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Tenth Annual Hyman P. Minsky Conference on Financial Structure

The Liberalization of Financial Markets: National and International Perspectives

As part of its research program on financial markets and monetary policy, the Levy Institute organized a conference, held on April 27-28 at Blithewood, to explore the ramifications of financial liberalization. Brief notes on the participants' remarks are given here.

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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.

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Dimitri B. Papadimitriou, *President*

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Tenth Annual Hyman P. Minsky Conference on Financial Structure

The Liberalization of Financial Markets: National and International Perspectives

SPEAKER: BARNEY FRANK

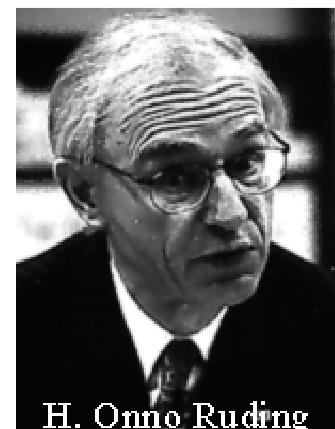
Barney Frank

Proponents of globalization have expressed frustration with the reluctance of some members of Congress to support it. U.S. Representative Barney Frank (D-Mass.) explained that it is not globalization per se that he and other members oppose, but globalization absent safety nets for those who are harmed by it.

Globalization proponents argue that capital should be freed from all constraints so that it can travel to where it can do the most good. In this way, everyone eventually benefits--the trickle-down theory. Frank said that globalization may be increasing world wealth as a whole, but the benefits are not being distributed equally. For example, contrary to arguments in favor of the North American Free Trade Agreement--that it would make some people better off and none worse off--it is now clear that NAFTA created both winners and losers, just as globalization has done. It is difficult for members of Congress to sell a policy to the public when that policy may benefit some but cause others to lose their job.

Frank said that the congressional opponents of increased globalization would be prepared to support it, if ways to alleviate its negative consequences were adopted. What is needed are public policies that provide a safety net for those who are harmed, for example, income support and health insurance for workers who lose their job. Other negative aspects of globalization that need to be addressed are increased pollution and competition for capital. Some argue that such government intervention is bad economic policy. But Frank said these same people do not complain about government intervention when it benefits them. Besides, he said, economic theories have turned out to be wrong in the past, and the notion that all government intervention is bad is just as likely to be wrong.

SPEAKER: H. ONNO RUDING


H. Onno Ruding

One feature of financial globalization is the rapidly increasing consolidation of banks. H. Onno Ruding, vice chairman of Citibank, said that while some analysts see bank mergers as dangerous, consolidation is unavoidable. Globalization has increased competition and many banks can survive only by growing larger. There are a number of reasons for banks to consolidate. Consolidation can increase a bank's capital pool. Larger banks have a larger reserve of capital and so can more easily absorb losses. Also, as customers grow larger, the size of their financial transactions grows larger, which requires a larger bank. Merging with other types of financial institutions allows banks to diversify and increase profits. Larger banks can better afford the investment required to keep up with changes in technology and communications. Finally, large and global banks can attract more customers because people tend to believe that such institutions are high quality or too large to fail.

Increasingly common are cross-border mergers, which, Ruding said, bestow many advantages. For some banks, especially those that are already strong in their own country, expansion can occur only by moving into other countries. Doing so enables them to provide better service for their foreign customers and for their domestic customers who do business internationally. But cross-border mergers involve the complications of different currencies, labor laws, and banking regulations. Ruding said he favors the "national treatment rule," according to which each country should treat foreign banks as it treats its own.

Despite many positive aspects of consolidation, Ruding cautioned, bigger is not always better and some mergers do fail. Merging two institutions that provide different services requires very talented managers; not all are capable of making good decisions when dealing with an unfamiliar business. A merger between two weak banks is likely to fail, although a weak bank might survive if it merges with a bank strong enough to help it. Even though larger banks may attract more large customers by virtue of their size, they may also lose some customers who simply prefer working with smaller banks. Finally, some analysts fear that consolidation will reduce competition. Ruding disagreed, saying that cross-border mergers and a more open financial system can actually strengthen competition; strong foreign banks will force domestic banks to be more competitive.

SPEAKER: HENRY KAUFMAN

Henry Kaufman

Henry Kaufman, president of Henry Kaufman & Co., Inc., addressed the need to understand changes in the financial system before embarking on structural reform. Kaufman attributed one significant change--the globalization of financial markets--partly to the growth of securitization, which has allowed a variety of obligations to be used to back investments in countries around the world. Globalization is eliminating market diversity. Where there were once Asian, American, and European markets, there is now one world market, and communications within that market are instantaneous. Kaufman said that one danger of this interconnectedness is contagion.

Kaufman noted other changes in the financial system that may be dangerous. One is what he termed the "illusion of liquidity," which he defined as the belief that one can know the value of one's holdings at any time and can liquidate them instantly. Other dangers are the expanded role of derivatives and the increase in the number of players (such as hedge fund and household investors) in the market, many of whom are risk takers. Kaufman also warned about the increased use of modeling to determine risk, which, he believes, merely gives an illusion of accuracy.

Kaufman expressed concern about the increasing consolidation of financial systems. Within the next decade only a few institutions will dominate in each economic sector, and the goal of many

of these large institutions will be to control prices. This consolidation will seriously challenge the economic and monetary policies of governments. Kaufman said that in the United States far too many analysts are specialists; if we are to address these challenges, we need generalists who are capable of seeing the whole picture. If the United States is to preserve and nurture economic democracy, it will require an approach that combines social, political, and economic policy.

SPEAKER: DAVID A. LEVY

David A. Levy, vice chairman of the Levy Institute and director of the Levy Institute Forecasting Center, took issue with those who argue that we no longer need to worry about such things as rising interest rates and rising equity values because in today's "new economy" productivity is keeping pace with these rising values. Levy said that even though it is true that technological advances have enormous potential to increase productivity, productivity is not increasing fast enough for us to reject the lessons of the old economy. Economic optimists are focusing too narrowly on productivity and not enough on financial balance sheets. Profits matter because they drive the behavior of firms. Financial balance sheets show that the total value of assets has risen more than the economy has grown. The debt-to-income ratio has been on the rise, fueled by an increasing willingness to borrow. These trends are unstable and if asset prices decline, spending will also decline, which will affect profits.

Levy was not optimistic that a way out of this problem can be found. There are still trouble spots in the global economy; Brazil and Russia are both on shaky ground. The financial health of the United States is tied to the stock market and if that bubble bursts, the U.S. economy will falter, with effects felt globally. Levy does not expect a major depression. He anticipates some form of economic downturn, but believes that Minsky's big government-big bank idea is correct and that a major disaster could be averted by public expenditure and a central bank acting as lender of last resort.

SPEAKER: WYNNE GODLEY

Distinguished Scholar Wynne Godley reiterated his warning that the current U.S. economic expansion cannot last without major policy changes. Certain features of the current U.S. economic expansion make it unsustainable. One is the negative balance of trade; the deterioration in the net asset position of the United States has resulted in a net flow of property income abroad. Another feature is the dramatic rise in private expenditure relative to disposable income. With expenditure exceeding income by growing amounts, spending has been fueled mainly by increased borrowing. For economic growth to continue, spending must continue, which means that borrowing must continue. However, the debt-to-income ratio cannot rise indefinitely. Borrowing must eventually stop when individuals, who must make interest payments and repayments of principal out of income, reach a point at which their income can no longer cover debt service.

Godley said he cannot predict when the boom will end (it could last another year or two), but he stands by his statement that it will end. And when it does, a total reorientation of macroeconomic policy will be required. One goal of that reorientation must be the reversal of the deterioration of the current account. Godley said that sustainable growth requires balanced growth of both domestic and export markets.

SESSION 1. STOCK MARKET EFFECTS AND THE MACROECONOMY

Moderator for this session was Dimitri B. Papadimitriou, Levy Institute president. Participants were Byron R. Wien, managing director and chief investment strategist for the United States at Morgan Stanley Dean Witter & Co.; Robert J. Barbera, executive vice president and chief economist at Hoenig & Co.; David A. Levy, vice chairman of the Levy Institute and director of its Forecasting Center, and Srinivas Thiruvadanthai, resident scholar at the Levy Institute Forecasting Center; Frank A. J. Veneroso, Veneroso Associates, and Robert W. Parenteau, director and economic strategist at Dresdner RCM Global Investors.

Byron R. Wien

Wien remarked that in the past 10 years stocks have performed better than most people ever thought possible and the composition of the stock market has shifted dramatically toward technology and Internet companies. He said that the astounding values of these stocks are both unjustifiable and unsustainable. He estimates the market is about 40 percent overvalued, well above the 20 percent that was once seen as the danger level. Despite this, a recession is not inevitable. The danger could be reduced if stock prices come down to more realistic levels.

Barbera was not optimistic about the continuation of the stock market boom. He predicted that the equity market bubble is likely to burst this year, with negative consequences for the economy. Price-to-earnings ratios are unlike any seen before. While some analysts argue that the boom could easily go on for another 10 years, Barbera said he knows of no economic model that would allow for such a situation without blowing up. Continuation of the boom would require factors impossible to achieve, such as an unemployment rate of zero percent and a continued growth of debt. Barbera predicted that the most serious problem will be in the technology market.

Levy and Thiruvadanthai agreed with Barbera that the current boom is

unsustainable. They focused on the unprecedented wealth effect of stock price escalation and the speed with which it is felt throughout the economy. Until 1996 consumer confidence was not strongly correlated with the stock market, but there has been a dramatic change in the past few years. Today, when the stock market rises, retail sales rise; when the stock market drops, retail sales drop. Thus, if the stock market goes into a decline, the economy could be affected rapidly and negatively.

Veneroso and Parenteau also agreed that the stock market is overvalued and high-tech stocks are the most overvalued. They applied Minsky's theory that markets naturally generate their own problems to the current asset market. They said that there are three groups of investors in the market--individual, hedge fund, and institutional. Individual investors, who are relatively new players in the stock market, are locked into chasing wealth and follow trends. Hedge fund investors follow the individual investors for fear of being left out and getting trampled by the trends. Institutional investors act out of fear of losing clients, who now have more options for investing. As a result, institutional investors are so concerned about stock performance that rather than keeping portfolios diversified, they are weighting them toward technology stocks. Veneroso and Parenteau said one danger of mass involvement in the stock market is that the government may feel that too many people are involved to let the market fail. But government intervention might hold off a crash, thus allowing the bubble to grow, so that when the crash does come, it will be worse.

SESSION 2. WHAT WOULD MINSKY THINK?

This session was moderated by Jamee K. Moudud, resident scholar at the Levy Institute. Participants were Martin Mayer, guest scholar at the Brookings Institution; Ronnie J. Phillips, professor of economics at Colorado State University; and L. Randall Wray, visiting senior scholar at the Levy Institute and professor of economics at the University of Missouri-Kansas City.

Mayer spoke of changes in the banking system. Legislation passed last year by Congress has dramatically changed the banking system, but banks, the Federal Reserve, and other institutions involved in the banking system are not entirely sure what the legislation means. According to Mayer, one thing that does seem clear is that while the rest of the world is moving toward separating monetary policy and banking supervision, the United States is moving toward linking them. This is happening at a time when the banking system is declining as an economic force; most financial transactions today do not go through banks. These changes in the financial system are a challenge for the Federal Reserve; in order to stay on top of them, it will need new tools.

According to Phillips, the Asian, Mexican, and Russian financial crises generated much research

aimed at understanding the crises, but all of this research will probably not prevent the next one. Phillips agrees with Minsky that market discipline alone will not prevent a crisis. What is needed for stability is structural and macroeconomic reform. Simply closing failed banks, as many countries caught in a crisis do, is not the answer. A better approach is recapitalization--putting money into institutions to get them back into the system.

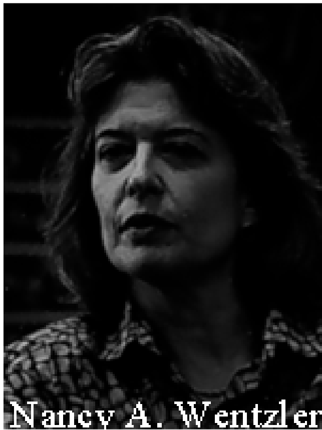
Wray discussed what Minsky would think about the current economic situation in the United States, especially with regard to consumer spending, interest rates, and the government surplus. Wray surmised that Minsky would say that deregulation of the financial system, which increases competition among lenders, has made it easier for consumers to borrow and that the high debt rates are a sign of trouble. Rising interest rates would also be troubling because they increase the burden of carrying debt. As debt service becomes an increasing proportion of income, consumers will cut back on borrowing, which could reduce the spending that is feeding the current economic boom. Minsky would probably argue, however, that the Fed cannot stimulate consumer spending by lowering interest rates. That could better be done, perhaps, through the government's ability to boost aggregate demand through public spending. Therefore, Minsky would most likely be concerned about the current government bias toward surplus and away from deficit.

SESSION 3. THE FINANCIAL ARCHITECTURE IN THE POST--GRAMM-LEACH-BLILEY ERA

Frances M. Spring, assistant director of the Levy Institute, was moderator of this session. Participants were Ernest T. Patrikis, senior vice president and general counsel of American International Group Inc.; Kenneth H. Thomas, independent bank analyst and consultant and lecturer in finance at the Wharton School of Business; and Nancy A. Wentzler, director of economic analysis at the Office of the Comptroller of the Currency.

Ernest T. Patrikis

Patrikis said the Gramm-Leach-Bliley legislation is not as liberalizing as many believe. Rather than less regulation, it will lead to more, especially by the Federal Reserve. The legislation passed because the Fed wanted it and because Fed officials were wise enough to push for it at a time when the Fed is popular. Patrikis said that while the Fed does well in a supervisory role, it cannot be as successful as a regulator. The important role for the Federal Reserve is to provide overnight credit. Commercial banks used to provide overnight credit, but consolidation in the financial sector has resulted in a situation in which the institutions capable of doing so are all in competition with one another, and who, Patrikis asked, is willing to help a competitor? Thus, it is important for the Fed to perform this function. This also gives the Fed an excuse to supervise banks because it has the right to gather information on the banks to which it lends.



Thomas discussed the rating of financial institutions, specifically the bank rating system that went into effect with passage of the Community Reinvestment Act of 1977. In 1990 these became the first and only bank ratings to be made public. Thomas examined thousands of these ratings and eventually used a sample of 250. There are four rating levels: outstanding, satisfactory, needs improvement, and noncompliance. Of the sample, 98 percent received one of the top two ratings. Skeptical of this result, Thomas evaluated the institutions in his sample and concluded that ratings were inflated. His estimate was that about 23 percent of institutions should fail a review. Thomas's explanation is that regulators simply find it easier to give passing ratings. If they fail an institution, they can expect it to appeal, which means they have to spend much more time documenting their decision. The ratings criteria were revised in 1993 with the aim of making them more accurate, but in a follow-up study Thomas found the problem of inflation remained. He suggested that what needs reform is the process of rating financial institutions rather than the ratings criteria.

Wentzler said that in order to survive, banks must address economic and technological changes and rethink the way they deliver their services. For example, the rise of e-commerce is dramatically altering the way customers relate to financial institutions. From their home computers, loan seekers can tap into e-commerce sites, fill out a loan form, and receive multiple loan offers within hours. The ease with which they can shop for the lowest interest rates means that they visit banks (and banks' web sites) less often, and this means that banks lose an opportunity to introduce the loan seekers to other services they offer. Banks must find new ways to hold on to customers, perhaps by becoming full-service institutions that offer customers everything they could possibly need, from investment strategies to college funds. This could be difficult for smaller banks, but, Wentzler suggested, many could survive as franchises that feed into larger banks.

SESSION 4. CHANGES IN THE INTERNATIONAL FINANCIAL STRUCTURE

Moderator for this session was Ajit Zacharias, resident research associate at the Levy Institute. Participants were Robert Z. Aliber, instructor in international finance at the University of Chicago; Philip F. Bartholomew, Office of the Comptroller of the Currency; Daniela Klingebiel, financial economist in the Financial Sector Policy and Strategy Group of the World Bank; and Jan A. Kregel, visiting senior scholar at the Levy Institute and international finance expert in the New York Liaison Office of the United Nations Conference on Trade and Development.

Aliber discussed three points regarding the financial system. First, one must distinguish between the source of a crisis and the trigger. In the case of Asia, foreign exchange was the trigger, but banks, which were

undermanaged and engaged in Ponzi finance, were the source. Second, an unwillingness to engage in financial liberalization, especially in the case of Korea, has resulted in an inefficient use of capital. Third, when capital inflows diminish, monetary policy tightens, which is the beginning of a credit collapse and of currency depreciation.

Bartholomew, formerly chief economist for the Democratic Staff of the House Banking Committee, discussed the reactions of the committee to the report of the International Financial Institutions Advisory Commission, issued in March. The report was highly critical of international financial institutions, especially the International Monetary Fund and its actions in response to the Asian crisis. Bartholomew agreed with the commission's statement that international institutions need reform, but he disagreed with some of its suggestions. He noted that no one is willing to address the question of how to reform these institutions because no one really knows how to go about it, so he doubts there will be any real change in the near future.

Klingebiel discussed what changes in the financial services industry mean for public policy and for developing countries in particular. Globalization, deregulation, and technological advances, especially the Internet, are dramatically altering the way services are offered. All countries will need to formulate new public policy regarding regulation and supervision of the financial services industry, the role central banks play in the system, and competition. With regard to developing countries, these changes offer many benefits in terms of improving the quality and scope of financial services, but they also present challenges, especially for those countries with weak governments, poorly developed institutional frameworks, scarce human resources, and concentrated ownership patterns.

Kregel discussed the euro's prospects for survival, particularly its ability to compete with the dollar. He argued that the dollar is strong relative to the euro because the dollar has become the currency for financial intermediation in the global financial market. This has happened because U.S. capital markets are broader, deeper, more resilient, and more efficient than any other capital markets. Thus, the euro cannot compete with the dollar until European capital markets can compete with U.S. capital markets, and, for structural reasons, European capital markets will be unable to do so in the near term.

An audio webcast of the conference is available on the Levy Institute web site, www.levy.org. Transcripts of the major addresses and summaries of the sessions will be published in the conference proceedings.

New Working Papers

The Brazilian Crisis: From Inertial Inflation to Fiscal Fragility

Jan A. Kregel
Working Paper No. 294

In earlier work, Visiting Senior Scholar Jan A. Kregel argued that the economic crises that have plagued Latin America since 1992 were radically different from the Asian crisis. The source of the Asian crisis was not a current account imbalance, but a capital account reversal. In this working paper, Kregel examines the Brazilian crisis from a Minskian perspective, analyzing the effects of high interest rates on private and public balance sheets. He finds that the Brazilian crisis, unlike other Latin American crises, differs from the standard Minsky crisis in that it is Brazil's government that is engaging in Ponzi financing while private sector balance sheets are relatively robust.

Kregel cites several reasons for the strength of the private sector. The Brazilian corporate sector was not highly indebted to banks; its main sources of funds were retained earnings and equity capital. The banks in Brazil did not have significant amounts of foreign currency loans. And the banking system had undergone a thorough restructuring process in 1994 and 1995 in which strict supervisory and regulatory provisions were introduced.

Kregel argues that the dilemma faced by Brazilian economic policy today is that attempts to stabilize the economy through high interest rates and expenditure cuts may produce private sector fragility.

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

Many economists, other social scientists, and policymakers attribute the growth in inequality in the last two decades to an imbalance in the demand for and the supply of employees with technological skills. The argument is, essentially, that technological advances led to an increased demand for workers with these skills and those few who had them were able to demand high wages. Resident Scholar Michael J. Handel asserts that the empirical basis for this argument is weak. He 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. According to Handel, any rising wages due to a shortage in supply would have been reflected in an increase in inequality in the late 1980s and 1990s. Instead, inequality increased most rapidly in the early 1980s and then stabilized in the 1990s. The recession that hit during the early 1980s coincides with a dramatic decline of traditionally better paid blue-collar workers, particularly in manufacturing. This suggests the need for a closer look at other possible causes of inequality growth, such as macroeconomic forces and the decline of institutional protections for workers.

An Alternative Stability Pact for the European Union

Philip Arestis, Kevin McCauley, and Malcolm Sawyer
Working Paper No. 296

The Stability and Growth Pact accompanied the introduction of a single currency in the European Union in January 1999. Visiting Senior Scholar Philip Arestis and Kevin McCauley, both of the University of East London, and Visiting Senior Scholar Malcolm Sawyer, of the University of Leeds, identify a number of problems with the pact and offer an alternative that treats new aspects of integration within the EU, new objectives for economic policy, and new institutions to reduce various kinds of disparities across the EU.

The authors refer to their alternative as a full employment, growth, and stability pact to emphasize the change in policy objectives they recommend. Their proposal has four major elements. First, it would reform the European Central Bank to make it more accountable and to expand its range of responsibilities to include lender of last resort and coordinator of monetary and fiscal policy. Second, it would enlarge the European Union budget so that it could become more redistributive across countries and time and allow national governments more discretion to pursue expansionary fiscal policy. Third, it would establish a European investment bank to ensure that less prosperous regions share in economic growth. Fourth, it would encourage institutional arrangements, such as centralized and collective bargaining, that are conducive to reducing inflationary pressures.

What's Behind the Recent Rise in Profitability?

Edward N. Wolff
Working Paper No. 297

The recent surge in the stock market has called attention to movements in the underlying rate of profit. Senior Scholar Edward N. Wolff attempts to explain movements in the profit rate through an examination of the period between 1947 and 1997. Movements in the rate of profit have long occupied Marxian economists and Wolff finds that Marxian theory provides a useful framework

for analysis, especially Marx's examination of the role of structural change on movements in the rate of profit. Wolff's analysis utilizes a conventional national accounting framework, with analogues to some of the concepts developed in the Marxian framework.

Wolff finds that the profit rate, based on a variety of measures, fell between 1947 and the early 1980s and then recovered; by some definitions it came close in 1997 to its postwar peak of the mid 1960s. He argues that the decline in the earlier period is traceable to rising capital-labor ratios on the industry level and a decline in the profit share. The recent recovery is traceable to a slowdown in capital-labor growth and a rising profit share. He found that employment shifts counteracted a falling rate of profit, and that without such structural change, the rate of profit would have declined substantially over the half century.

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

Jan A. Kregel
Working Paper No. 298

Paul Krugman has said that the Japanese economy is in a liquidity trap and that a central bank policy of "credible inflation" could lead Japan to an economic recovery. Krugman, who draws his view of the liquidity trap from the work of Fisher, defines a liquidity trap as a situation in which nominal interest rates are at or near zero and any change in the monetary base is not expected by economic agents to be sustained. As a result, monetary policy becomes ineffective at raising inflation and real interest rates. Visiting Senior Scholar Jan A. Kregel argues that both Fisher and Krugman misinterpreted Keynes's original concept of a liquidity trap in a number of ways, and his (Krugman's) misinterpretations lead to policy recommendations that can result in neither the elimination of the trap nor in Japan's economic recovery.

Kregel argues that, according to Keynes, it is not a credible inflation policy, but a credible interest rate policy that is lacking. Kregel argues that the central bank should adopt a policy of pegging long rates to eliminate the portfolio risk of a rise in interest rates. Policy should aim to ensure increased returns to investment, which may or may not be accompanied by rising prices. Such a strategy requires increases in aggregate demand, which could be generated by a credible policy of increasing the return on production for domestic demand.

The Public Commodities Problem

Karl Widerquist
Working Paper No. 299

Resident Research Associate Karl Widerquist posits that the decision about how much to spend on a public program depends on the answers to two questions: (1) Should the government pursue the goal of the program? (2) If the goal should be adopted, what is the optimal level of spending to achieve it? If the answer to the first question is yes, it would seem desirable to set spending at the optimal level, but, in practice, there is likely to be an underfunding bias.

Widerquist uses the median-voter theorem to demonstrate that the level of funding approved does not depend solely on the amount supporters think is necessary. Opponents of the program (who would not want to spend anything on it) and supporters (who favor relatively less spending than other supporters) may form a coalition that ensures that the level of spending will be lower than what most supporters think is optimal. The difference between actual spending and optimal spending depends on the number of opponents and the amount of disagreement among supporters about the optimal level.

Recent Trends in Wealth Ownership, 1983-1998

Edward N. Wolff
Working Paper No. 300

Most studies of inequality in the United States have used income as a measure. Senior Scholar Edward N. Wolff instead uses family wealth, which he argues is an indicator of well-being independent of the direct financial income that it provides. In previous work, he used data from the 1983 and 1989 Surveys of Consumer Finances as evidence that household wealth inequality rose sharply during those years. He is now using the 1998 survey to update his study.

Wolff finds that despite the booming stock market and the increase in the number of households that own some form of stock, wealth inequality has continued to rise in the United States since 1989, although at a slower rate. Among his findings are that between 1983 and 1998, 53 percent of the total growth in net worth accrued to the top 1 percent of households and 91 percent to the top 20 percent. In 1998 about 90 percent of the total value of stocks, bonds, trusts, and business equity were held by the top 10 percent of households.

Despite the widening ownership of stocks (48 percent of households owned some in 1998), the richest 10 percent of households accounted for 78 percent of the total stock value. Between 1983 and 1998 African-American households made some gains relative to whites in median net worth and home ownership, but remained the same in terms of mean net worth. Hispanic households made significant gains on white households in terms of mean net worth but not in terms of median wealth. Wolff also found evidence of the growing indebtedness of households; the overall debt-equity ratio climbed from 0.151 in 1983 to 0.176 in 1998.

New Policy Notes

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 gap in international competitiveness. The gap 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.

Is the New Economy Rewriting the Rules?

James K. Galbraith
Policy Note 2000/2

In a speech delivered at the White House Conference on the New Economy on April 5, Senior Scholar James K. Galbraith addressed the question, Can full employment without inflation endure? According to the old economic rules, the current economic boom in the United States cannot continue because growth is too rapid, unemployment too low, and stock prices too high. A second view is that a "New Economy," driven by technological advances, has changed the rules and economic growth can continue at its current pace. A third view, held by Galbraith, is that the old economic rules were wrong all along. Economist Robert Eisner was correct when he taught that growth could raise wages and yet also spur investment and productivity.

Galbraith believes that the economy can continue to grow, further reducing unemployment, raising productivity, and without increasing inequality. He sees dangers in high interest rates, stock market speculation, and excessive budget surpluses, but believes that with good leadership and prudent policy changes the dangers can be managed. Debt burdens can be offset by raising family income; for example, the minimum wage should be raised, the earned income tax credit expanded, and collective bargaining supported. The Federal Reserve can rein in stock market speculation by controlling margin lending. And the federal government can avoid excessive budget surpluses; too much taxation and too little spending create a "fiscal drag" on growth.

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Lectures

RONNIE J. PHILLIPS: BRAVER NEWER WORLD? INTERNATIONAL BANKING REGULATION IN THE 21ST CENTURY

On March 28 at Blithewood, Ronnie J. Phillips, a professor of economics at Colorado State University, discussed the history of international banking regulation and the direction that regulation will take in the future. In the aftermath of the Asian financial crisis, some economists and policymakers began calling for increased government regulation, but others believe that regulation should be left to market discipline. Phillips disagrees with the market approach. He recognizes problems inherent in regulation, for example, moral hazard, but sees an important role for government involvement. Governments initially became involved domestically in bank regulation in order to protect depositors and the domestic financial and monetary systems. International banks themselves have often pushed for regulation in order to level the global playing field.

International regulation, however, has been difficult to achieve because it has been difficult to get all countries to agree on regulatory principles. One big sticking point is the responsibility for insolvent institutions. Does the responsibility lie with the parent country or the host country? Neither wants to deal with the problem. Another point at issue is information. Since regulators cannot know as much about an institution as the institution knows about itself, regulators must depend on institutions to supply them with reliable and sufficient information. Some have called for a form of supranational regulatory agency, but Phillips doubts this will happen. What has evolved, and what Phillips expects will remain, is an international regulatory system that relies on a mix of market forces, internal controls, and supervisory cooperation among nations.

S JAY LEVY: THE VIEWS OF JEROME LEVY AND MICHAL KALECKI

Jerome Levy began his serious interest in economics and the derivation of the profits identity in 1908; unemployment was high in that recession year and no unemployment insurance or other public safety net was available for those who were out of work. Levy saw the profits equation as a tool to help address the scourge of unemployment. Michal Kalecki derived his version of the equation about 30 years later. He, too, was disturbed by unemployment and poverty. In a lecture on April 20 at Blithewood, Chairman S Jay Levy compared the work of these two thinkers.

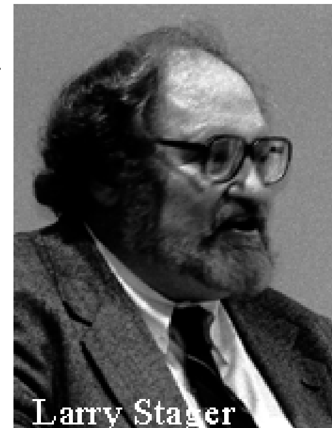
The Levy and Kalecki profits equations are essentially identical, but the processes of derivation are different. Although the two men would have understood and appreciated each other's work and probably would have broadly supported each other's point of view, they came from different cultural and theoretical places. Kalecki was a Pole who lived in a society of rigid classes: rich and poor and, to a great extent, rulers and ruled. He was dismayed by the inability of capitalism to provide full employment and by its lopsided distribution of wealth and power. Because he believed that unemployment was a feature of capitalism, he was attracted to Marxist ideas. Jerome Levy, born in the small American town of Honesdale, Pennsylvania, was a member of a fluid society that lionized and rewarded able innovators. The Wright brothers, Irving Berlin, Henry Ford, George Eastman, David Sarnoff, Marcus Loew, George Pullman, and J. Walter Thompson were just a few of Levy's more or less contemporaries who justified America's designation as the "land of opportunity."

Kalecki noted that capitalists' markup (the rate of profit on sales or revenue) determined the distribution of consumption between them and workers. He believed that capitalism tended to become increasingly monopolistic and that markups therefore tended to increase. Levy was not primarily concerned with the institutional form of an industry, that is, whether it was a monopoly in some sense or not. His primary interest was whether the rate of profit (the markup) was justified in terms of the productive risks of the industry.

Levy's premise was that profits are the sine qua non for private sector employment under

capitalism, but not all profits induce desired production and employment. Kalecki would say that the current high and chronic unemployment in most of Europe supports his belief that such a situation is the natural outcome of capitalism. Levy would say that it is the result of abuses of the capitalist system, of the ways in which enterprises can "waste" profits. "Wasted profits" are those secured by enterprises that do not assume productive risks. Among these is the risk that the enterprise may not find a market for its products at prices that bring it a profit. To improve the standard of living of wage and salary earners and to assure full employment requires curtailing the waste of profits. Four fifths of the jobs in the United States are in private, profit-seeking establishments. Profits are important and they should not be wasted.

LARRY STAGER:
PHOENICIAN PORT POWER:
THE ORGANIZATION OF MARITIME TRADE AND HINTERLAND PRODUCTION


Larry Stager

Larry Stager, Dorot Professor of the Archaeology of Israel at Harvard University, with funding support from Leon Levy, vice chairman of the Levy Institute Board of Governors, has been excavating the sites of two ancient Mediterranean seaports--Ashkelon and Tyre. On May 3 at Blithewood, he discussed his research findings. From 800 to 600 B.C.E. the Phoenicians founded colonies throughout the entire Mediterranean region. It seems that their major objective was to exploit the precious metals and other resources of the hinterlands, but they limited their settlements mainly to the coasts. Stager used the term "port power" to explain this settlement pattern. The production centers of the interior were integrated economically, in a noncoercive manner, with the coastal colonies and overseas emporiums. Through their occupation of strategic nodes in this system, the Phoenician import-export merchants could reap sizable profits and wield economic power and influence that was far greater than the power of the harbor princes who protected them or the rulers of the interior, whose authority was largely circumscribed by territorial limits.

In the course of his investigation of the Phoenicians' maritime networks, Stager discovered two ships that set sail from the Phoenician homeland (modern Lebanon) about 2,700 years ago on their way to Egypt or the fledgling colony of Carthage, but sank in a storm. Stager believes that both were part of a larger fleet. These ships, along with other evidence found in his excavations of Ashkelon and Tyre, suggest the existence of a large and complex trading system and the power the port cities could derive from their control of this system.

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Events

Conference:
SAVING, INTERGENERATIONAL TRANSFERS, AND THE DISTRIBUTION OF WEALTH.

June 7-9, 2000, Annandale-on-Hudson, N.Y.
Audio webcasts of the sessions are available on our web site, www.levy.org/webcast. Extended summaries of the sessions will be published in the conference proceedings.

Conference:
ISSUES RAISED BY THE NEW FORMULATION OF "THE RACE QUESTION" IN THE U.S. CENSUS.

September 22-23, 2000, Annandale-on-Hudson, N.Y.
Details will be posted on the Institute web site--www.levy.org-- as they become available.

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Publications and Presentations

DISTINGUISHED SCHOLAR WYNNE GODLEY

Publication: "Is Goldilocks Doomed?" (with L. Randall Wray), *Journal of Economic Issues,* March 2000.

VISITING SENIOR SCHOLAR PHILIP ARESTIS *Publications:* "OECD Unemployment: Structural Breaks and Stationarity" (with Iris Biefang-Frisancho Mariscal), *Applied Economics,* March 2000; "History Warns Against Ditching the Pond at this Level" (with Malcolm Sawyer), *The Guardian,* April 3.
Presentations: "The Economics of New Labour" (with Malcolm Sawyer), Conference on Economics of the Third Way, University of East London, May 26; "Financial Sector Reforms in Developing Countries with Special Reference to Egypt," The Economic Policy Initiative Consortium Conference on Financial Development and Competition in Egypt, Cairo, May 30-31; "The Relevance of Kalecki's 'Political Aspects of Full Employment' to the 21st Century" (with Frank Skuse) and "Economics of New Labour: An Assessment" (with Malcolm Sawyer), Post Keynesian International Conference, Knoxville, Tennessee, June 22-28.

SENIOR SCHOLAR
WALTER M. CADETTE

Publication: "Financing Long-Term Care," *Sanders Research Associates' Quarterly Commentary,* First Quarter 2000.
Presentation: "Financing Long-Term Care," Institute for SocioEconomic Studies and Manhattanville College, Purchase, New York, April 24.

SENIOR SCHOLAR STEVEN M. FAZZARI

Publication: "Investment-Cash Flow Sensitivities Are Useful: A Comment on Kaplan and Zingales" (with R. Glenn Hubbard and Bruce Petersen), *Quarterly Journal of Economics,* May.
Presentation: "How Responsive is Business Capital Formation to Its User Cost? An Exploration with Micro Data," CIDE, Mexico City, May 26.

SENIOR SCHOLAR JAMES K. GALBRAITH

Presentations: "Is the New Economy Changing the Rules?" White House Conference on the New Economy, First Plenary Panel, April 5; "Inequality, Unemployment, and Growth: Was Kuznets Right After All?" Florence Davis Dean Lecture, University of Vermont, Burlington, April 20; "Issues in the 2000 Campaign," The Century Foundation Panel Discussion, National Press Club, Washington D.C., April 28; "Sustainable Development and the Open Door Policy in China" (with Lu Jiaqing), Workshop on Sustainable Development, Council on Foreign Relations, New York, May 5; "Inequality, Unemployment, and Economic Growth," University of California at Riverside, May 17; "The Evolution of Wage and Earnings Inequality in the World Economy," University of California at Santa Barbara, May 18; "What Can be Done About Unemployment?" Learning2000 Conference, Lisbon, Portugal, May 28.

PRESIDENT DIMITRI B. PAPADIMITRIOU

Publications: "Minsky, Hyman P.," a biographical entry in R. J. Barry Jones (ed.), *Routledge Encyclopaedia of International Political Economy,* (Routledge, 2000); "Minsky's Analysis of Financial Capitalism" (with L. Randall Wray), in Ricardo Bellofiore and Piero Ferri (eds.), *The Legacy of Hyman P. Minsky* (Elgar, 2000).
Presentations: "The Budget Surplus and the State of the U.S. Economy," Eastern Economic Association, Crystal City, Virginia, March 23; "The State of the U.S. Economy" and "Full Employment Policy and the Benefits of Public Investment," St. Petersburg State University, Russia, April 4-6; "Prospects for Full Employment: Theory and Evidence" and "Can Social Security Be Saved," at the Western Economic Association's International Conference, Vancouver, June 30.

VISITING SENIOR SCHOLAR MALCOLM SAWYER

Publications: "The Theory of Industrial Policy," in Wolfram Elsner and John Groenewegen (eds.), *New Challenges to Industrial Policy* (Kluwer Academic Publishers, 2000); "History Warns Against Ditching the Pond at This Level" (with Philip Arestis), *The Guardian,* April 3.
Presentations: "The Economics of New Labour" and "Endogenous Money and Economic Policy," University of the Basque Country, Bilbao, Spain, April 13-14; "Britain and the Single Currency," UNISON and National Union of Teachers, London, May 19; "The Economics of the New Labour" (with Philip Arestis), Conference on Economics of the Third Way, University of East London, May 26; "Kalecki on Money and Finance," "The Economics of the Third Way," and "Economics of New Labour: An Assessment" (with Philip Arestis), Post Keynesian Conference, Knoxville, Tennessee, June 22-28.

SENIOR SCHOLAR EDWARD N. WOLFF

Publications: "Technology and the Demand for Skills," in Lex Borhans and Andres de Grip (eds.), *The Overeducated Worker?* (Elgar, 2000); "How Persistent is Industry Specialization Over Time in Industrialized Countries?" *International Journal of Technology Management,* Vol. 19, nos. 1 and 2.
Presentations: "U.S. Income Distribution," Economics Club, New York University, April 18.
Media: Interview, Brazil's Globostate television, April 13; Interview, Harold Channer's *Conversations* television program, April 17; Interview, IDEA-TV, April 19; Interview, Public Broadcasting Station program *After the Gold Rush,* April 20; Interview, Harold Channer's *Conversations* television program, May 15.

VISITING SENIOR SCHOLAR L. RANDALL WRAY

Publication: "Is Goldilocks Doomed?" (with Wynne Godley), *Journal of Economic Issues,* March 2000.
Presentations: "The Surplus Threatens Goldilocks," Boston Economics Club, Federal Reserve Bank, April 19; "The Tale of the Surplus that Devoured Goldilocks," Bradley Institute of Belmont Abbey College, Charlotte, North Carolina, April 25.

RESIDENT SCHOLAR OREN M. LEVIN-WALDMAN

Publication: "The Minimum Wage Can Be Raised: Lessons from the 1999 Levy Institute Survey of Small Business," Challenge, March-April; "The Rhetorical Evolution of the Minimum Wage," *Rhetoric & Public Affairs,* June.
Presentations: "Welfare Reform: Theory and Practice," Eastern Economic Association, Crystal City, Virginia, March 23.
Media: Interview, National Public Radio, May 1.

RESEARCH ASSOCIATE MATHEW FORSTATER

Publications: "Adolph Lowe on Freedom, Education, and Socialization," *Review of Social Economy,* June 2000; "Savings-Recycling Public Employment: An Assets-Based Approach to Full Employment and Price Stability," *Journal of Post Keynesian Economics,* Spring, 2000; editor (with Aaron Warner and Sumner Rosen), *Commitment to Full Employment: The Macroeconomics and Public Policy of William S. Vickrey* (M. E. Sharpe, 2000).
Presentations: "Sraffa, Lowe, and the Revival of Classical Political Economy," History of Economics Society, Vancouver, June 2000; "'You Know My Method!': Analysis and Synthesis in Lowe, Peirce, and Polya (and Sherlock Holmes!)," International Network for Economic Methodology, Vancouver, June 2000; "Full Employment Policies Must Consider Effective Demand and Structural and Technological Change," Post Keynesian Workshop, Knoxville, June 2000; "Working Backwards: Instrumental Analysis as a Policy Discovery Procedure," and "Freedom, Education, and Socialization," Western Social Science Association, San Diego, April 2000; "Full Employment and Multicultural Democracy," Conference on Public Service Employment Assurance, University of Missouri-Kansas City, March 2000.

RESEARCH ASSOCIATE WILLEM THORBECKE

Publications: "Monetary Policy, Time-Varying Risk, and the Bond Market Debacle of 1994," *Journal of Macroeconomics,* Vol. 22, no. 1; "A Public Choice Perspective on the Globalizing of America," in Thomas L. Brewer and Gavin Boyd (eds.), *Globalizing America* (Elgar, 2000).
Presentations: "Budget Deficits, Inflation Risk, and Asset Prices," Washington Area Finance Association Conference, April 28; "European Macroeconomic Policy Interdependencies," Rutgers University Law School, June 9.

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