



Report

FEBRUARY 2003

VOLUME 13, NUMBER 1

STRATEGIC ANALYSIS

Is Personal Debt Sustainable?

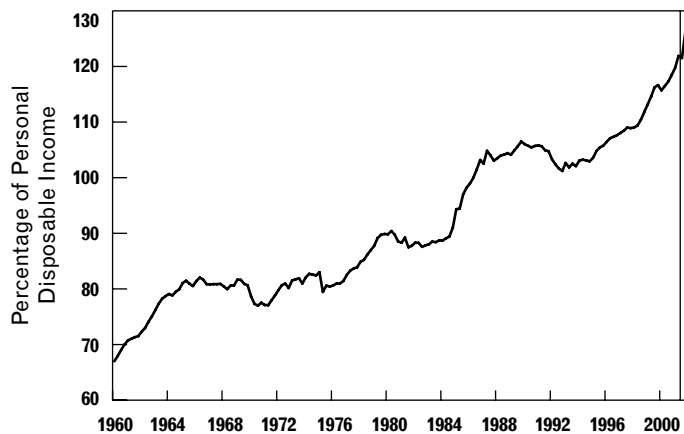
DIMITRI B. PAPADIMITRIOU, ANWAR SHAIKH,
CLAUDIO DOS SANTOS, AND GENNARO ZEZZA

www.levy.org/docs/stratan/pdfs/perdebt.pdf

Many observers believe that the U.S. economy has emerged, at least temporarily, from recession. With investments still sluggish and a trade deficit that shows no signs of improving, the U.S. consumer has played the greatest role in keeping the economy (barely) on its feet. Despite the collapse in stock prices, consumers have taken advantage of rising property values and low interest rates to continue borrowing and spending. Debt in the personal sector now stands at nearly 130 percent of disposable income. What will happen to the economy when this buildup comes to an end? In the latest Strategic Analysis, Levy Institute President Dimitri B. Papadimitriou, Senior Scholar Anwar Shaikh, and Research Scholars Claudio Dos Santos and Gennaro Zezza assess the ways in which the economy will be affected in future years by its burden of debt.

Continued on page 3

Personal Sector Debt Outstanding



Sources: NIPA, Flow of Funds, and authors' calculations

13th Annual Hyman P. Minsky Conference: "Economic Policy for Sustainable Growth"
New York City, April 15, 2003 See page 8

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

The *Report* is a quarterly publication of The Levy Economics Institute of Bard College.

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The authors examine several possible scenarios for the coming years. They find that in the absence of growing government deficits, maintaining growth would require a continued spiral of debt-financed consumer spending. Since the authors consider such a trend unsustainable, they calculate the impact of the almost inevitable retrenchment in consumption. Without a compensating infusion of spending from either the foreign or government sectors, they demonstrate that the economy would enter a prolonged, deep recession. Growth would average 1 percent from 2002 to 2006 and the unemployment rate would rise to 8 percent by the end of that period.

Clearly this scenario is unacceptable to policymakers and the public. The government would probably react to a recession by dramatically easing its fiscal stance. (The administration has already staved off the worst outcome with its recent tax cuts.) How much fiscal stimulus would be needed to maintain a reasonable rate of growth in the face of a drop-off in private borrowing? The authors calculate that the total deficit of the public sector would have to rise to 8 percent of gross domestic product just to meet existing Congressional Budget Office growth forecasts.

Many policymakers would find this scenario unpalatable and perhaps just as unsustainable as the current buildup of private sector debt. The only alternative, the authors argue, is an improvement in the current account deficit, which now stands at near record levels. Effecting a turnaround in the current account without a decline in the value of the dollar (or depreciation) may be difficult, however. A lower dollar would raise the price of imports (in dollars) and make U.S. goods less expensive abroad. A depreciation of about 25 percent would probably be necessary. A long-expected fall in the value of the dollar has only begun to materialize, however, and a reduction in U.S. imports would imperil economies around the world that count on income from exports to the United States. A policy of weakening the dollar would therefore have to be combined with stimulative measures, such as increased government spending, not just in the United States, but also in its trading partners.

If policymakers brought the current account under control, the government deficit and private sector balances could be returned to sustainable levels within about five years. This objective may be difficult to achieve, say the authors, but there is no acceptable alternative.



JAMES K. GALBRAITH

New Policy Note

The Big Fix: The Case for Public Spending

James K. Galbraith

Policy Note 2003/1

www.levy.org/docs/pn/03-01.html

As the need for further government action to maintain sufficient growth becomes increasingly apparent, politicians are considering various economic stimulus plans forwarded by the administration and Congress. In a new Policy Note, Senior Scholar James K. Galbraith suggests an appropriate stimulus package in the form of new spending on vital programs and tax cuts for those who need them the most.

Galbraith criticizes proposals to cut taxes for wealthy investors, arguing that only the prospect of renewed growth can encourage new spending on factories, equipment, and other capital goods.

Moreover, in the absence of decisive action, several trends having little to do with excessive taxation will dampen economic growth. Because the current slowdown has reduced the flow of new tax revenues, state and local governments are being forced to cut back on spending for programs such as Medicaid. If the current buildup of private debt reaches its limit, consumer spending may fall dramatically.

To counteract these potentially perilous developments, Galbraith writes, Congress should provide what the private sector cannot: expenditures on needed public services and

investments for the future, such as research on environmentally sound technologies. Any tax cuts should be aimed at a broad swath of low-income and middle-class workers, who are more likely to pour any windfall back into the economy than wealthy investors.

Policymakers should also bear in mind the danger of a collapse of the dollar, which would be the likely outcome of a decision by foreign investors to stop financing the yawning U.S. current account deficit. This threat only heightens the need for economic stimulus and the cost of directing new resources where they are needed least.

New Working Papers

Financial Policies and the Aggregate Productivity of the Capital Stock: Evidence from Developed and Developing Countries

Philip Arestis, Panicos Demetriades, and Bassam Fattouh
Working Paper No. 362
www.levy.org/docs/wrkpap/papers/362.html

Financial deregulation, or “liberalization,” is a high priority these days for the U.S. government and international lending organizations. Many economists advocate the elimination of capital controls and other restraints, on the grounds that such moves will attract more needed capital to developing countries and ensure that borrowed funds are allocated to their most productive uses. Other economists blame financial liberalization in part for the recent crises in Asia. In a new working paper by Senior Scholar and Institute Professor Philip Arestis, Panicos Demetriades of the University of Leicester, and Bassam Fattouh of the Centre for Financial and Management Studies and the School of Oriental and African Studies at the University of London, recently developed statistical methods and a new source of data are used to assess the benefits of financial liberalization in developed and developing countries.

No doubt there exist tenable arguments that liberalization spurs economic growth. For example, reserve requirements for banks should, according to this view, be eliminated or reduced, because they amount to an incentive-distorting tax on banking. Opponents of rapid liberalization of capital

markets counter that when lenders, nonfinancial companies, and investors do not have perfect information about one another’s activities, strict financial regulations may actually improve efficiency. For example, allowing banks to charge unlimited interest rates on loans may have the unintended effect of deterring the safest borrowers and attracting those who are more likely to default.

The authors find no clear empirical justification for either a complete rejection of financial liberalization or its unconditional acceptance. They examine the effects of a number of different types of financial regulation in 14 nations: restraints on interest rates; controls on capital inflows and outflows; and reserve, liquidity, and capital requirements for banks. They find that the impact of abandoning each of these types of regulation has differed from country to country. In no case do the authors find that a particular type of liberalization consistently improved or hurt productivity (the amount of goods and services produced per unit of capital). The strength of bank supervision and other institutional features of a particular country may have an important influence on the effectiveness of various types of financial reforms.

Does the Stock of Money Have Any Causal Significance?

Philip Arestis and Malcolm Sawyer
Working Paper No. 363
www.levy.org/docs/wrkpap/papers/363.html

What became of money? Is it making a comeback? These questions are addressed in a new working paper by Institute Professor Philip Arestis and Senior Scholar Malcolm Sawyer of the University of Leeds.

Once, many mainstream economists argued that inflation was the direct result of an excessive money supply. By controlling the growth of the money supply, these economists said, the central bank could quell inflation and ensure steady economic growth. When the U.S. and British central banks attempted to follow monetarist prescriptions in the late 1970s and early 1980s, they failed to control the growth of the stock of money, interest rates became unstable, and both countries entered deep recessions. By the mid 1980s, the United Kingdom and the United States had abandoned monetarist policies. Even Switzerland, which had been rela-

tively successful in targeting the money supply, changed course in the late 1990s, and today, no western European or North American central bank focuses its attention mainly on the stock of money.

The intellectual counterpart of this widespread change in policy was an updated form of economic model, or mathematical representation of the economy, in which total amounts of money were nowhere to be seen. The quantity of money in circulation, it was believed, passively adapted to the evolution of prices and economic output, rather than the other way around. Arestis and Sawyer investigate some new attempts to “reinstate” the supply of money as an important part of economic models.

Once one recognizes that money is an effect, rather than a cause, of economic activity and inflation, finding a role for it becomes difficult. Arestis and Sawyer analyze four attempts to do so. The first was a study arguing that central banks could benefit by using money supply figures as predictors of future economic growth and inflation. Arestis and Sawyer find this claim dubious, since it is inconsistent with the modern view that changes in the money stock merely reflect past movements in other readily observable variables, such as inflation.

A second study looked at the effects of the stock of money on the incidental costs of buying and selling goods and services. These effects did not account for a large proportion of the movement of the inflation rate, however. A third study argued that when new money was created, various prices, interest rates, and other economic quantities would have to adjust until people were satisfied with the amount of money they held. Fourth, some economists argue that monetary policy matters because it can affect the amount of credit available for investment in capital goods such as factories and equipment. Since a lack of capital can reduce the amount of goods and services the average worker produces, this view contradicts new-Keynesian beliefs that money cannot cause abiding changes in the rate of growth of GDP. Thus, economists have yet to be successful in finding a place for money in their latest theories.

“New Consensus,” New Keynesianism, and the Economics of the “Third Way”

Philip Arestis and Malcolm Sawyer

Working Paper No. 364

www.levy.org/wrkpap/papers/364.html

In this new working paper, Institute Professor Philip Arestis and Senior Scholar Malcolm Sawyer of the University of Leeds critique the “third way,” the policy agenda broadly attributed to center-left European leaders, especially Prime Minister Tony Blair of the United Kingdom and Chancellor Gerhard Schroeder of Germany. This agenda is strongly influenced by mainstream economics, especially of the kind practiced by new-Keynesian theorists. The authors show that the program is flawed.

During the Great Depression, when economist John Maynard Keynes wrote his best-known book, many economists believed that any bout of significant unemployment would be short-lived. Recessions would end spontaneously because the interest rate would automatically adjust to exactly the appropriate level to ensure that all able-bodied people were employed. This theory contradicted Keynes’s view that, even over a period of a few years, the demand for goods and services might not be sufficient to ensure that all were employed. The mathematical model used by many economists who have influenced the third way is in many aspects similar to the pre-Keynesian view. In this model, disturbances to the economy are short-lived and can be dampened by appropriate interest rate policy. Thus, as in pre-Keynesian economics, a mechanism exists to counteract recessions rapidly and effectively. This view contrasts with Keynes’s idea that the aggressive use of government deficits may be needed to pull an economy out of recession or depression.

For many reasons in theory and in practice, this optimistic view of the economy’s abilities to right itself after a setback may not be accurate. The interest rate that would hypothetically ensure full employment might be unattainable, no matter how much a central bank eased its monetary policy. This would be true, for example, if the full-employment rate of interest were below zero. Saving and investment might not always be responsive to changes in interest rates. Moreover, the Federal Reserve and other central banks control interest rates on only short-term loans, while long-term rates are relevant for investments in many economically important assets, such as homes and factories.

Even if some hypothetical interest rate existed that would bring about full employment, it is not clear that any central bank in the world would be capable of determining what it was. (Consider the poor forecasting abilities of government and Wall Street economists.) Finally, in setting interest rates, central banks are constrained by the fact that if rates are too low (high), capital will flow out of (into) the country in unacceptable volumes. All of these considerations lead to the conclusion that the economics of the third way do not provide the necessary tools to deal with recessions and depressions, a consideration that is becoming ever more important.

Is There an American Way of Aging? Income Dynamics of the Elderly in the United States and Germany

Thomas L. Hungerford

Working Paper No. 365

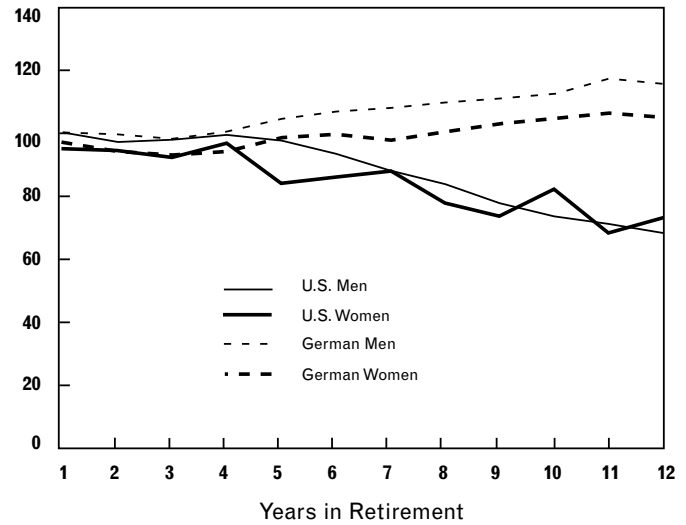
www.levy.org/wrkpap/papers/365.html

Although the U.S. Social Security system was modeled after the German one, the two programs differ in many respects. The German system, created in the 19th century, replaces a larger percentage of pre-retirement earnings than old age and survivors' benefits do in the United States. On the other hand, fewer Germans than Americans are entitled to private pensions. In recent work, Research Director and Senior Scholar Thomas L. Hungerford followed the economic status of a representative group of retirees in each country, starting at retirement. His aim was to determine how the economic fortunes of the elderly evolved in the years following their retirement.

Hungerford used data from studies in which researchers interviewed and reinterviewed the same group of Americans and Germans repeatedly over a period of many years, asking them about the amounts and sources of their income. The data indicated that the Americans' inflation-adjusted income eroded as they aged, falling by approximately 30 percent over the first 12 years after retirement. In contrast, the Germans' income tended on average to rise steadily in the years after their retirement (*see chart*).

Part of the explanation for the difference, writes Hungerford, lies in the way social security is indexed for inflation in the two nations. American Social Security recipients are given a cost-of-living adjustment each year, based upon that year's rate of inflation. German pension benefits

**Real Total Income in Retirement
(Men's Year 1 Income = 100)**



Source: Author's analysis of Panel Study of Income Dynamics and German Socioeconomic Panel data

are indexed in a different way, one that actually increases the purchasing power of benefit checks over time. This difference is important: people often exhaust their savings before they die, and the value of non-social security income is diminished by inflation. Since older Americans tend to rely more heavily on these dwindling private income sources, they tend to lose ground over time.

Hungerford concludes that U.S. citizens and Germans do have distinctive "ways of aging." He points out that future reforms of the social security systems in each country may alter the situation further, causing patterns of income receipt to diverge further or become more alike.

Why the Tobin Tax Can Be Stabilizing

Korkut A. Ertürk

Working Paper No. 366

www.levy.org/wrkpap/papers/366.html

The Mexican peso crisis of 1994–1995 led a series of collapses in worldwide currency markets. Some countries, such as South Korea, seem to have recovered, but others, including Argentina, are still mired in depressions. Many of these debacles started when speculators began selling their currency holdings, in anticipation of a fall in value. To some extent, speculators' expectations proved to be self-fulfilling prophecies, because each sale of a currency pushed it closer

to collapse. Can such crises be prevented or their effects alleviated? In a new working paper, Research Associate Korkut A. Ertürk provides some theoretical evidence that judicious policies can stabilize currency markets without completely shutting them down.

Speculators do not purchase currency or other investments for their long-term returns. Instead they seek to make money by betting on day-to-day and even minute-to-minute changes in the value of their portfolios. For this reason, they tend to hold investments for short periods of time. By engaging in a game of rapid and impatient buying and selling, speculators tend to amplify the very fluctuations of which they wish to take advantage. James Tobin, the late Nobel laureate in economics, argued that governments could slow down this process, and thus stabilize markets, by putting a small percentage tax on the value of currency transactions.

Ertürk provides evidence that this plan (called a Tobin tax) would work. He points out two key factors that help determine whether a currency market is stable. First, the more quickly traders react when they perceive that a currency is over- or undervalued, the more easily that currency can begin a downward spiral of devaluation. The second factor is the extent of what might be called the bandwagon effect, in which investors become “bears” in a falling market or “bulls” in a rising market. A Tobin tax works through the first factor; it encourages traders to be sufficiently patient to hold currencies even when they appear slightly overvalued, or to wait for a bargain before making seemingly good investments. (For example, a currency trader who expects the dollar to appreciate by .1 euros would presumably not buy dollars in the presence of a tax of more than that amount.) Thus, by slightly curtailing investors’ freedom to move capital across borders, policymakers could greatly diminish the instability of currency markets and thereby ensure steadier growth worldwide.

The Persistence of Hardship over the Life Course

Thomas L. Hungerford

Working Paper No. 367

www.levy.org/wrkpap/papers/367.html

Improvements in the Social Security system in the United States have, along with other types of pensions, reduced the poverty rate for the elderly to below that of many other groups, including children. Nevertheless, many individuals do not fare well in their later years, and certain categories of the elderly, such as racial and ethnic minorities, have high poverty rates. In a new working paper, Research Director and Senior Scholar Thomas L. Hungerford investigates whether hardship in old age tends to be a carryover from middle age or a new turn of fortune.

Pointing out that hardship goes beyond material deprivation, Hungerford presents evidence on the persistence of such characteristics as health and marital status from ages 40 to 49 to age 66. He focuses on about a thousand subjects born between 1924 and 1931 who participated in the Panel Study of Income Dynamics (PSID). He shows that often, but not always, old-age hardships are rooted in much earlier events. Over 37 percent of those who were poor or near poor in their 40s were still or again poor by old age; only 7 percent or so of those who avoided chronic poverty in middle age were poor when they were 66. Even more striking is that individuals with very low income in middle age had a 20 percentage-point greater chance of dying before age 66 than others. Every measure of middle-aged hardship had a strong effect on the probability of most old-age hardships that Hungerford studied.

Once again, an important point is that relatively rosy statistics on the elderly conceal dramatic differences in well-being between different subgroups. For example, blacks who were poor in their 40s had a 39 percentage-point greater chance than blacks who were not poor in their 40s of being in poverty at age 66; for whites, the corresponding figure is 27 percentage points. Moreover, for women more often than men, poverty or near poverty in old age was foreshadowed in middle age.

The fact that those who experience hardship in old age tend to have previous experiences of deprivation does not necessarily imply a causal link, writes Hungerford. Some overlooked factor might tend to cause poverty in both the old

and the middle-aged. He was able to rule out that possibility in most cases, however, by comparing individuals of the same race and educational background, among other factors. Finally, Hungerford finds the risk of hardship in old age often increases progressively with each additional instance of middle-aged hardship.

To the extent that these results indicate a true persistence of hardship, policymakers seeking to help the aged should consider measures to alleviate the problems of the middle-aged. Improved outcomes, like hardships, might carry over from one stage of life to the next.

Levy Institute News

New Research Director

Thomas L. Hungerford has joined the Levy Institute as research director and senior scholar. Previously he was a senior economist in the Social Security Administration's Office of Policy and an adjunct associate professor of economics at American University. He has also worked at the Office of Management and Budget, the General Accounting Office, and Wayne State University. His research interests include poverty, income inequality and mobility, social welfare policy, the economics and demography of aging, and time use. Hungerford received M.P.P. and Ph.D. degrees from the University of Michigan.

Institute Publishes Leon Levy's

The Mind of Wall Street

Leon Levy, founder and chairman of the board of The Levy Economics Institute, has published a new book, *The Mind of Wall Street: A Legendary Financier on the Perils of Greed and the Mysteries of the Market*. Written with Eugene Linden, the book offers anecdotes and insights from Levy's 50-year career on Wall Street. Levy describes in detail his contrarian philosophy of investing, which emphasizes looking for values and maintaining a circumspect attitude toward the fads and fancies of the day. He gives his account of the "irrational exuberance" of the 1990s and the debacle of the past two

years and explains why he believes that the fallout from the last decade will continue for some time. The book, the latest in a series published by The Levy Economics Institute, also covers Levy's wide-ranging philanthropic activities, which reflect his varied interests, from archaeology to Keynesian economics.

Upcoming Event

13th Annual Hyman P. Minsky Conference "Economic Policy for Sustainable Growth"

Tuesday, April 15, 2003

Hilton New York, 1335 Avenue of the Americas,
New York City

Participants to include:

Lakshman Achuthan, Managing Director, Economic Cycle
Research Institute

Robert Barbera, Executive Vice President and Chief
Economist, Hoenig & Co., Inc.

J. Alfred Broaddus Jr., President, Federal Reserve Bank of
Richmond

William Dudley, Managing Director and Director of U.S.
Economic Research, Goldman Sachs & Co.

Marc Faber, Marc Faber Limited

* **Peter R. Fisher**, Undersecretary for Domestic Finance, U.S.
Department of the Treasury

* **R. Glenn Hubbard**, Chairman, Council of Economic
Advisers

John Lipsky, Chief Economist, JP Morgan Chase

* **Lucas Papademos**, Vice President, European Central Bank

James W. Paulsen, Chief Investment Strategist, Wells Capital
Management

William Poole, President and CEO, Federal Reserve Bank of
St. Louis

Ernst Welteke, President, Deutsche Bundesbank

* *invited*

Registration and program information will be posted on the
Levy website (www.levy.org) as it becomes available.

Publications and Presentations

Publications and Presentations by Levy Institute Scholars

INSTITUTE PROFESSOR

PHILIP ARESTIS

Presentations: “Can Monetary Policy Affect the Real Economy?” (with Malcolm C. Sawyer), Association for Evolutionary Economics, and “Finance and Development: Institutional and Policy Alternatives to Financial Repression Theory” (with M. Nissanke and H. Stein), Association of Comparative Economic Studies, both at the annual meeting of the Allied Social Sciences Association, Washington, D.C., January 3–5.

SENIOR SCHOLAR

WALTER CADETTE

Publications: “Caring for a Large Geriatric Generation: The Coming Crisis in U.S. Health Care” and “Employee Stock Options: The Case for Expensing,” Mapping the Real Deal series, Sanders Research Associates (www.sandersresearch.com), first quarter, 2003; “The Paradox of Our Health Care,” *Challenge*, January–February 2003.

SENIOR SCHOLAR

JAMES K. GALBRAITH

Publication: “The Tax Cuts and Economic Reality,” *Austin American Statesman Insight*, January 12, 2003.
Presentations: “Toward a New Pragmatism,” keynote address to the socioeconomic section of the

American Association of Law Schools, Washington, D.C., January 4; “Inequality and Globalization: What is the Evidence?” National Economic Association, at the annual meeting of the Allied Social Sciences Association, Washington, D.C., January 4; “The War, the Economy, and What (God Help Them) the Democrats Should Do Now,” New America Foundation, Washington, D.C., January 6.

RESEARCH DIRECTOR

AND SENIOR SCHOLAR

THOMAS L. HUNGERFORD

Presentation: “Is There an American Way of Aging? Income Dynamics of the Elderly in the U.S. and Germany,” Gerontological Society of America Annual Research Conference, Boston, November 26.

RESEARCH SCHOLAR

GENNARO ZEZZA

Publication: “Il Contesto Economico in Cui Operano le Imprese On Line” (“E-Commerce: The Economic Background”), *Diritto ed Economia dei Mezzi di Comunicazione*, 2002.

Recent Levy Institute Publications

WORKING PAPERS

Polish and Italian Schooling Then, Mexican Schooling Now?
U.S. Ethnic School Attainments Across the Generations of the 20th Century
Joel Perlmann
Working Paper No. 350

Race, Ethnicity, and the Gender-Poverty Gap
Yuval Elmelech and Hsien-Hen Lu
Working Paper No. 351

Critical Realism and the Political Economy of the Euro
Philip Arestis, Andrew Brown, and Malcolm Sawyer
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Managed Care, Physician Incentives, and Norms of Medical Practice: Racing to the Bottom or Pulling to the Top?
David J. Cooper and James B. Rebitzer
Working Paper No. 353

Should Banks Be “Narrowed”?
Biagio Bossone
Working Paper No. 354

Can Monetary Policy Affect the Real Economy?
Philip Arestis and Malcolm Sawyer
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Asset Poverty in the United States, 1984–1999: Evidence from the Panel Study of Income Dynamics
Asena Caner and Edward N. Wolff
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The Euro, Public Expenditure, and Taxation
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Threshold Effects in the U.S. Budget Deficit
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Financial Globalization: Some Conceptual Problems
Philip Arestis and Santonu Basu
Working Paper No. 360

Credibility of EMS Interest Rate Policies: A Markov Regime-Switching Approach
Philip Arestis and Kostas Mouratidis
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Financial Policies and the Aggregate Productivity of the Capital Stock: Evidence from Developed and Developing Countries
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The Persistence of Hardship over the Life Course
Thomas L. Hungerford
Working Paper No. 367

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Are We All Keynesians (Again)?
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The Brazilian Swindle and the Larger International Monetary Problem
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European Integration and the “Euro Project”
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A Study of the Effects of Campaign Finance Reform
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The Markets vs. the ECB
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Should Banks Be “Narrowed”?

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Biagio Bossone

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*Medical Practice Norms and the
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David J. Cooper and James B. Rebitzer

No. 70, 2002 (Highlights, No. 70A)

***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)

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