that puts full employment and fiscal autonomy at the forefront. The public policy brief by Research Associate Willem Thorbecke, of George Mason University, rebuts arguments that the overriding goal of the Federal Reserve should be price stability and gives reasons why full employment must receive equal weight in the formulation of monetary policy.*

*The program on federal budget policy includes a brief by Policy Advisor Edward V. Regan, chairman of the Municipal Assistance Corporation of New York City, in which he puts forward a new approach to financing public infrastructure investment that overcomes the inefficiency and inequity of the current tax-exempt bond system. In a policy note, Walter M. Cadette argues that the privatization of Social Security cannot be considered a wise alteration of the present system.*

*In an interim report in a series of strategic analyses, Distinguished Scholar Wynne Godley discusses the U.S. trade and balance of payments deficits. Three special studies are summarized. Anwar M. Shaikh, of New School University, provides in a policy note an explanation of the U.S. trade deficit. Resident Research Associate Karl Widerquist argues in his working paper that there is an inherent tendency in the political process toward underfunding public goods spending. In a seminar at the Institute, Michael North, of Ernst Moritz Arndt University, discussed institutional factors in Germany's economic development in the fifteenth through early nineteenth centuries.*

*As always, I welcome your comments and suggestions.*

*Dimitri B. Papadimitriou  
President*

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## Institute Research

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### Project Report

#### **The Long-Term Effects of Technological Change on Earnings, Inequality, and Labor Demand**

[Edward N. Wolff](#), Senior Scholar

This new project on the long-run implications of technological change for the structure of labor demand and earnings was motivated by some extraordinary results Research Associate William J. Baumol and I obtained in our Levy Institute project, "Protracted Frictional Unemployment as a Heavy Cost of Technical Progress." In that project, we examined the effects of technological change, especially computerization, on the duration of unemployment in the United States. As presented in "Speed of Technical Progress and Length of the Average Interjob Period" (Baumol and Wolff 1998b), we found that two proxies for technical activity had major and statistically significant effects on unemployment duration. Specifically, we found that a 1 percentage point increase in annual total factor productivity (TFP) growth is associated with an 11 percent increase in the mean duration of unemployment, and an increase of \$1,000 (in 1987 dollars) in office, computer, and accounting equipment (OCA) investment per employee is associated with a 45 percent increase in the mean duration of unemployment. Moreover, we computed that over the period 1970 to 1997, during which mean unemployment duration increased by 84 percent (from 8.6 to 15.8 weeks), OCA investment per employee accounted for over 60 percent of the increase. Rising from virtually zero to \$860 (in 1987 dollars), it had the greatest impact on duration of all the variables we looked at.

We also found that computerization in particular and technological progress in general had differential impacts on different groups of workers. Older workers in particular got "hammered" by computerization. In our regression analysis, we found that among both men and women, the coefficient of TFP growth rises almost monotonically with age group, from zero for the youngest to 0.22 for the oldest. The coefficient of the computerization variable (OCA investment) likewise rises monotonically with age group, from -0.06 for the youngest to 0.76 for the oldest, and it is very significant for the four oldest groups. It is striking that the coefficients of both TFP growth and computerization are zero or less for the youngest age group.

My new project will extend the scope of the study to an analysis of the effects of technological change on the structure of labor demand and earnings for different skill groups of workers. A

few words should be said about differences in these effects through the two characteristic stages of the innovation process. Economic historians explain that when a new technology (or a new product) reaches the market, it is typically relatively difficult to use, unreliable, in need of frequent attention, and limited in range of application. Introduction is followed by a relatively long period of improvement during which the technology becomes easier to use, more reliable, and more widely applicable. It is during this period that standard measures of technical change (such as TFP growth) show steady growth. This can be seen in examples ranging from Watt's steam engine to the computer.

The introduction stage seems to be advantageous for specialized and educated workers, who are needed to use the new technology initially and to improve it. It is therefore relatively disadvantageous for the unskilled. This condition reverses during the improvement stage. As it becomes easier for the unskilled to work with the new technology, the need for skilled and specialized workers is reduced and the demand for unskilled workers increases.

Results obtained in the first project support this conjecture (see Wolff 1995). While the growth in total factor productivity generally downgrades skill levels, other dimensions of technological activity--particularly growth in the capital-labor ratio, research and development intensity, and computerization--tend to raise the level of cognitive and interactive skills required.

One view that has received widespread support is the capital-skills complementarity hypothesis. The argument is that greater investment in equipment is associated with greater demand for skilled labor since new equipment presumably embodies more complex technology, which requires greater skills to use. An indirect implication of this hypothesis is that (at fixed output) employers will expand their use of capital and hence skilled labor (since the two are complementary) when the price of capital services declines. However, preliminary work finds no confirmation of this hypothesis.

The notion that technological change may stimulate the demand for more-skilled or better-educated labor can be found in the work of Arrow (1962) and Nelson and Phelps (1966). According to Arrow's notion of "learning by doing," experience in the application of a given or new technology leads to increased efficiencies over time. One implication of this notion is that if it is assumed that a more-educated labor force "learns faster" than a less-educated group, industries with more rapid rates of technological innovation will favor the workers with the greater learning potential. Similarly, Nelson and Phelps argue that more-educated workers may make it easier for a firm to adopt new technologies because they are more able than less-educated workers to learn new functions and routines and to evaluate and improve innovations.

Several studies provide evidence (both direct and indirect) of a positive relation between technological activity and the demand for educated labor. Welch (1970) analyzed the returns to education in U.S. farming in 1959 and concluded that a portion of the returns results from the greater ability of more-educated workers to adapt to new production technologies. Bartel and Lichtenberg (1987), using industry-level data for 61 U.S. manufacturing industries over the

1960 to 1980 period, found that the relative demand for educated workers was greater in sectors with newer vintages of capital. They inferred from this that highly educated workers have a comparative advantage with regard to the implementation of new technologies.

I use five indexes of technological activity in this study. The first three are rate of TFP growth, ratio of R&D expenditures to GDP, and number of scientists and engineers engaged in R&D per employee. The fourth, investment in new equipment and machinery (including computers) per employee, is included to allow for the possibility that new technology may be embodied in new capital equipment and machinery, and standard measures of TFP growth do not adequately capture this effect. The fifth index, investment in computers (or investment in information technology more generally) per employee, is included because computers may play a particularly important role as transmitters of new technologies.

I have also compiled structural and organizational dimensions of production for each industry: (1) share of employees in an industry covered by union contracts, (2) share of employees working in large establishments (defined as 500 or more employees), (3) industry employment growth, (4) ratio of imports to industry sales, and (5) ratio of exports to industry sales. I plan to use a measure of information technology that is more general than computer investment. This measure includes investment in office, computing, and accounting equipment; communications equipment; and computer software and computer services. The productivity analysis and the basic data framework will be based on U.S. input-output tables, obtained from the Bureau of Economic Analysis. The rationale for the use of this framework is twofold. First, it provides the necessary data on industry purchases of computer software and computer services; second, it provides a better measure of TFP growth since it includes material inputs (interindustry flows) as well as direct labor and capital inputs.

I will also employ census data on jobs by industry in the United States over the period 1950 to 2000. This will allow me to construct measures of job composition by industry and of changes in the structure of jobs over time. I will also use auxiliary data from the National Income and Product Accounts, the National Science Foundation, and other sources to construct measures of rate of technological change, rate of investment in machinery and equipment, rate of patenting, and R&D intensity by industry. It will then be possible to isolate the effects of rate of computerization and diffusion of information technology on changes in the structure of jobs. I will be able to determine which kinds of jobs are being displaced by the process of technological change over time--clerical and administrative or blue-collar and menial labor; to measure the extent to which the new technology downgrades or upgrades skill levels; to estimate the pace of job creation and destruction; and to see if the pace has increased in recent years. These measures will enable me to project likely shortages in the types of skilled labor that are required by newly developing technology and likely surpluses of low-skilled labor.

William Baumol and I found a strong connection between technological change and the duration of unemployment in our public policy brief *The Side Effects of Progress* (1998a). I expect equally strong results for the new project. Indeed, preliminary results show that both TFP

growth and computerization have strong positive effects on the demand for high-skilled workers and their earnings and negative effects on the demand for low-skilled workers and their earnings.

The policy implications are manifold. The research will suggest the type of training and education system that is necessary to deal with the constant displacement of workers and changes in required skills. It will suggest the type of income support that is needed to bridge the periods of unemployment that result from rapid changes in technology. It may also suggest that strategies such as raising the minimum wage and expanding the earned income tax credit can be effective.

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## Program: Distribution of Income and Wealth

### **The Social Wage, Welfare Policy, and the Phases of Capital Accumulation**

[Jamee K. Moudud](#) and [Ajit Zacharias](#)  
[Working Paper No. 291](#), December 1999

Until the late 1960s there was a broad consensus that some desirable combination of growth and social justice could be maintained within the context of a capitalist economy. But that consensus has unraveled. In recent years several OECD countries, with institutional structures as diverse as the United States and Sweden, have rolled back the welfare state. The now prevailing

conventional wisdom and policies, informed by monetarist and rational expectations versions of neoclassical economic theory, rest on the premise that there is a fundamental conflict between growth and social justice under capitalism. Resident Scholar Jamee K. Moudud and Resident Research Associate Ajit Zacharias assess the neoclassical rationale for social policy and the macroeconomic impacts of welfare spending. The main thrust of their argument is that the trade-off between growth and social policy postulated in orthodox theory is a false one and that the recent cuts in the welfare state in the United States are unjustifiable on purely economic grounds.

Moudud and Zacharias point out that the neoclassical rationale for social policy is derived mainly from insurance market failures caused by a set of principal-agent problems. For example, the justification for state-sponsored unemployment insurance and Social Security is that private insurance markets cannot provide protection efficiently to those who demand it. This is in stark contrast to the 1960s view in which the justifications for social policy were the "national interest" and the beneficial impact of social expenditures in stabilizing business cycle swings in aggregate employment and output. This view is based on the idea that a capitalist economy maintains persistent inequalities and generates recurrent mass unemployment--an idea discredited in the current conventional wisdom. Moudud and Zacharias argue that a series of responses to insurance market failures cannot explain social policy in the history of the United States. Conflicting demands by different social classes during the different phases of capital accumulation and the efforts of the state to mediate these conflicts provide a superior vantage point from which the contours and specifics of social policy can be comprehended.

According to Moudud and Zacharias, the neoclassical analysis of the macroeconomic impact of social expenditures is unrealistic and theoretically incongruous. Social expenditures become a drag on economic activity, according to the neoclassical assumptions, because they lower household saving. Even if one were to accept this, the next step of the argument--that there is a one-to-one relationship between household saving and business investment--is hard to sustain in a world characterized by fundamental uncertainty and endogenous money. A rise in liquidity preference, for example, could make households hoard their money rather than invest it in risky securities. Furthermore, empirical estimates for the United States have shown that the welfare state has not lowered the saving rate of worker households because, on average, the taxes that they pay to the state are matched by the benefits that flow back to them in the form of social expenditure. Other underlying assumptions of the neoclassical analysis, such as rational expectations, Say's Law, continuous full employment, and intertemporal utility maximization, also severely limit its applicability to the real world.

To assess the macroeconomic effects of social policy, Moudud and Zacharias do not favor traditional Keynesian theory, with its focus on short-term demand management, as an appropriate alternative to the unrealistic neoclassical theory. They favor a classical-Harrodian model of cyclical growth. Investment and profitability are the driving forces in this model in which growth is occurring continuously and money is endogenous. The authors argue that an increase in the level of social expenditures, other things remaining constant, will not lower the long-run growth rate. Moreover, the share of social expenditures in the national income could



even rise without compromising long-run growth to the extent allowed by an increase in the business saving rate, an increase that can be brought about via appropriate taxation and industrial policies.

Several mainstream economists have claimed that the rolling back of the welfare state has been instrumental in sustaining the long-wave upturn in the United States that began in the early 1980s. Since the main causal link in this explanation is the positive effect on the saving rate of cutting government expenditures, it is worthwhile to examine that effect. Moudud and Zacharias find that ratio of aggregate saving to GDP actually fell during the 1980s and 1990s from its rather stable and higher levels during the 1960s and the 1970s. The empirical evidence that the welfare state has not been a drag on capital accumulation indicates that there may be no tension between social policy and capital accumulation and the recent rolling back of the welfare state is not justified on these grounds.

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#### **Employment Inequalities**

Andrew Glyn and Wiemer Salverda

[Working Paper No. 293](#), December 1999

Many economists have argued that only wage flexibility can increase the employment available for the least-educated workers in the OECD countries, citing the low unemployment rate in the United States as confirmation. But does the record of the last two decades bear this out? Andrew Glyn, of Corpus Christi College of Oxford University, and Wiemer Salverda, of the University of Groningen, document the employment disadvantage faced by the least-educated workers and examine reasons for the differing extent of this disadvantage across countries.

The most frequently used measures of employment disadvantage are the ratio of the unemployment rate of those with the least educational qualifications to the unemployment rate of those with university degrees and the ratio of the nonemployment rate (100 percent minus the employment rate) of the one labor market segment to the other. According to Glyn and Salverda, both these measures suffer from serious flaws. The authors adopt as their measure of employment disadvantage the difference between the employment rate of the best-educated quartile of the population (aged 25 to 64) and the employment rate of the least-educated quartile.

Based on data for 19 countries in 1994 (the latest year for which reasonably comprehensive data are available from the OECD), Glyn and Salverda find that the employment rate for the least-educated quartile of men generally ranges from 50 to 75 percent and that for the most-qualified quartile from 80 to 90 percent. The difference is more than 30 percent in Ireland and Belgium and below 10 percent in Portugal, Japan, and Switzerland. Strikingly, the least-educated quartile

of men is 21 percent less likely to have a job than the most-educated quartile in the United States, a figure that is considerably higher than in Germany, a country with allegedly inflexible labor markets. The employment disadvantage in the United States is about equal to the European average, even though wage differentials are far higher in the United States. The assertion that lower relative wages enable less-educated American workers to find jobs more easily is simply not supported by the data.

Employment differences are greater for women than for men and more variable across countries, reflecting the fact that the entry of women into the labor force has generally had a greater effect on better-educated women and an extremely uneven effect on less-educated. Although a large proportion of American women have jobs, the difference between employment rates for the most and the least educated on average is also no smaller than in European countries.

An examination of changes in the employment position of least-educated men and women from the early 1980s to the mid 1990s shows significant differences across countries. In the majority of countries employment rate differences between the most- and least-educated quartiles rose between 6 percent and 15 percent. In the Netherlands and Sweden there was no rise at all, and the United States also suffered only a small deterioration in the relative employment of the less educated. This may at first seem to support a favorable comparison of the United States with several European countries, but it should be noted that the position of the least-educated men in the United States had become extremely bad by 1981, with only the Netherlands (of the 14 countries for which there are data) having a lower employment rate for the least educated. The least educated in the United States lost jobs in the 1970s and then their relative pay declined in the 1980s. Simply comparing the small deterioration in their employment position in the 1980s with the larger deterioration in some European countries provides only a partial view.

Using cross-country data for 1994, Glyn and Salverda examine the influence of a number of macroeconomic and structural factors on the employment disadvantage. For men, increases in the overall demand for labor reduce the employment gap; higher import penetration from low-wage countries and greater disparities in literacy skills have the opposite effect. For women, labor demand and imports have the same effect (although to a lesser extent), but the literacy skills disparities do not play a role.

The authors also examine the impact of various dimensions of wage and labor market flexibility. A number of recent studies have challenged the orthodoxy that higher employment rates for the least educated can be attained via reductions in their relative pay. Glyn and Salverda find little consistent support for the idea that wage dispersion has been the main influence on employment for the less educated, thus lending further support to growing skepticism about the orthodoxy. They also find that labor market policies that are allegedly contributing to labor market inflexibility have no influence on the employment gap. Proxies for labor market inflexibility, such as the generosity of minimum wages and unemployment benefits, an OECD index of the degree of employment protection, and the extent of unionization, all turn out to be insignificant in their quantitative analysis.

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## **Is There a Skills Crisis? Trends in Job Skill Requirements, Technology, and Wage Inequality in the United States**

[Michael J. Handel](#)

[Working Paper No. 295](#), February 2000

In the 1970s many social scientists agreed that there was a glut of high-skilled workers relative to the number of jobs requiring their skills. In the 1980s many believed that the opposite had become true--that there was a shortage of high-skilled workers relative to jobs for them. Many economists agree that the large growth in wage inequality reflected a rising payoff to education resulting from an imbalance between growth in the supply of and in the demand for skilled labor as a consequence of technological shifts, especially the increasing use of computers in the workplace.

For both of these theories to be true, the demand for skilled labor must have suddenly reversed and raced ahead of supply, but Resident Scholar Michael J. Handel does not find evidence that this did in fact occur. He uses a number of data sets to study trends in worker skills and job skill requirements, including the 1 percent Public Use Microdata Sets of the U.S. Census for 1960 to 1990, the March Annual Demographic files of the Current Population Survey (1962 to 1997), and the Merged Outgoing Rotation Group (MORG) files of the Current Population Survey (1979 to 1997). These data sets provide information on education, occupation, and industry for more than 30 years.

Handel finds that changes in the supply of and demand for more-educated workers are not consistent with changes in inequality. The growth of the supply of more-educated workers decelerated during the 1980s. Allowing for a lag in the impact on inequality, rising wages due to the shortage in supply would have been reflected in an increase in inequality in the late 1980s and into the 1990s. Instead, inequality increased most quickly during the recession of the early 1980s and actually stabilized in the 1990s. On the demand side, trends in occupational composition do not suggest that, relative to the 1970s, upgrading was particularly rapid in the 1980s and 1990s.

Growth trends for a number of occupations that are likely to be sensitive to technological change (for example, computer programmer and bank teller) do not show the kinds of expansions or contractions one would expect if technology were having dramatic employment effects during the 1980s and 1990s. The one major possible exception is the decreasing share of clerical workers in the economy, which may reflect the effects of computerization, but even this trend does not coincide particularly well with the trend in wage inequality. Computer use itself does seem to be associated with more-educated workers, even controlling for occupation, but the

causal relationship here is uncertain and the magnitude of the observed association does not seem large enough to have seriously compromised the ability of supply to meet the implied growth in demand.

It does not appear that either deceleration in the growth of the supply of skilled workers or acceleration in demand can explain the early 1980s surge in inequality. There is little evidence that computer technology dramatically altered the occupational composition during this period, either adding jobs at the top of the skill hierarchy or automating them away at the bottom, nor does it seem that computer use significantly raised within-occupation skill requirements. Handel concludes that the pattern of inequality growth and the trend in blue-collar manufacturing employment suggest that a closer look at causes other than technology-driven imbalances between supply and demand for skills is needed. Both macroeconomic forces and the decline of institutional protections for workers may play important roles in the growth of U.S. wage inequality.

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### **What's Behind the Recent Rise in Profitability?**

[Edward N. Wolff](#)

[Working Paper No. 297](#), March 2000

Several analysts, both within and outside the Marxian tradition, have put forward explanations for the secular decline in the United States's profit rate from the late 1940s to the 1980s and its rise since the early 1980s. According to Senior Scholar Edward N. Wolff, the Marxian theory provides a useful framework for analyzing the factors driving the profit rate. He employs it using the conventional national income accounting categories as proxies for the Marxian categories.

Wolff estimates several measures of the profit rate, defined as the ratio of profits to current dollar value of net fixed capital stock, using alternative definitions of profits and national income for the corporate sector and private sector. The results show a remarkable degree of congruity in profitability trends. There is a declining trend from 1947 until the early or mid 1980s (depending on the measure chosen) and a steady rise since then. For example, corporate profitability fell by over 9 percentage points between 1947 and 1987 and rose by about 3.5 percentage points between 1987 and 1997.

Wolff decomposes the movements in the profit rate--his preferred measure is the ratio of property-type income adjusted for the wage-equivalent of the proprietors to the current dollar value of net fixed capital stock--into the movements in its determinants. The profit rate can be expressed as a ratio of two ratios: the profit-wage ratio (a proxy for the Marxian rate of surplus value) and the capital-wage ratio (a proxy for the Marxian organic composition of capital). A

rise in the profit-wage ratio raises the profit rate, and a rise in the capital-wage ratio has the opposite effect.

These two ratios can in turn be decomposed into their determinants. The profit-wage ratio can be expressed as a ratio of labor productivity to the product of the real wage and the price of consumption goods relative to the overall price level. Between 1947 and 1987 labor productivity and the real wage grew at the same rate. During the same period the consumer price index grew faster than the GDP deflator, causing a decline in the profit-wage ratio. Between 1987 and 1997 labor productivity grew slightly faster than the real wage, more than compensating for the rise in the consumer price index relative to the growth in the GDP deflator, thus leading to an increase in the profit-wage ratio.

The capital-wage ratio can be expressed as a function of the capital-labor ratio and the amount of wages required to obtain a unit of capital. The latter can be considered to be a measure of the labor content of capital, if the real wage and labor productivity move in tandem, except that it is measured in wage terms rather than in labor terms. An increase in the capital-labor ratio will raise the capital-wage ratio, while an increase in the amount of wages required to obtain a unit of capital will lower the capital-wage ratio. The capital-wage ratio shows no secular pattern, contrary to Marx's prediction that it will rise over the long term.

Wolff also undertakes a decomposition of changes in the profit rate into a technology effect and a real wage effect. The technology effect is a summary measure of the contribution of the labor productivity effect, the capital-labor ratio effect, and the effect of the changing labor content of capital. The decomposition shows that the two dominant causes for the rise in profitability since 1987 are the slowdown in the growth of the real wage and the marked slowdown in the increase in the capital-labor ratio.

To find an explanation for the lack of an upward trend in the capital-wage ratio, Wolff examines the hypothesis (originally advanced by Marx) that the shift of capital to more labor-intensive sectors can inhibit the increase in the capital-wage ratio. He finds that Marx's hypothesis is valid for the entire period from 1947 to 1997. Over that period, if the distribution of employment across industries had remained constant, the capital-wage ratio would have risen 54 percent, instead of only 5 percent. This would have resulted in a dramatic fall of 10 percentage points in the net profit rate. Structural change at the industry level thus plays an important role in regulating the trends in the profit rate.

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## **Program: Financial Markets and Monetary Policy**

### **The Brazilian Crisis: From Inertial Inflation to Fiscal Fragility**

Jan A. Kregel  
[Working Paper No. 294](#), February 2000

Visiting Senior Scholar Jan A. Kregel, an adviser at the United Nations Conference on Trade and Development, examines the Brazilian economic crisis from a Minskian perspective by analyzing the effects of high interest rates on private and public balance sheets. A similar analysis showed that the unraveling of the private balance sheets was the primary force behind the Asian crisis. In contrast, the crisis in Brazil is better characterized as a public debt deflation process.

The evolution of internal public debt and the dynamics of Brazilian macroeconomic policy during the 1980s and the early 1990s were strongly influenced by hyperinflation until the introduction of the Real Plan in 1994. Hyperinflation causes a rapid decline in the real value of government debt, thereby making it unattractive to private investors. The government sought a solution in the full indexation of the highly liquid government debt, but, in the context of hyperinflation, this meant that neither fiscal policy nor the money supply could be manipulated, leaving the interest rate as the only policy instrument to stabilize prices. The high interest rate policy was not effective and in fact worsened inflationary pressures by increasing the cost of capital and increasing the government deficit, since government debt was directly linked to short-term rates.

The Real Plan introduced the nominal exchange rate as an anchor for price stability, while retaining the interest rate as a major instrument of policy. With increasing global capital flows, the interest rate had an important effect on the exchange rate and capital inflows. In the early phase of the Real Plan, the real appreciated by about 15 percent against the U.S. dollar, although the plan originally intended to maintain it at dollar parity. The appreciation of the real contributed to the decline in inflation and led simultaneously, with the help of a liberalized trade regime, to current account deficits. Foreign capital inflows that exceeded current account deficits affected the fiscal balance because the central bank followed a policy of sterilization. The sterilization policy, along with the faster growth of government expenditure than of government revenue as a result of the decline in inflation, produced a growing budget deficit. Thus, although the Real Plan was immensely successful in taming inflation, the success was achieved at the price of growing imbalances in the domestic and foreign accounts. These imbalances set in motion a tendency toward deflation that led to the recent exchange rate crisis.

The major source of deflationary tendency was the debt deflation of the public sector. The success of the Real Plan was predicated on attracting sufficient amounts of foreign capital into the country and this required a high interest rate policy. However, the high interest rate worsened the government deficit directly by increasing the public debt service burden and indirectly through the sterilization of excessive capital inflows. Another impact of international financial market integration was that an increasing proportion of public debt came to be held by foreigners and thus the rate of interest effectively paid to foreigners also became the domestic interest rate. This meant that changes in the interest rate also had a direct impact on the foreign

deficit via changes in interest payments to foreigners. The only avenue through which the government deficit could be controlled was a continual reduction in government expenditure and the only avenue through which the current account deficit could be controlled was increased export growth. All market participants recognized that these imbalances could not be sustained in the long run. A gradual, but certain, outflow of capital began, culminating in a full-blown exchange rate crisis.

The private sector, unlike the case in the East Asian crisis, did not undergo a meltdown in the recent Brazilian crisis for several reasons. The Brazilian corporate sector was not highly indebted to the banks; its main sources of funds were retained earnings and the equity markets. The banks in Brazil did not have significant amounts of foreign currency loans and were therefore not much affected by exchange rate fluctuations. Furthermore, the banking system had undergone a thorough restructuring process in 1994 and 1995 in which strict supervisory and regulatory provisions were introduced.

The crisis poses a serious dilemma for Brazilian macroeconomic policy. Estimates show that the current annual growth rate of the Brazilian labor force is about 2.7 percent and productivity growth is about 3.5 percent. This implies that Brazil requires a growth rate in excess of 6 percent to avoid increases in the current level of unemployment. Without drastic interest rate reductions, there is no plausible way for the economy to generate the required growth rate. Some economists suggest that this objective can be achieved by a rise in the export surplus generated by the devaluation. However, current indications are that the export surplus is a result of imports falling more rapidly than exports, with the sharp declines in income cutting consumption and imports. This suggests that any decline in the interest rate that leads to a resumption of growth high enough to reduce unemployment is likely to aggravate the foreign imbalance, thus forcing a reversion to a high interest rate policy which, in turn, will curtail growth.

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#### **An Alternative Stability Pact for the European Union**

[Philip Arestis](#), Kevin McCauley, and [Malcolm Sawyer](#)  
[Working Paper No. 296](#), March 2000

Visiting Senior Scholar Philip Arestis, of the University of East London; Kevin McCauley, of the University of East London; and Visiting Senior Scholar Malcolm Sawyer, of the University of Leeds propose an alternative to the European Union's Stability and Growth Pact. They refer to their alternative as a full employment, growth, and stability pact to emphasize the change in policy objectives they recommend.

The Stability and Growth Pact accompanied the introduction of a single currency in the

European Union (EU). The pact sets four rules for economic policy: the European central bank (ECB) is granted independence from political influence, bail outs of national government deficits are not permitted, monetary financing of deficits is prohibited, and member states are instructed to avoid excessive deficits (defined as more than 3 percent of GDP). These rules seem to be based on several assumptions--that the democratic process in general and politicians in particular cannot be trusted to make economic policy with the best long-term interest of society in mind, but that central bankers who are not subject to political pressure can be trusted; that inflation is a monetary phenomenon that can be controlled through monetary policy; that the level of unemployment is determined by supply-side factors only; and that fiscal policy cannot affect real variables. The pact restrains member nations' ability to use fiscal policy to achieve full employment at the national level, but does not provide any institution that can conduct fiscal policy at the EU level, leaving the European central bank's monetary policy working through interest rates as the only stabilization policy tool available in the EU.

The authors believe that a Keynesian analysis of the workings of the economy is more appropriate than the assumptions on which the pact is based. In the Keynesian view, high aggregate demand is required to sustain high levels of economic activity, and inflation arises from pressures on the real side of the economy. The creation of productive capacity through investment and the building of an equitable income distribution are important ingredients of antiinflationary policy. Since there is no strong reason to believe that the private sector will generate sufficient demand to achieve full employment, expansionary fiscal policy may be necessary. Furthermore, an overly tight monetary policy may reduce capacity and make it more difficult for the economy to achieve full employment without inflation.

According to this view, the Stability and Growth Pact has several flaws. Monetary policy alone cannot achieve full employment. Interest rate changes will have different effects in different member countries because of large divergences in the financial products used. Present unemployment disparities suggest that even if full employment were achieved in some regions, substantial unemployment would remain in others; inflationary pressure would build up in fully employed regions even when less prosperous regions still had significant unemployment. In addition, insulating the ECB from political pressure is undemocratic. The central bank was designed to be insulated from political pressure on the grounds that the setting of interest rates is a purely technical matter. However, because the rates have distributional consequences, for income groups, industries, and regions, their setting should be influenced by those consequences.

The authors' proposed full employment, growth, and stability pact has four major elements. The ECB should be reformed to make it more accountable and to pursue a broader range of objectives; it must act as lender of last resort and participate in the coordination of monetary and fiscal policy. The EU-level budget should be enlarged to become more redistributive (across countries and time) and to allow national governments more discretion to pursue expansionary fiscal policy. A European investment bank should be established to ensure that less prosperous regions share in economic growth. Institutional arrangements, such as centralized collective bargaining, should be encouraged to create an environment in which inflationary pressures are kept low.



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### **Krugman on the Liquidity Trap: Why Inflation Won't Bring Recovery in Japan**

Jan A. Kregel

[Working Paper No. 298](#), March 2000

Paul Krugman has argued that Japan is in a liquidity trap, and he has made recommendations, based on a Hicksian understanding of the liquidity trap, that are similar to Fisher's proposals during the Great Depression in the United States. According to Visiting Senior Scholar Jan A. Kregel, both Hicks and Krugman misinterpreted Keynes's concept of the liquidity trap and the policy recommendations that follow from their versions cannot bring recovery to Japan.

Hicks's version of the liquidity trap employed Fisher's definition of the real interest rate as the nominal rate minus the inflation rate. If the equilibrium real rate of interest is negative but the nominal rate of interest cannot go below zero, then, in a world of stable prices, the equilibrium real rate of interest cannot be reached. However, as Fisher recommended, a positive inflation rate would allow the real rate of interest to become negative and restore equilibrium. In Krugman's version, an expansionary monetary policy may be incapable of creating the necessary inflation to reach equilibrium if the public does not expect the increase in the money supply to be sustained. To succeed, the monetary authority must convince the public that it will keep the money supply growing at the new, higher rate perpetually. The liquidity trap occurs because the real rate of interest cannot be influenced by monetary policy unless the monetary authority can make the threat to create inflation credible.

Kregel believes that both versions misinterpret Keynes's liquidity trap, which has nothing to do with Fisher's distinction between real and nominal interest rates. The cause of the liquidity trap in Keynes is the expectation of future yields. Higher yields cause capital losses to those holding existing bonds that will more than offset the increased interest earnings. The loss in holding the liquid asset money is the loss of interest earnings, but the loss in holding bonds is the much larger decline in capital value. Thus, the liquidity trap will occur whenever investors expect interest rates to rise by more than enough to create a capital loss large enough to offset the increased yields. The lower the interest rate, the more likely a reversal in interest rates, but because liquidity preference is a relative concept, the existence of a liquidity trap at higher interest rates cannot be ruled out. Thus, the true Keynesian liquidity trap does not depend on the absolute level of the interest rate or on the distinction between real and nominal interest rates or on the lack of credibility of the central bank.

On the basis of the Keynesian liquidity trap, Kregel concludes that Krugman's policy of credible inflation cannot work. Instead, the central bank should adopt a policy of pegging long rates to

eliminate the portfolio risk of a rise in interest rates. It is not a credible inflation policy but a credible interest rate policy that is lacking. The stimulating effect of the expectation of higher prices is caused by raising the expectation of returns on new investment relative to the rate of inflation, which is to say that the Fisher relation should not hold. What is required is a credible policy to ensure increased returns on investment, which may or may not be accompanied by rising prices. This strategy requires increases in aggregate demand, which could be generated by a credible policy of increasing the return on production for domestic demand.

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### **A Dual Mandate for the Federal Reserve**

[Willem Thorbecke](#)

[Public Policy Brief No. 60](#), 2000

The Federal Reserve currently has two legislated goals--price stability and full employment--and it has been pursuing both. However, Congress is engaged in a continuing debate about whether that mandate should be changed to make price stability its "primary and overriding goal." Research Associate Willem Thorbecke, of George Mason University, rebuts the case for price stability as a single goal and then argues for giving full employment equal importance in formulating monetary policy.

The case for assigning primacy to fighting inflation rests on four arguments: monetary policy cannot affect real variables; it cannot be used to moderate short-run economic fluctuations because it has an inflationary bias; even moderate inflation inhibits economic growth; and inflation targeting provides the nominal target that monetary policy needs. Thorbecke finds that the recent history of monetary policy and economic performance contradicts these arguments. It shows that the natural rate of unemployment is affected by disinflationary policy and duration of unemployment benefits, implying that monetary policy can affect long-run real variables. In 1979 the Fed did engineer a deflation and it has since kept inflation low without adopting binding rules. The costs of anticipated inflation have been minuscule, and the costs of unanticipated inflation have been estimated to be quite small. Finally, the Fed has kept inflation low without using an explicit nominal anchor such as a target for the exchange rate or inflation.

Thorbecke presents several reasons for emphasizing full employment. First, under the current dual mandate the United States has experienced low unemployment and low inflation, while many countries whose central banks target inflation are experiencing double-digit unemployment. Second, the costs of unemployment are known to be substantial, but the costs of moderate inflation are probably not large. Third, central bankers tend to be inflation-averse and, if anything, need to be prodded to take goals other than inflation into account. Fourth, if the Fed pursues only price stability, the price level is not free to increase; such an increase may be necessary to avoid large increases in unemployment following an adverse supply shock.

According to Thorbecke, the current monetary policy regime has had excellent macroeconomic results. The dual mandate has allowed the Fed to focus on inflation or unemployment as conditions demand and to balance the effects of policy decisions. Shifting from an approach that has been so successful to a single goal of price stability, which has not proved successful in other economies, seems unwise.

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### **Program: Federal Budget Policy**

#### **A New Approach to Tax-Exempt Bonds**

[Edward V. Regan](#)

[Public Policy Brief No. 58](#), 1999

Policy Advisor Edward V. Regan, of the Municipal Assistance Corporation of New York City, proposes an alternative to the system of tax-exempt bonds currently used to finance capital investment by local and state governments. His alternative is designed to overcome three main problems with the current system: its inefficiency and the inequitable transfer of wealth to high-income investors, exclusion of potential assets, and lack of stable institutional oversight.

The current system exempts interest payments on municipal debt from federal income taxes. Purchasers of municipal bonds are willing to accept a lower rate of interest because they receive interest payments that are tax free, thereby lowering the cost of borrowing to state and local governments. If the tax revenues forgone by the federal government were completely matched by the reduction in borrowing costs for the municipalities, the current system could not be faulted on grounds of inefficiency. However, Regan argues, since the amount of municipal borrowing needed outstrips the capacity and willingness of high-bracket taxpayers (the usual purchasers of the bonds) to provide such financing, the interest rates on municipal bonds have to rise to attract investors from lower tax brackets. As a result, the tax-equivalent yield for the high-income investors rises and they obtain windfalls at the expense of average taxpayers. The loss of subsidy to the municipalities and its transfer to the wealthy are both inefficient and inequitable.

According to Regan, another serious problem with the current system is that it excludes several categories of large institutional investors with their huge pools of capital. As a result of changes in the tax treatment of institutional holdings of tax-exempt bonds in U.S. Treasury and Internal Service rulings and the 1986 Tax Reform Act, corporations and commercial institutions such as banks divested themselves of municipal bonds. Foreign investors are also excluded from the municipal bond market and pension funds have never participated in it. In most other industrial countries, municipal infrastructure projects can exploit broader markets. Exclusion of large institutional investors also contributes to a lack of stable oversight, which would go a long way toward preventing scandals such as the Orange County bankruptcy.

The solution proposed by Regan is a new security concept, the American global infrastructure security, or AGIS. The idea is to create a taxable bond for sale in the regular capital markets, but one that contains a special tax-exempt benefit that can be stripped from the bond and sold separately to investors who seek tax sheltering but do not want to buy a long-term municipal bond or an interest in a municipal bond mutual fund. The purchasers of the tax benefits would receive an annual exclusion from gross income equal to what would otherwise be the tax-exempt interest on the bond and pay a price based on the after-tax present value of a stream of future annual exclusions. They apply against their annual taxable income an amount equal to the associated tax benefits. Municipalities would use the money they receive from the sale of the tax benefits to reduce the principal amount of bonds required to be issued to finance the desired level of capital expenditures.

Separating the two components of the municipal bond--tax exclusion and a fixed-income government security--makes the AGIS bond competitive in two separate markets. The pools of capital that municipalities can tap into for financing their infrastructure projects is thereby broadened to a universe of interest-income seekers including U.S. pension funds and banks, foreign pension funds, and global investors. Competitive bidding among these numerous investors could lower interest rate costs to the issuing governments and their taxpayers.

Regan does not believe that the AGIS should supplant the tax-exempt market; the latter would remain as an alternative and as a check on the efficiency of the new process. With the emergence of large pension funds, entry of private firms into infrastructure financing, and several municipal bond scandals, the arguments against the current form of tax exemption of municipal bonds have never been so strong; with the Supreme Court finding against its constitutional protection, the legal argument for maintaining it has never been so weak. Federal legislation to allow a test of AGIS bonds would begin to tackle a long-standing inefficiency in the municipal bond market and move that market in a healthy direction.

### **Social Security Privatization: A Bad Idea**

[Walter M. Cadette](#)  
[Policy Note 1999/10](#)

In the debate over Social Security many have called for partial or full privatization of the system. The typical privatization plan retains a scaled-down public program to provide a basic benefit to all and assigns the rest of the Social Security taxes to private accounts. Senior Scholar Walter M. Cadette argues that this is unwise public policy.

According to Cadette, the Social Security system has pursued two conflicting objectives throughout its history. Individual equity (or money's worth) is the goal implicit in benefits formulas that relate pensions to taxes paid: the more workers put in during their working life, the more they get back in dollar terms during retirement. Social adequacy (protection of the low-

income elderly) is reflected in higher percentage returns on the taxes paid in by relatively low-income workers. Conflict between these two objectives has been muted in the past by favorable demographics, but as the ratio of workers to retirees falls, the conflict is intensifying.

Carving out taxes for individual accounts would undermine the redistributive mechanism that is essential to Social Security's mission. Privatization puts retirement benefits at risk, especially for low-income workers who may have little investment experience and who are vulnerable since Social Security is apt to be their major or only source of retirement benefits.

A crucial assumption underlying most privatization plans is that the long-term, inflation-adjusted rate of return on equities of 7.5 percent will hold into the future. For these returns to continue, economic activity would have to advance more rapidly than the economy's long-term growth potential or price-earnings ratios would have to rise even further above their historical levels than they are now.

Privatization plans also downplay the transition costs; new taxes will be needed to fund both the existing liabilities and the private accounts. Whenever part of the Social Security taxes are first devoted to private accounts, the then current workforce will be funding its own pension as well as the pensions of current retirees.

Cadette acknowledges that thirty years from now Social Security probably will not be able to meet its current commitments at current tax rates under plausible assumptions regarding demographic change and economic growth. The way to deal with this impending problem is not through privatization or other reforms of Social Security itself, but through long-run macroeconomic policy. The leakages from tax revenues to service domestic public debt have to be checked, and the ever-growing share of the national income that has to be devoted to foreign claimants as a result of external deficits should be also be curbed. Privatization is not the answer. The current system, which is essential for the welfare of the relatively low-income elderly, need not be compromised in the name of saving it.

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## Strategic Analysis

### **Interim Report: Notes on the U.S. Trade and Balance of Payments Deficits**

[Wynne Godley](#)

<http://www.levy.org/docs/sreport/stratan.html>

This is Distinguished Scholar Wynne Godley's summary of a report in his series of strategic

analyses based on projections derived from his accounting-based models of the U.S. and world economies. He presented these findings in December to the congressional Trade Deficit Review Commission.

1. The United States has a balance of payments deficit worth nearly 4 percent of GDP and negative net foreign assets (or foreign debt) worth nearly 20 percent of GDP. If U.S. growth is sustained in the medium term, it is quite likely that the balance of trade in goods and services will not improve. The United States is the only major country or country "bloc" to have a substantial trade deficit and this is proving of great advantage to the rest of the world.

2. If the balance of trade does not improve, there is a danger that over a period of time the United States will find itself in a "debt trap," with an accelerating deterioration both in its net foreign asset position and in its overall current balance of payments (as net income paid abroad starts to explode). Such a trap would call imperatively for corrective action if it is not at some stage to unravel chaotically.

3. The emergence of a debt trap is put forward as a possibility that must be taken seriously rather than as a forecast of what is most likely to happen. Policymakers are advised to ensure that adequate instruments are available should things start getting out of hand.

4. Whether the outflow of property income starts to accelerate depends critically on the rate of return earned on internationally owned assets and liabilities. The well-known condition for exploding payments on debt is that the rate of interest exceeds the growth rate. At present the United States's negative position is worth about \$1,500 billion while the net foreign income outflow is only about \$10 billion, so it might be supposed that there is nothing to worry about. But this is deceptive. The low rate of return overall, measured *ex post*, is the consequence of the extremely low return so far earned on foreign direct investments in the United States. However, the bulk of any change in the net asset position, in the future as in the past, is likely to take the form of financial investment, which has been earning a much higher rate of return and one that already slightly exceeds the growth rate. Also, the return on foreign direct investment in the United States may improve.

5. There have recently been extremely heavy direct investments by foreign firms in the United States, but a high proportion of these have been financed by exchange of shares and, to that extent, make no contribution at all to the financing of the deficit. The analysis of capital account flows and rates of return would be greatly facilitated if acquisitions financed by share exchange were identified separately in the accounts.

6. Policy responses in principle come down to (a) reducing domestic demand, (b) raising foreign demand, (c) reducing imports and increasing exports relative to GDP, preferably by changing relative prices.

7. The danger is that resort (perhaps by default) will be had to remedy (a), in other words, that chronic and growing imbalances between the United States and the rest of the world come to impart a deflationary bias to the entire system, with harmful implications for activity and unemployment. Remedy (b) reads hollow when neither appropriate institutions nor agreed upon principles exist, but should not be dismissed out of hand. As for remedy (c), currency depreciation is the classic remedy. But, in view of the way global capital markets work, depreciation has ceased to be a policy instrument in any ordinary sense, and "floating" cannot be counted on to do the trick. Policymakers should be aware of the possibility of using nonselective (nondiscriminatory) control of imports in extremis in accordance with the principles set out in Article 12 of the WTO. Such a policy is to be sharply distinguished from "protectionism" as commonly understood.

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## Special Studies

### **Explaining the U.S. Trade Deficit**

Anwar M. Shaikh

[Policy Note 2000/1](#)

According to Anwar Shaikh, of New School University, a trade balance has two components: a long-term or structural component that is related to competitiveness and a short-term component that is related to countries' relative growth rates. Conventional economic analysis is based on the notion that real exchange rates will move in such a way as to make countries equally competitive without requiring any changes in productivity and real wages. Shaikh argues that just the opposite is the case. Relative production costs, governed primarily by real wages and productivity, determine real exchange rates and therefore a country with relatively high costs will suffer persistent trade deficits vis-à-vis its competitors in the world market. Differentials in growth rates can aggravate or weaken the fundamental pattern imposed by competitiveness, but they do not determine that pattern itself.

The structural deficit of the United States has been growing since the mid 1970s because of a lack of international competitiveness. The gap in competitiveness has narrowed over time, but it is still considerable between the United States and its Asian competitors. The short-term deficit is due to the relatively faster growth of the United States in recent years, which has made its imports grow faster than its exports.

Shaikh argues that it is important not to overestimate the impact of the short-term component on the overall trade balance. If this were the decisive factor, Japan should have had a large trade

deficit during the period of rapid growth from 1960 to 1990 and the United States should have had a trade surplus during its period of slow growth in the 1970s and 1980s. The patterns in these two periods were, in fact, the opposite.

According to Shaikh, his alternative analysis of the trade deficit has clear policy implications. First, it provides a rule of thumb that differs from the conventional wisdom. The appropriateness of the real exchange rate should be judged by whether it is in line with relative costs rather than by its ability to balance trade. Second, a focus on rapid productivity growth should be an essential component of trade-related policy since productivity differentials play a crucial role in determining the structural component of the trade deficit.

## **The Public Commodities Problem**

[Karl Widerquist](#)

[Working Paper No. 299](#), March 2000

The median voter theorem states that on a one-dimensional issue on which voters have single-peaked preferences, the median voter's position cannot lose under majority rule voting. This theory has been taken to imply that the level of spending on public goods should reflect the amount the typical voter believes is reasonable. Resident Research Associate Karl Widerquist discusses a problem with the median voter theorem created by the fact that one person's public good is another's public bad.

Although public goods spending is a continuous variable, it often has a binary goal. Normally, the public goods problem is framed as the question, what is the optimal level of spending on a public good? However, this question can be separated into two. The first question is normative and binary: Should the government pursue this goal? The second question is positive and continuous: If this goal is adopted, what is the optimal level of spending given that goal? The question of whether the goal of a spending program is legitimate cannot be separated from the question of how many resources should be devoted to achieving that goal. Widerquist attempts to demonstrate that the inability of the political process to separate these questions leads to a level of spending that is less than the typical voter believes is optimal given the goal of spending. In other words, there is an underfunding bias.

Widerquist believes that the normative question separates voters into two distinct groups--supporters of a public good and opponents. Because the positive question is continuous, it is likely that there will be disagreement among supporters about the optimal level of spending. Voters will cluster into two populations: opponents, whose ideal level of spending is zero and who always favor less spending over more, and supporters, who favor some positive level of spending but disagree about the ideal level. ("Negative" spending is defined as spending to block the goal.) Supporters have an incentive to answer the positive question honestly; therefore, the median supporter's position can be taken to be the amount the typical supporter believes is the optimal level of spending given the goal of spending. Opponents do not have an incentive to



be honest about their answer to the positive question; instead, they have an incentive to keep spending as low as possible no matter how much spending they believe is necessary to achieve the goal.

According to Widerquist, if the majority of voters are supporters, some positive level of spending will pass. However, if a substantial minority of voters are opponents, a coalition of opponents and the supporters who desire relatively less spending can assure a level of spending that most supporters agree is below optimal. Opponents may agree that the level is below what would be optimal to achieve the spending's goal, but because they oppose the goal they have no reason to reveal this belief. Thus, the amount of spending approved by the global median voter (the median of the entire population) will not reflect the level of spending that the typical supporter believes is optimal, but will be determined largely by the relative numbers of supporters and opponents.

The more opponents there are (and the more disagreement there is among supporters about the optimal level of spending), the greater the difference will be between the median supporter and the global median. If opponents are 40 percent of the population, the global median will be nearly 1 standard deviation below the median supporter. If opponents are 49 percent of the population, the global median will be more than 2 standard deviations below the median supporter. As long as there are any opponents, the global median will be below the median supporter. Thus, there is a bias toward underfunding.

Widerquist uses the Reagan-era budget cuts as an example of the public commodities problem. In that era there was a large reduction in the level of spending on social programs but few were eliminated. According to the traditional median voter theorem, this type of budget cutting would occur if the typical voter decided that less spending was needed to achieve each program's goals but did not change his or her support for the goals of the programs. This hardly seems to coincide with the rhetoric of the times; those who proposed the cuts often attacked social programs as having no value. It is more likely that the number of congressional opponents of social programs increased; they failed in their attempt to eliminate most of the programs, but managed to cut spending on many of them. This is exactly what would be predicted by Widerquist's version of the median voter theorem if the number of opponents increases but fails to become a majority.

## **Institutional Factors in the Economy of Early Modern Germany**

Michael North

Seminar, March 2

According to Michael North, of Ernst Moritz Arndt University, the study of economic history in the United States and the United Kingdom has been greatly influenced by the new institutional approach since the 1960s, when institutions and institutional change began to be seen as a driving force. Historical studies of the German economy, however, have barely been affected.

North attempts to rectify this by examining the economic effects of institutions in early modern Germany.

North defines institutions as "humanly devised constraints that shape human interaction." They can be formal (such as laws and contracts) or informal (such as cultural norms). The significance of formal institutional structure in early modern Germany has been underestimated largely because the Holy Roman Empire was not a modern nation state but a confederation of self-governing states. But, imperial institutions contributed to the development of a market economy in Germany.

The supreme courts--the Imperial Chamber Court and the Imperial Council--were among the most important institutions for economic development and growth. To determine the courts' role, North examined every documented case that was brought before the Imperial Chamber Court from Hamburg, Lübeck, Mecklenburg, Schleswig-Holstein, and Pomerania between 1495 and 1806. He found that economic matters constituted by far the majority of cases from Lübeck and Hamburg. The economic cases were a smaller share of the cases from the more agrarian Mecklenburg, but that share was still significant. Decisions such as those enforcing contracts and settling guild disputes created a culture of confidence in market participation and production, which was decisive for the expansion of trade. The imperial jurisdiction was closely connected with economic activity and was a major institutional factor in development of a market economy.

North noted three areas in which the institutional approach could make a valuable contribution to the study of economic history. First, there should be a reevaluation of the role of the state in the economy because it was the state that largely initiated institutional change up until the beginning of the nineteenth century, when that role was taken over by the subjects. Second, there should be discourse between economics and law, especially between economic history and the history of law, which can establish a link between constitutional history and the causes of economic growth. Third, there should be discourse between economic history and social and cultural studies to increase understanding of the effects of informal institutions on economic behavior.

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## Institute News

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### Upcoming events

## **The Liberalization of Financial Markets: National and International Perspectives**

### **Tenth Annual Hyman P. Minsky Conference on Financial Structure**

April 27-28, 2000

Blithewood

Liberalization of international capital flows is hailed by some analysts as the means by which emerging nations can be drawn into the globalized financial market, but others warn that if those nations make the leap into modern capitalism without first establishing a sound regulatory and institutional framework, they are embarking on a path that can lead to national and ultimately international disaster.

As part of its research program on financial markets and monetary policy, the Levy Institute is organizing this conference to explore the ramifications of financial liberalization by considering questions such as:

- What is the current status of international and domestic financial markets?
- What effect will recent policy decisions by international agencies and national governments have on the stability of these markets?
- What is the current status of electronic banking and what impact will it have on the financial system?
- Is a new international regulatory and institutional framework needed to create a system that can withstand shocks without deteriorating into crisis? If so, what form might or should it take?
- What have been the successes and failures of monetary integration in Europe?
- What are the pros and cons for Latin American economies of dollarization?

See our web site for [program and registration](#) information.

### **Workshop on Earnings Inequality**

June 6, 2000

Blithewood

(By invitation only)

### **Conference: Saving, Intergenerational Transfers, and the Distribution of Wealth**

June 7-9, 2000

Blithewood

(Conference fee: \$150)

### **Publications and Presentations by Levy Institute Scholars**

### **Distinguished Scholar Wynne Godley**

**Presentations:** "Notes on the U.S. Trade and Balance of Payments Deficits," Testimony before the Trade Deficit Review Commission, Washington, D.C., December 10, 1999; "Credit and Money in a Keynesian Model," University of Ottawa, December 17, 1999; "Why the U.S. Boom Is Unsustainable," Allied Social Sciences Association, Boston, January 7-9, 2000.

### **Visiting Senior Scholar Philip Arestis**

**Publications:** "Globalization, Regionalism and National Economic Policies" (with E. Paliginis), in J. Toporowski (ed.), *Political Economy and the New Capitalism: Essays in Honour of Sam Aaronovitch* (Elgar, 1999); "Financial Liberalisation: The Experience of Developing Countries" (with P. Demetriades), Working Paper no. 19, Department of Economics, University of East London, November 1999; "Financial Crisis in South East Asia: Dispelling Illusion the Minskyan Way" (with M. Glickman), Working Paper no. 22, Department of Economics, University of East London, December 1999; "Financial Liberalisation in Developing Countries" (with P. Demetriades), *Eastern Economic Journal*, Fall 1999.

**Presentations:** "The Relevance of Kalecki's 'Political Aspects of Full Employment' to the 21st Century" (with F. E. Skuse) and "The Economics of New Labour: An Assessment of the First Two and a Half Years" (with M. Sawyer), Allied Social Sciences Association, Boston, January 7-9, 2000.

**Senior Scholar James K. Galbraith Publications:** "Inequality and Unemployment in Europe: The American Cure" (with Pedro Conceição and Pedro Ferreira), *New Left Review*, no. 10, 1999; "Inequality in American Manufacturing Wages, 1920-1998: A Revised Estimate" (with Vidal Garza-Cantú), *Journal of Economic Issues*, September 1999; "The American Wage Structure, 1920-1947" (with Thomas Ferguson), *Research in Economic History* 19 (1999); Review of *Boggs: A Comedy of Values by Lawrence Weschler*, *The American Prospect*, December 6, 1999; Review of *The Economic Report of the President*, *Challenge*, November-December 1999; Review of *Money and the Nation State: The Financial Revolution, Government and the World Monetary System*, Kevin Dowd and Richard H. Timberlake Jr. (eds.), *Journal of Economic History*, December 1999; "How the Economists Got It Wrong," *The American Prospect*, February 14, 2000.

**Presentation:** Testimony before the Trade Deficit Review Commission, Washington, D.C., December 10, 1999.

### **President Dimitri Papadimitriou**

**Presentation:** "Unfinished Agenda for Full Employment Policy," New York University, November 23, 1999.

### **Senior Scholar Joel Perlmann**

**Publications:** "Multiracials, Racial Classification, and American Intermarriage," in Werner Sollors (ed.), *Interracialism* (Oxford University Press, 2000); "Are the Children of Today's Immigrants Making It?" (with Roger Waldinger), in Stephen Steinberg (ed.), *Race and Ethnicity in the United States* (Blackwell, 2000).

### Visiting Senior Scholar Malcolm Sawyer

**Publication:** Editor, *The Legacy of Michal Kalecki*, vols. 1, 2 (Elgar, 1999).

### Senior Scholar Edward N. Wolff

**Publications:** "The Economy and Philanthropy," in Charles T. Clotfelter and Thomas Ehrlich (eds.), *Philanthropy and the Nonprofit Sector in a Changing America* (Indiana University Press, 1999); "Specialization and Productivity Performance in Low-, Medium-, and High-Tech Manufacturing Industries," in Alan Heston and Robert E. Lipsey (eds.), *International and Interarea Comparisons of Income, Output, and Prices, Studies of Income and Wealth*, vol. 61 (Chicago University Press, 1999); "Recent Trends in the Distribution of Household Wealth," in Ray Marshall (ed.), *Back to Shared Prosperity?* (M.E. Sharpe, 2000).

**Presentations:** "Will Stocks Save the Middle Class?" Japan External Trade Organization, New York, October 12, 1999; "Recent Trends in Wealth Inequality," Georgetown Law School, Washington, D.C., January 5, 2000; "Why Stocks Won't Save the Middle Class," American Association of Law Schools, Washington, D.C., January 6-7, 2000; "Has Canada Specialized in the Wrong Manufacturing Industries?" CSLS Conference: The Canada-U.S. Manufacturing Productivity Gap, Ottawa, January 21-22, 2000.

**Media:** Commentary on Donald Trump's proposal for a wealth tax, CNN Nightly News, December 15, 1999; "The O'Reilly Factor," Fox Cable News, January 18, 2000; Commentary on inequality in the United States, ECON News (Japan), February 4, 2000.

### Visiting Senior Scholar L. Randall Wray

**Publications:** "The 1966 Financial Crisis: Financial Instability or Political Economy?" *Review of Political Economy*, no. 4 (1999); "Money, Credit and Finance" and "Monetary Theory of Production" (with Johan Deprez), in Phillip O'Hara (ed.), *Encyclopedia of Political Economy* (Routledge, 1999); "Subway Tokens and Social Security," Center for Full Employment and Price Stability, Policy Note 99/2 and Dismal.com, September 1999.

**Presentations:** "Buckaroos: The Community Service Program at UMKC," Second Annual Path to Full Employment, University of Newcastle, Australia, December 1-2, 1999; "Can Penal Keynesianism Replace Military Keynesianism?" Allied Social Sciences Association, Boston, January 7-9, 2000.

**Media:** Interview, community public radio, Kansas City, December 1999.

### Research Associate Mathew Forstater

**Publications:** "Vision and Analysis in Heilbroner's Political Economy: Worldly Philosophy and the Nature and Logic of Capitalism," *Journal of Economic Issues*, December 1999; "Savings-Recycling Public Employment: Vickrey's Assets-Based Approach to Full Employment and Price Stability," in A. Warner, M. Forstater, and S. Rosen (eds.), *Commitment to Full Employment* (M.E. Sharpe, 2000); editor (with A. Warner and S. Rosen), *Commitment to Full Employment* (M.E. Sharpe, 2000).

**Presentations:** "Working Backwards: Instrumental Analysis as a Policy Discovery Procedure," New York University, November 1999; "Full Employment and Discrimination," Allied Social Sciences Association, Boston, January 7-9, 2000; "Must Spontaneous Order Be Unintended?" Conference: Science as a Spontaneous Order, Copenhagen, January 2000.

**Resident Scholar Oren M. Levin-Waldman**

**Publication:** "Minimum Wage and Justice," *Review of Social Economy*, March 2000.

**Resident Scholar Jamee K. Moudud**

**Publication:** "Economic Growth," in *International Encyclopaedia of Political Economy* (Routledge, 2000).

**Presentation:** "Open Economy Macrodynamics," Allied Social Sciences Association, Boston, January 7-9, 2000.

**Resident Research Associate Ajit Zacharias**

**Presentation:** "Wassily Leontief and Mainstream Economics," Allied Social Sciences Association, Boston, January 7-9, 2000.

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