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The 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.

Dimitri B. Papadimitriou, *President*

The *Summary* is a quarterly publication of The 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.

*Editor:* Ajit Zacharias  
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### Letter from the President

*To our readers:*

The program on the distribution of income and wealth begins with summaries of the sessions and a speech made at a conference on the quality of life in the United States and other advanced industrialized nations. This conference was organized as part of a new research program initiated at the Levy Institute, with the objective of developing quality of life indexes. Three working papers are also summarized. Conchita D'Ambrosio of Università Bocconi and Senior Scholar Edward N. Wolff propose new methods to measure polarization of wealth. The next paper, by Wolff, examines trends in wages and reasons for their sluggish growth in the last 25 years. Thomas I. Palley of the AFL-CIO attempts an explanation of how, despite worsening income distribution, the U.S. economy was able to

achieve high levels of aggregate demand.

Summaries of the speeches and sessions at the 11th Annual Hyman P. Minsky Conference on Financial Structure are included in the program on financial markets and monetary policy. This year's conference focused on the slowdown in the United States and its implications for world economic growth, options for stabilization policy, and lessons from financial crises. Five working papers are also summarized. Visiting Senior Scholars Philip Arestis of the University of East London and Malcolm Sawyer of the University of Leeds argue that the current policy framework underpinning the euro can worsen existing economic problems and create new ones. Arestis and Sawyer, along with Iris Biefang-Frisancho Mariscal of the University of East London and Andrew Brown of South Bank University also criticize the dominant explanations offered for the euro's decline and propose an alternative explanation. In a related working paper, Visiting Scholar Jörg Bibow of the University of Hamburg argues that the poor economic performance of Europe during the 1990s was due mainly to faulty macroeconomic policies--a lesson not appreciated, unfortunately, by those at the helm of the policy regime put in place with the introduction of the euro. Separately, Bibow presents an analysis of the widely held view that unification with the East contributed substantially to Germany's economic woes in the 1990s, and finds it inadequate. Marc Lavoie of the University of Ottawa argues that the series of models advanced by Distinguished Scholar Wynne Godley provides an appropriate framework to discuss some contentious issues in contemporary Post Keynesian monetary economics. A policy note by Senior Scholar James K. Galbraith scrutinizes Alan Greenspan's statements on recent economic growth.

A conference aimed at discussing determinants of academic achievement and evaluating educational policies was sponsored by the Levy Institute and the Center for Advanced Social Science Research, New York University. The speakers' remarks and the sessions are summarized in the section on special studies. Two working papers are also summarized. Jeremy Atack of Vanderbilt University, Fred Bateman of the University of Georgia, and Senior Scholar Robert A. Margo utilize unpublished data to shed new light on an important aspect of 19th-century American manufacturing. Jorge H. del Pinal, Leah M. Taguba, and Arthur R. Cresce of the U.S. Census Bureau and Ann Morning of Princeton University analyze multiraciality in the United States. The current crisis in health care financing is discussed by Senior Scholar Walter M. Cadette in a policy note.

As always, I welcome your comments and suggestions.

*Dimitri B. Papadimitriou*  
President

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## Institute Research

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### Program: Distribution of Income and Wealth

#### Conference: What Has Happened to the Quality of Life in America and Other Advanced Industrialized Nations?

*This conference was organized as part of a new Levy Institute research project aimed at developing quality of life indexes for the United States and other developed economies. It was coordinated by Senior Scholar Edward N. Wolff, who is directing the new project. Brief summaries of the speaker's remarks and sessions are given below.*

#### **Marc Miringoff**

Marc Miringoff, an assistant professor at the Graduate School of Social Service at Fordham University and director of the Fordham Institute for Innovation in Social Policy, stated that progress in the United States is currently measured by market indicators: popular media create the impression that if the GDP and stock market indexes are doing well, then so is the nation as a whole. Unfortunately, the general public and policymakers also appear to share this view to a considerable extent.

The central deficiency with market indicators is that they are based on a narrow view of the quality of human life. According to Miringoff, this view has to be challenged. This will require growing participation by academic intellectuals in the public realm. The development and popularization of quality of life indexes can offer the public an alternative way to view the quality of life; however, in order to get public attention and to be persuasive, such indexes must be simple and easily understood. Miringoff discussed how the work done by his research group over the past 15 years in creating indexes of social health has attempted to contribute to these goals.

Social health indexes are constructed by combining economic indicators, such as the unemployment rate, with social problem indicators, such as teen pregnancy or drug use. These have been effective, said Miringoff, in getting some policymakers and members of the general public to accept the idea that social indicators are important. However, the United States ranks the lowest among industrialized nations in its attention to social indicators. Unlike its counterparts, it does not publish yearly indicators of social well-being, although some states have recently begun doing so. Miringoff noted that it is a peculiarly American feature that efforts to develop such indicators and use them in assessing progress come from the local level. However, local-level indicators are limited in that they tend to focus on a narrow set of issues, such as women's welfare.

Academic researchers can fill this gap, said Miringoff, by developing more comprehensive indicators. It is important that this effort be

done in consultation with advocacy groups and other organizations that have an interest in promoting an alternative way of measuring progress and well-being. Miringoff's research team is contributing to this task by implementing a research project that uses 16 indicators to construct an index of social health for each U.S. state. These indexes are based on data going back to 1970 and will be updated annually.

Miringoff said that data on U.S. social problems are plentiful, but that there is no context, language, or mechanism to report the figures to the public in a meaningful way. Much of this data is in a form accessible only to researchers, who should be held responsible for making the information contained in the data comprehensible to the general public. In order to maintain public attention and policy pressures, such efforts must be updated and reported periodically, just as market indicators are. Quarterly reports would be the most desirable because the media are more likely to report a social indicator that is up or down from a previous quarter rather than from years past. According to Miringoff, the fact that during elections voters raise a variety of nonmarket issues with candidates suggests that there is a growing popular awareness that progress cannot be measured by the yardstick of markets alone.

### **Session 1. Consumption-Based Measures of Living Standards**

According to **David Johnson** of the Bureau of Labor Statistics, people are concerned about changes in their levels of well-being over time and relative to others. These concerns can only be addressed by dealing with the issues involved in the concept of well-being and the measurement of standard of living. The most widely used measures in the United States, median family income, poverty rate, and the Gini coefficient of income inequality, all indicate marked improvement during the period 1959 to 1973, stagnation or deterioration thereafter, and some recovery since 1995. Some analysts have argued that these measures are misleading because they are based on how much people earn rather than how much they consume. Johnson pointed out that choices made regarding other measurement options also complicate the assessment of intertemporal and interpersonal changes in the standard of living: interpersonal comparisons have to take into account differences in family size and composition, while intertemporal comparisons must adjust family income or consumption expenditures for inflation. There are no generally accepted principles regarding how these adjustments are to be made and, as a result, assessments of living standards can vary substantially from one another. Johnson presented a variety of estimates of living standards illustrating his arguments. A common feature of all measures is that they suggest an improvement since 1995.

**Dean Baker** of the Center for Economic and Policy Research discussed issues related to the construction of the Consumer Price Index (CPI). In his assessment, the work done by the Boskin Commission was politically motivated by a desire to cut the budget deficit, and its main conclusion, that the CPI overstates inflation by 1.1 percentage points annually, was not based on sound economic research. However, the debate around the commission's work raised several important issues whose implications go well beyond its specific recommendations. Baker argued that the commission's basic assumption that the CPI can serve as a cost of living index is flawed because it does not take into account changes in the physical and social infrastructure or the provision of public goods and services (such as changed availability of clean drinking water, increased costs of commuting and pollution, and exposure to new diseases). Nor does it take into account relative consumption, that is, the changes in consumption standards brought about by changing notions of social status. These considerations suggest that the CPI can, at best, serve the narrow purpose of measuring price changes of consumption goods and services. Two main concerns raised by the Boskin Commission in this regard were substitution bias and quality change. Baker noted that the first problem could be important during times when prices of a narrowly defined group of goods change rapidly. With respect to quality change, the commission argued that the CPI was systematically recording quality improvements as price increases. Baker responded that several alleged quality improvements were not based on systematic empirical research and that the results of empirical research on quality change are, at best, mixed. Consequently, there is no strong evidence pointing to an inflationary bias in the CPI.

Discussant **Dimitri B. Papadimitriou** of the Levy Institute commended both presenters for their insightful analyses. Papadimitriou stated that he does not favor consumption-based measures of living standards, which rely primarily on survey data of questionable quality and contain a significant number of imputed values (for example, value of home production). They also disregard how consumption expenditures are financed, although the source of finance is important for public policy. As an example, Papadimitriou cited the unprecedented level and burden of household debt in America today and its implications for macroeconomic policy--a topic he and other scholars at the Levy Institute have investigated. He concurred with Baker that the CPI cannot be used as a cost of living index. As a price index, one serious problem is that it includes an imputed rental value for owner-occupied housing. Because this imputed value has a weight of approximately 20 percent in the index, the CPI can potentially give wrong indications regarding the direction and magnitude of changes in the general price level.

### **Session 2. Material Indicators of Well-Being**

Between 1969 and 1989, the official poverty rate for American children increased from 14 to 20 percent, then fell to about 17 percent by 1999. In the debates surrounding the 1996 welfare reforms, those on the left used the official measures to support increased social spending, while those on the right argued that such spending fails to achieve poverty reduction. According to **Christopher Jencks** of Harvard University, both arguments relied mostly on official poverty measures that have three important flaws: children's households now include nonrelatives whose income is excluded from the official measure of family income; the official poverty threshold has risen faster than the true rate of inflation; and cash and noncash government benefits have been excluded from family income. When corrected for these flaws, it appears that child poverty fell during the 1970s, remained constant during the 1980s, and fell again in the 1990s. Jencks examined the robustness of this finding by considering direct measures of children's living conditions. He presented evidence on changes in housing conditions, incidence of crime, ownership rates of automobiles, and access to telephones and medical care. The overall evidence suggests that children on the bottom rungs of the income distribution are now living in families whose material conditions have improved over time.

Senior Scholar **Edward N. Wolff** presented a variety of indicators that showed stagnation or sluggish growth in American living standards since 1973, as compared to the period 1947-1973. Median family income and, to a lesser extent, per capita disposable income have grown more slowly since 1973. The mean income of those in the bottom quintile of the distribution and the share of that quintile in total income have fallen, indicating a worsening of living standards for those at the bottom in both absolute and relative terms. Wolff argued that the main reason for stagnant median family income is the slowdown in labor earnings since 1973, as supported by a variety of estimates of labor income. Income inequality has also worsened, as indicated by the significant rise in the Gini coefficient, the share of income received by the richest 5 percent of families, and the ratio of their average income to that of the poorest 20 percent. Wolff pointed

out that the behavior of labor earnings and education trends since 1973 flatly contradicts the standard human capital explanations. While average years of schooling and the share of highly educated people in the adult population have risen, average labor earnings have stagnated; inequality in earnings has widened even though inequality in educational attainment (as measured by years of completed schooling) has fallen. Yet another anomaly is the behavior of real wages and labor productivity: while both tended to grow at the same rate until 1973, there has been a sharp divergence since then, with real wages growing at a significantly slower rate than labor productivity. This has contributed to a rise in profitability and an increase in the share of profits in national income. Evidence also shows a shift in wealth distribution favoring the wealthiest, stagnation in median household wealth and home ownership rates for those with an average amount of wealth, and a growing burden of household debt. Wolff concluded that the last 25 years or so has seen a stagnation of earnings, income, wealth, and consumption expenditures for the average American, as well as rising poverty and inequality.

Discussant **Juliet Schor** of Harvard University stated that she found the evidence presented by Jencks unconvincing. The material indicators he considered include only goods and services provided via the markets and ignore nonmarket aspects of well-being such as environmental quality. Neglect of intrahousehold distribution of resources and relative poverty further weakens the argument that material conditions have improved for those at the bottom. Schor concurred with the conclusions of Wolff's paper: the damaging evidence presented regarding the human capital explanation of wages highlights the need for an alternative theory of distribution that emphasizes political and institutional factors. Reempowering labor is necessary to improve living standards among average and less fortunate Americans, but such efforts must focus on a broad view of the quality of life and the possible divergence between income and well-being.

### Session 3. Time and Well-Being

**Jared Bernstein** of the Economic Policy Institute discussed the increase in family hours of work during the 1980s and 1990s, which was especially sharp for families with median income. The main force behind the rise was the increasing number of hours worked by wives. Bernstein found that, surprisingly, the rate of growth in hours worked by wives with higher-income husbands was much greater than the corresponding increase for those with lower-income husbands. This suggests that stagnant incomes for the middle- and lower-income groups may not completely explain the growth in wives' hours of work. A decomposition showed that 50 percent of the increase was due to rising labor force participation by wives, while growth in the number of weeks worked and weekly hours accounted for the rest. Bernstein also pointed out that the income inequality among families would have been higher in the absence of increased hours of work by wives. Regression analysis of factors determining the hours worked by wives in various income groups showed that their labor is becoming increasingly inelastic with respect to their own and their husbands' incomes. These estimates, Bernstein argued, suggest the inadequacy of the standard labor/leisure tradeoff approach to labor supply and point to the need for considering cultural and demographic factors.

**Maria S. Floro** of American University and **Thomas L. Hungerford** of the Social Security Administration presented their analysis of time-use data from Australia by pointing out that how people spend their time is an important determinant of their well-being. The 1992 data pertained to adults between the ages of 25 and 64. According to the researchers, one advantage of these data is that they permit an investigation of the intensity of time-use, that is, the simultaneous performance of multiple activities (such as mending clothes while waiting for the pot roast to cook). Ignoring this dimension poses methodological problems in allocating time between activities and creates a systematic bias in the reporting of unpaid work. Floro and Hungerford addressed these issues by classifying overlapping activities into adverse (for example, cooking and cleaning at the same time) and beneficial (for example, listening to music and reading) types. They also examined the extent and duration of such overlapping activities, and the incidence of such activities among individuals according to their gender, income, and family type (for example, single versus married). Results show that the incidence and duration of adverse overlapping activities were greatest for women, particularly those who were relatively poor, had children, and did not work full time. The authors concluded that time intensity can have a significant impact on women's health and child development.

Commenting on Bernstein's analysis, discussant **Stephen Rose** of the Educational Testing Service indicated that working more hours is a double-edged sword. Most salaried employment involves working 40 hours per week, and career advancement and higher-level jobs demand longer hours. At the same time, increased work hours mean less leisure and less time for oneself and one's family. Rose argued that those who favor a higher degree of labor force participation by women and more female representation in higher-level jobs will have to also accept the fact that such tendencies will have implications on the time women spend with their families. While commending Floro and Hungerford for their innovative analysis, he found the exclusive focus on overlapping activities limited and that it prevented the full exploitation of the level of detail available in the data. Another drawback was that the study was based on data for a single year, which makes it difficult to assess trends over time.

### Session 4. Wealth and the Standard of Living

According to **Seymour Spilerman** of Columbia University, household wealth, especially parental wealth, has a significant impact on living standards in Israel. A variety of factors put young couples in a situation where most have no alternative but to purchase a home early in their marriage. Yet, compared to a typical income, home prices are extremely high and given the absence of adequate government subsidies and high down payment requirements, young couples have to rely on parental help to acquire a home. Spilerman used data from the 1994-1995 Survey of Families in Israel and a variety of measures--home ownership, car ownership, ownership of a number of consumer durables (such as video recorders and dishwashers), frequency of paid household help, ability to save from income, and subjective perception of living standards--to assess the importance of parental wealth and parental assistance in determining the living standards of young couples. Regression analysis showed that both factors were very significant, even after controlling for household income. Spilerman also found that parental wealth and parental assistance have a substantial influence in shaping the disparity in living standards between Jews of European and Arab origins. This suggests that the current emphasis of Israeli policy on improving educational attainment may not be sufficient because it will, at best, have an impact on current income, but not on parental wealth.

Senior Scholar **Robert A. Margo** discussed trends in the black-white gap in home ownership in the United States over the last century. According to him, this gap has important implications for living standards because wealth disparity between the races is much larger than income disparity and because owner-occupied housing is the most important component of wealth for an average family. Estimates show that the ratio of black to white ownership rose from about 45 percent in 1900 to 67 percent in 1980 (with most of the increases occurring after 1940) and then declined slightly to 65 percent in 1990. Strikingly, the ownership rate for blacks in 1990 was actually lower than it was for whites in 1900, indicating a large and persistent ownership gap between races. Several analysts have suggested that growing up

in owner-occupied housing confers some positive effects on children. The proportion of children under age 10 living in owner-occupied housing has increased for both races over time, but much more slowly for blacks; as a result, the racial gap in the likelihood of children living in owner-occupied housing has widened over the last century, indicating that there is tremendous room for racial convergence. In an arithmetical sense, the growing gap stems from a combination of lower ownership rates for female-headed households and the increasing proportion of black children living in such households. The slow decline in the racial gap in ownership prior to the 1940s was due to the virtual unavailability of conventional mortgage financing to blacks. The civil rights movement and associated legislation help explain, at least in part, why there was a quickening in the closing of the gap in the 1960s and 1970s. However, the stagnation in the gap during the 1980s suggests that broad-based growth in real incomes is also crucially important.

Discussant **Thesia I. Garner** of the Bureau of Labor Statistics stated that both studies emphasized asset ownership, history, and cultural factors as important determinants of well-being. She commended the researchers for taking into account legislation, tax structure, and the development of financial markets. With respect to Spilerman's findings, she pointed out that it may be worthwhile to examine whether discrimination could explain some of the gap between Jews of European and Arab origins; missing observations and small sample size may have biased some of the findings. According to Garner, Margo's findings are interesting, but it is hard to infer causality from the decomposition analysis and type of regression analysis conducted. Part of the reason, argued Garner, is because some of the causal relationships suggested are longitudinal while the data used are not. The solution to this problem might be to use a longitudinal database such as the Panel Study of Income Dynamics.

### Session 5. Cross-Country Comparisons in Well-Being

**Lars Osberg** of Dalhousie University presented his estimates of economic well-being for Canada and the United States. Conventional indicators have shown significant improvement in recent years; however, they exclude factors important to economic well-being, such as environmental degradation costs and income inequality. Osberg suggested that an index of economic well-being can be constructed as the weighted sum of current consumption, total wealth (all tangible and intangible assets, including natural resources), distribution of income, and economic security. Value judgments are inevitable in the determination of weights--for example, the standard use of current consumption alone as an indicator of well-being involves assigning weights equal to zero for the other three components. Osberg argued that the evidence suggests that the index is very sensitive to the choice of weights. Worsening distribution of income and increasing economic insecurity made the index rise much more slowly than the per capita GDP in both countries. Osberg predicted that the cutbacks in social spending implemented recently will have a detrimental effect on the economic well-being of the vast majority of people.

Comparisons of average real incomes across countries can be misleading because of international differences in the pattern of income distribution. According to **Timothy Smeeding** of Syracuse University, additional insights into international differences in living standards can be obtained by examining the real incomes of those at the same point of within-country distribution as well as measures of within-country income inequality. Smeeding provided estimates of distribution of disposable real personal income in 21 OECD countries, with income expressed in a common currency--purchasing power parity-adjusted dollars. The estimates show that the gap between the richest and the poorest 10 percent of the population is largest in the United States and lowest in Sweden. Further, the poorest 10 percent of U.S. residents have a lower average income than their counterparts in all but two countries, while the richest 10 percent have a higher average income than their counterparts elsewhere. Smeeding argued that it is also important to consider the real incomes of children (computed using an equivalence scale) because it sheds light on how opportunities differ for children in low-income groups as compared to those in middle- and high-income groups. Only in the United Kingdom, the estimates showed, was the gap in opportunity greater than that in the United States. More importantly, it emerged that the poorest 10 percent of U.S. children are poorer in absolute terms than their counterparts in all but two countries. Smeeding concluded that his findings suggest that while the United States has a higher level of average income than other countries in the group, low-income adults and low-income children are worse off in the United States than in most other countries.

Discussant **Stein Ringen** of Oxford University argued that the index of economic well-being proposed by Osberg is too complicated to be useful in public policy debates. He pointed out that if the aim of proposing the index is to motivate political change supporting the social safety net, then it may be more useful to separately highlight the two index components most relevant to this issue--inequality and economic insecurity. Value judgments involved in aggregating different components can also be avoided by following such a procedure. Ringen stated that Smeeding's application of purchasing power parity exchange rates to microdata in order to conduct international comparisons was an important methodological innovation. The finding that poor children in the United States and United Kingdom are worse off than those in most other countries has serious implications for public policy and provides a sad commentary on the political systems of those countries.

### Session 6. Indicators of Worker Well-Being

Several analysts have pointed to the importance of worker rights and labor strength for the well-being of workers and macroeconomic performance. **Robert Buchele** of Smith College and **Jens Christiansen** of Mount Holyoke College have constructed an index of relative worker strength for advanced capitalist economies, using indicators that can be broadly grouped into three categories that reflect important aspects of labor strength: employment protection (e.g., ease of dismissing workers), representational strength (e.g., union density) and social protection (e.g., unemployment benefits). Factor analysis was used to combine the different indicators into a single index. Comparing index values across countries shows that the United States ranks at the bottom and Sweden the top in labor strength. Buchele and Christiansen also considered the relationship between their index of labor strength and other economic and social indicators using correlation analysis. They found a positive but insignificant relation with per capita GDP growth (a result of the index being correlated positively with labor productivity growth and negatively with employment growth), a strong positive relation with real wages and mandated vacation time, and a strong negative correlation with income inequality.

In recent years, two views have emerged with respect to the quality of jobs. One holds that shortened job tenure, stagnant wages, and "flexible" labor markets have eroded job quality. The other holds that innovative work practices (e.g., teamwork) and technological improvements have enhanced job quality. **Michael J. Handel** of the University of Wisconsin, Madison, and the Levy Institute evaluated the two views by analyzing data from the General Social Surveys for 1989 and 1999. Summary statistics constructed from responses to questions pertaining to several dimensions of job quality (such as material rewards and quality of interpersonal workplace relations) were reported. Regression models that tested the significance of changes over time were estimated using dummy variables for

years and controlling for worker characteristics such as age, gender, occupation, and race. Overall, most of the results suggest that there has been no marked change in perceived job quality. While these findings do not give credence to either view, Handel cautioned that subjective and objective measures of job quality can diverge, and there may be biases in the survey data.

**Conchita D'Ambrosio** of Università Bocconi discussed the two papers. She stated that the analysis by Buchele and Christiansen sheds important light on the rolling back of the welfare state. However, she noted, their finding that higher labor strength is positively correlated with desirable social and economic outcomes does not necessarily imply causation. In fact, it may be that better social and economic outcomes lead to higher labor strength. Furthermore, it is important to consider how actual enforcement of workers' rights varies with economic conditions. The index used is a composite of individual indexes; D'Ambrosio wondered whether the possible correlation among them was properly accounted for in the construction of the index. With respect to Handel's presentation, she noted that the sample used in his study was too small and that the estimation methods could also be improved by constructing an index of job quality and analyzing the relative importance of different components.

### **Session 7. Quality of Life Indicators**

**Daphne Greenwood** of the University of Colorado discussed quality of life indicators that have been developed in some localities in the United States. One type supplements standard measures of current economic well-being with a number of social indicators (such as the crime rate); another also takes into account measures of sustainability (primarily imputed costs of depletion of natural resources and environmental degradation). Greenwood argued that local-level indicators are useful because the quality of environment and neighborhoods, as well as access to cultural and natural resources, may be uniform across the locality. In addition, some policy changes that affect the overall quality of life (such as school board or zoning decisions) are made locally; good scores on such indicators can help in attracting residents and businesses to the area. The efforts to develop quality of life indicators are driven by increasing costs of economic growth and a growing awareness that well-being requires more than just-sufficient income. However, she noted, there are also problems associated with local-level indicators, such as their incomparability over time and across localities. In spite of such difficulties, some of the changes in local quality of life indicators mirror similar changes occurring at the national level.

According to **Richard H. Steckel** of The Ohio State University, children's average heights can serve as a reasonably good predictor of quality of life. Under normal conditions most growth takes place during infancy and the early teenage years, but lack of proper diet, disease, or excessive physical exertion can interrupt this pattern and reduce the growth rate. Steckel presented evidence showing that the average height of 12-year-old boys increases with a country's per capita GDP, but at a diminishing rate. The relationship suggests that reductions in income inequality will have beneficial effects on the heights of poor children and almost no negative effects on those of rich children. There is also a positive correlation between life expectancy and height, indicating that greater height is associated with overall physical well-being. Steckel emphasized the importance of feedback relations: adverse social and economic conditions lead to inadequate nutrition and therefore a lower average height. In turn, a smaller stature can have negative effects on physical health and labor productivity, which can contribute to the maintenance of adverse social and economic conditions. Recent trends in average heights show that there has been a slowdown in U.S. growth rates, while several European nations have surged ahead. Steckel attributed the U.S. slowdown to increased incidence of drug use and numbers of people lacking health insurance.

Discussant **Amy Caiazza** of the Institute of Women's Policy Research commended both presenters for drawing attention to the need to take into account nonmarket determinants of well-being. According to her, quality of life indicators must incorporate such determinants and be easy to interpret and accessible to advocacy groups and policymakers, interaction with whom must be an integral part of constructing indicators in order to achieve the goals of simplicity and accessibility. Caiazza suggested that Greenwood's arguments could be broadened by analyzing the local-level social and political processes that led to the construction of indicators. With regard to Steckel's presentation, she suggested that increasing environmental degradation and human exposure to toxic substances might have also contributed to the recent slowdown in the average heights of Americans. Caiazza also stated that the analysis could be extended and made more comprehensive by considering the influences of gender.

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### **Is Wealth Becoming More Polarized in the United States?**

Conchita D'Ambrosio and Edward N. Wolff  
[Working Paper No. 330](#), May 2001

Several studies have documented the sharp rise in the inequality of wealth and income in the United States during the 1980s and 1990s. Conchita D'Ambrosio of Università Bocconi and Senior Scholar Edward N. Wolff examine another aspect of the distribution of wealth, defined as polarization. This concept differs fundamentally from that of inequality and refers to the formation of clusters (a sizeable number of individuals or households) around certain levels of wealth. For example, suppose that the distribution of household wealth in a country is uniform between \$0 and \$1,000. If something were to cause the wealth of all households in the range \$0-\$500 to be equal to \$250 and those in the range \$501-\$1,000 to be equal to \$750, the usual measures of inequality would indicate that the distribution of wealth has become more equal. However, the index of polarization proposed by D'Ambrosio and Wolff would indicate that the distribution has become more polarized. The authors also develop methods to gauge the extent of polarization between groups of households classified according to different household characteristics, track changes in the extent of polarization over time, and assess the effects of polarization on the overall pattern of distribution of wealth.

The main data sources used for the study were the 1983, 1989, 1992, 1995, and 1998 Surveys of Consumer Finances conducted by the Federal Reserve Board, supplemented by data drawn from the Statistics of Income and the Flow of Funds. Marketable wealth (or net worth), defined as the current value of all marketable assets less the current value of all liabilities, is used as the measure of wealth. Estimates show that the distribution of wealth became more polarized over the period examined, especially in the 1980s. Households were partitioned into groups on the basis of home ownership, race, age, family type, income, education, and stock ownership, and

wealth distributions for groups corresponding to each such categorization were estimated. (For example, for the category of home ownership, wealth distributions were estimated separately for homeowners and renters.) The estimates indicate that wealth distributions differ markedly between groups in any given year and that changes in the distribution over time differ across groups.

Household wealth by homeowner status, race, educational status, and stock ownership was distributed very differently between the groups for all the years under consideration. Renters, nonwhites (blacks and Hispanics), family heads with less than a college degree, and households not owning stocks were concentrated at low levels of wealth compared to homeowners, whites, family heads with a college degree, and households with stock ownership. The gaps between homeowners and renters, between college graduates and nongraduates, and between stock owners and nonowners widened throughout the period under study as wealth tended to concentrate with homeowners, college graduates, and stock owners.

The gaps between groups in other categories displayed different patterns of evolution and, in some cases, were sensitive to the index of polarization employed. Gaps between racial groups increased between 1983 and 1989 and then decreased somewhat between 1989 and 1998 according to one index, while another indicates growing racial polarization throughout the period. Differences in wealth ownership by age showed a declining tendency between 1983 and 1989 as the gaps between middle-aged and elderly family heads narrowed, and a rising tendency between 1989 and 1998 as the gaps between elderly and young family heads widened. In the case of family type, the extent of polarization was found to be sensitive to the index used: one index showed households headed by married couples becoming increasingly wealthier compared to households headed by single females and single males, while the other showed no definite trend. Finally, wealth distribution by income classes showed a close correspondence between income levels and wealth; however, the extent of polarization of wealth by income classes declined during the period under study.

D'Ambrosio and Wolff also examined whether the changes in the overall distribution of wealth over the period under consideration were due mainly to changes in household characteristics or to changes in the distribution of wealth within households with the same characteristic (for example, a college education). The main finding is that most of the variation in the overall distribution of wealth is attributable to striking shifts in within-group wealth schedules.

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## **Skills, Computerization, and Earnings in the Postwar U.S. Economy**

Edward N. Wolff

[Working Paper No. 331](#), May 2001

Senior Scholar Edward N. Wolff examines two important issues concerning the dynamics of earnings in the American economy since the Second World War. The first is how labor earnings have been affected by the major structural changes undergone by the economy: the growing share of services in total employment, acceleration in the introduction of information technology since the 1970s and consequent organizational changes in the firms, and the increasing importance of foreign trade. The other issue presents itself as a seeming paradox: while the skill levels and educational attainment of the average worker have risen throughout the period, average real earnings have not kept pace since 1973, and in the case of wages (excluding salaries and fringe benefits), average real wages have actually fallen since that year.

To assess trends, Wolff presents data on a variety of indicators of average real earnings, educational attainment, and skills. The most important of these for earnings are hourly earnings of production and nonsupervisory employees in the private sector, employment cost index for all workers in the private economy, employee compensation based on national income accounts, and earnings of year-round, full-time workers based on the Current Population Survey. All the measures are strikingly similar in their basic trends: rapid growth from 1947 to 1973, followed by decline or extremely sluggish growth (due to growth in fringe benefits) until 1997. Data on educational attainment show a steady increase in the median years of schooling and the percentage of adults who have completed high school and college; especially striking is the rapid growth in the share of college graduates in the adult population since 1973. A variety of skill measures computed on the basis of the Dictionary of Occupational Titles and census data show that the skills of the average worker grew more or less steadily throughout the period 1947 to 1997. However, as noted above, the close correlation between growth in average earnings and growth in educational attainment and skills breaks down after 1973. Wolff notes that a similar break occurred in the relationship between labor productivity growth and wage growth around the same time. The two variables moved in tandem until 1973. After that, both declined, but wage growth fell much more.

Wolff decomposed changes in average earnings to changes in earnings at the level of individual sectors or industries (usually interpreted as reflecting technological changes in the industry) and shifts in the distribution of employment across sectors or industries (usually interpreted as reflecting changes in the composition of demand). Over the period 1950-1997, the predominant influence on earnings growth was wage growth at the industry level. Employment shifts were taking place steadily from high-paying, goods-producing industries to low-paying services. During the 1950s and 1960s, this negative effect was offset by the reduction of jobs in low-paying agriculture. Subsequently, however, further reductions in agricultural employment were minimal, so that the net effect of employment shifts was substantially negative.

Factors driving earnings in the aggregate and at the industry level were analyzed using regression methods. At the aggregate level, it was found that labor productivity growth; the proportion of equipment investment to GDP; the proportion of office, computing, and accounting machinery investment to GDP; foreign trade variables (such as exports to GDP ratio); and the minimum wage were statistically significant in explaining earnings growth. Unionization, educational attainment, and skills did not appear to have a significant influence on growth in average earnings. Splitting the time period into two subperiods, pre- and post-1973, or introducing dummy variables to capture a possible shift, did not change the results appreciably, suggesting that the factors driving wage growth remained substantially the same over the entire period. Pooled estimation with the same set of independent variables was also performed for 44 industries and the

results were different in some ways from those obtained at the aggregate level. Of the foreign trade variables used, only the share of exports in total sales was found to have a significant (negative) impact on earnings growth. A dummy variable discriminating between service and other industries was also significant, while labor productivity growth was not. The latter can be accounted for by the fact that labor markets tend to equalize wages across industries in the absence of mobility barriers.

According to Wolff, his results overall suggest that the human capital explanation of wages--the proposition that earnings growth is generally driven by improvement in skills and education--cannot account for the observed patterns of earnings dynamics in the United States. The sluggish behavior of average earnings during 1973-1997 is best explained by a combination of slowing labor productivity growth, dramatic increases in the use of information technology, and rising international trade.

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## **Contradictions Coming Home to Roost? Income Distribution and the Return of the Aggregate Demand Problem**

Thomas I. Palley

[Working Paper No. 332](#), June 2001

Recent indicators of economic activity show that the exceptional U.S. boom of the 1990s may be coming to an end. Current discussions among economists and policymakers suggest two distinct views of the slowdown: that it represents a temporary setback in an otherwise balanced and sustainable economy, or that the current U.S. economy faces deeper structural problems in generating high levels of aggregate demand. If the first view is correct, interest rate cuts by the Federal Reserve should put the economy back on track with little need for other corrective action. If the second view is correct, a host of alternative policies are required to ensure prosperity. Thomas I. Palley of the AFL-CIO argues for the second view and suggests that the main structural problem confronting the United States is the deterioration of the income distribution.

Palley presents data for the 1980s and the 1990s indicating that working families have been squeezed at two margins as a result of the falling share of wages in national income and growing wage inequality between nonsupervisory and production workers on the one hand and managerial workers on the other. The result has been a steady skewing of the distribution of personal income favoring rich families. Keynesian analysis suggests that the worsening distribution of personal income must result in sluggish aggregate demand growth. Yet, the U.S. economy generated substantial increases in aggregate demand over the last two business cycles. Palley identifies factors that can explain this apparent inconsistency.

One important factor, often neglected nowadays, was the federal budget deficit. Throughout the 1980s and until 1997, persistent budget deficits financed by a growing public debt played a crucial role in boosting aggregate demand. Another factor, particularly in the second half of the 1990s, was the steady decline in household saving. Yet another source of increased aggregate demand was the rapid growth in household debt that financed additional consumer spending. A closer analysis based on data from the Federal Reserve shows that the debt-to-income ratio is far higher for households on the middle and bottom rungs of the income distribution. According to Palley, this pattern of distribution of debt burden has important implications for monetary policy. Interest rate cuts may not boost consumer spending significantly because rich households who are not liquidity-constrained may not engage in much additional borrowing and banks may not, irrespective of a falling federal funds rate, extend more loans to lower-income households with high debt burdens. Further, attempts to reduce debt burdens accompanied by a slowdown in lending might create a vicious cycle by lowering income, which leads to a rise in debt burden, which in turn further lowers lending and income.

Palley argues that an increase in investment demand--driven by a combination of wild speculations regarding payoffs from information technology and solid increases in profitability--also played an important role in boosting aggregate demand. However, recent data indicating extensive excess capacity in U.S. and world manufacturing suggest that profit margins might already be under pressure. Palley also identifies the extraordinary stock market boom as contributing to aggregate demand via lowering private saving (the wealth effect) and encouraging investment by reducing the cost of equity capital for firms.

Overall, Palley argues that the negative aggregate demand effect of a deteriorated income distribution was overcome in the last two business cycles by a combination of growing public (in the 1980s and early 1990s) and household debt, a stock market boom, and an investment boom sustained by increased profitability. However, the current slowdown indicates that these sources of aggregate demand are drying up and that their maintenance over time has resulted in serious imbalances in the economy. The slowdown can be made worse by the continuing trade deficit and a deflationary fiscal policy stance. Palley outlines a set of policy proposals to address the symptoms as well as the root cause of the current aggregate demand crisis. They include, inter alia, calls for interest rate cuts, tax cuts, and an increase in government spending as short-term measures, and as a long-term measure, development of a trade strategy along with a reformed international financial system that helps U.S.-based producers without hurting others in the developing world. However, for balanced and sustained growth in aggregate demand, the fundamental problem of maldistribution of income in the United States--a shrinking share of personal income received by nonsupervisory and production workers as opposed to an increasing share received by managerial personnel--must be addressed by increasing the minimum wage and promoting collective bargaining.

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**Program: Financial Markets and Monetary Policy**



## The 11th Annual Hyman P. Minsky Conference on Financial Structure Can the Financial Structure Avert an Economic Downturn?

*As part of its research program on financial markets, the Levy Institute organized a conference, held on April 26-27, to explore changes in the financial structure, their impact on the financial markets and policy, the options for stabilization policy in the current slowdown in American economic growth, and the dynamics of global financial crises. Brief summaries of the speakers' remarks and the sessions are given here.*

### **Thomas M. Hoenig**

In the recent past, there has been a proliferation of financial crises in developed capitalist nations and emerging markets. Thomas M. Hoenig, president of the Federal Reserve Bank in Kansas City, discussed the broad policy lessons that can be learned from the crises and their implications for the Federal Reserve's role in crisis management.

The first lesson is that financial market regulation must be dynamic and adapt to changes in financial environment, triggered in part by responses to regulation. Second, regulatory change must be carefully managed, and in some instances, gradually implemented. Although necessary, it is also difficult and costly and, in the short run, can be destabilizing. This was the case for the U.S. savings and loan industry in the early 1980s and for developing countries that opened domestic financial markets to capital and great competition.

The third lesson is that once a crisis begins, there are no easy solutions. When the intermediation process breaks down, as it did in Japan, bank lending must be restored, which may be difficult because regulators do not have the information or tools to resolve a crisis that affects a large portion of the financial system. Moreover, supervisory actions tend to be overly restrictive; new bank lending may require a recapitalization of the banking system, and it may be difficult to convince well-capitalized banks to undertake additional lending.

All of these problems result in greater difficulties and higher costs, which suggests a fourth lesson: that crisis prevention should be the focal point of financial market regulation. Of late, the U.S. regulatory structure has been enhanced in this regard through a series of efficiency and transparency reforms. The strong performance of the economy, however, has left some of these new procedures untested under the fire of a significant economic downturn. Moreover, the evolution of financial markets will require further changes in the regulatory and supervisory structure. A particular concern in this arena is whether consolidation will exacerbate the "too big to fail" problem to the extent that market discipline will be applied unevenly across different-sized financial institutions.

The fifth lesson is the importance of a diversified system of financial intermediation, which, historically, most countries have relied heavily on the banking system to undertake. However, trouble in the banking system can weaken the intermediation process with severe macroeconomic consequences. When intermediation is more broadly based, the resulting system may be more stable and robust in times of crisis. It is important, however, to recognize that banks and capital markets are not perfect substitutes: banks lend to a broad spectrum of businesses, while capital markets are less open to the needs of the smaller firm.

Hoenig made several observations about how changes in financial markets over the past 20 years have affected the Federal Reserve's role in crisis management, especially its performance as lender of last resort. The traditional route of provision of liquidity via the discount window is less effective now because of regulatory changes and because crises increasingly originate in nonbank institutions. This leaves open market operations as the only channel by which the Federal Reserve can provide liquidity in times of crisis. However, using open market operations rather than the discount window necessarily alters the stance of monetary policy. This raises two serious questions: first, whether there can be a conflict between the appropriate monetary policy stance and the provision of liquidity and second, whether the appropriate time to remove the liquidity to avoid inflationary pressures can be determined. These questions demand further research and analysis.

### **Roger W. Ferguson Jr.**

Roger W. Ferguson Jr., vice chairman of the Federal Reserve Board of Governors, discussed consolidation in the financial sector. In September 1999, the finance ministers and central bank governors of the Group of Ten (G-10) nations commissioned a study on the potential effects of financial consolidation on regulation and supervision, and monetary policy in the G-10 nations, Australia, and Spain. Ferguson, the director of this study, discussed some of its findings.

The study's two major objectives were to isolate the effects of consolidation from those of other forces (such as technological change) and to identify the areas in which policy changes are needed to handle them. While the diversity of the national economies made generalization difficult, some patterns did appear to be common across countries. The report found that mergers and acquisitions (M&A) among financial firms (defined to include depository institutions, securities firms, and insurance companies) occurred at high levels throughout the 1990s, with the pace of consolidation increasing through the decade. Joint ventures and strategic alliances also increased dramatically. The United States accounted for 55 percent of M&A activity. An important conclusion of the study is that consolidation, driven by improvements in information technology, deregulation, globalization of markets, and increased shareholder pressures for profitability, has helped to create a significant number of large, complex multinational institutions. Ferguson said that he expects consolidation to continue in the future.

The tendency toward greater consolidation in the financial sector poses challenges for monetary policy in three key areas. First, if it reduces the efficiency of the market for central bank reserves or the markets used in the conduct of monetary policy operations, consolidation could make it more difficult for central banks to implement policy. Second, it could affect the transmission mechanism linking changes in the policy interest rate to the real economy and alter the credit channels of monetary policy through changes to the



liquidity or volatility of key financial markets. Third, it might affect the environment in which policy is conducted through, for example, faster transmission of shocks to financial markets across countries.

Despite these challenges, Ferguson said the study finds that financial consolidation has not significantly affected the central banks' ability to achieve the objectives of monetary policy. Many central banks reported that the effects of consolidation have been small. A key reason for this is that the financial markets that are important for monetary policy have remained highly competitive. According to Ferguson, this finding implies that central banks should keep close watch on the competitiveness of markets and monitor its potential effects on the transmission mechanism for monetary policy.

Ferguson concluded by addressing the effects of consolidation on three other issues: financial risk; the payment and settlement system; and the efficiency of financial institutions, competition among such firms, and credit flows to households and small businesses. The study found that existing policies appear adequate to contain financial risk in the intermediate term, but policymakers should step up efforts to understand the cross-market and cross-border effects of large and diversified transnational financial institutions and develop international coordination of regulation and supervision. It also found that consolidation has led to a greater concentration of payment and settlement flows among fewer parties, but this does not seem to have reduced competition for such services. With regard to the third issue, consolidation does not seem to increase efficiency as much as firms claim, suggesting that efficiency claims of M&A activity should be evaluated against their implications for market power. The study also found that the effects of consolidation on credit flows varied from market to market.

### **Diane Swonk**

Diane Swonk, chief economist and a senior vice president of Bank One Corporation, addressed the question of whether the U.S. economy has already slipped into a recession. She stated that it has not, despite the tribulation of the stock markets. Ironically, the same analysts who, even as late as last year, were proclaiming a new economic era in which business cycles and inflation no longer exist are now announcing the onset of recession. According to Swonk, this swing in attitude reflects a fact of human nature: people tend to look at the recent past to extrapolate into the future.



There has been a slowdown in economic growth, but Swonk argued that this reflects the effects of transitory shocks. Investment had accelerated to unsustainable levels as a result of the Y2K scare. The severe winter of 2000-2001 slowed down production and sales, thus leading to productivity declines. An additional factor slowing the economy is rising energy prices.

According to Swonk, several indicators suggest that these temporary shocks are unlikely to push the economy into a recession. Consumer spending has remained strong. Growing levels of employment and a healthy unemployment rate indicate that the labor market is far from weak. Real wages have also grown rapidly in recent years and real income growth is in positive territory. While indebtedness has risen, credit is still easily available (reflected, for example, in the upward trend in mortgage refinancing), which suggests the absence of any serious liquidity crunch. Swonk also predicted that vehicle sales will be strong in the coming months, which would help the economy avoid recession. The labor market is in good shape and has acted as a shock absorber during this slowdown.

Swonk disputed arguments that the decline in stock market wealth alone will curb consumer spending. Such claims assume that people consider capital gains income, when most actually reinvest them. Further, equity ownership is concentrated in the hands of the very rich and their spending is not that sensitive to fluctuations in the stock market in any case.

Swonk commended the Federal Reserve for its agility in adapting its policy stance to shifts in the economic situation. As an example, she cited the fact that in spite of the interest rate hikes during the first half of 2000, it cut interest rates afterwards. The Federal Reserve should also be given credit for allowing the economy to grow at the pace it has, although several economists had argued that unemployment had fallen "too low." According to Swonk, the current policy stance suggests that the Federal Reserve is transmitting a strong message to financial markets about its determination not to let the economy slip into a recession. It may very well be possible that monetary policy would tighten as growth rebounds; there are indications that bond prices already reflect such inflationary expectations.

### **Marc Faber**

Marc Faber, an investment advisor, fund manager, and broker-dealer, discussed the prospects and problems of global economic growth. He noted two significant changes at the end of the 20th century. One was the fall of communism, which suddenly added millions of people to the capitalist world economy. The other was the emergence of a truly global capital market. In the 1980s and early 1990s, many expected that this would lead to industrialization and modernization of developing regions. However, the dangers inherent in a system with instantaneous mobility of financial capital became visible in the financial crises that affected several emerging markets. By the end of the 1990s, the visions of prosperity offered by global capitalism in the beginning of that decade had become somewhat unreal.



Faber noted that the United States was the engine of growth in the world economy during the 1990s. The U.S. boom was driven by a technological revolution, marked by the emergence and rapid deployment of information technology. Technological change produced profitmaking opportunities and created an investment boom. However, many failed to appreciate the dangers in investing in new technology, such as the overestimation of demand, underestimation of supply, and rapid rate of obsolescence. While such failure was common in the case of previous technological changes, a unique feature of the current phase is the acceleration in the speed of change. For example, it took television prices about 25 years to decline, but computer prices declined much more rapidly. The technological innovations have in their wake encouraged overinvestment, which by creating excess capacity put pressures on profitability.

Faber cited the transformation of the Chinese economy as another major event of the 1990s. He presented evidence indicating that in terms of the time taken to double per capita income and reduce the share of population engaged in agriculture, China has outperformed

several other major nations. Their economic growth has global implications: other countries, especially in East Asia, are rapidly losing market share to them and the United States has a growing trade deficit with them. By virtue of its low wages, China is also attracting an increasing share of global direct investment.

Faber said that a consideration of long-term patterns of growth in world per capita GDP indicates three distinct phases: 1820-1950, 1950-1973, and 1973-present. The second period was one of exceptional growth in all regions of the world economy. The current phase is characterized by a much lower growth rate that is in line with the pre-1950 experience, although in some regions the performance since 1973 has been worse even by that standard. Faber noted that since the 1980s, commodity prices, interest rates, and real wages have fallen, and severe recessions have occurred in several countries. The generally poor economic scenario stimulated the search for cost-cutting innovations and increased the pace and extent of mergers and acquisitions, both nationally and globally.

Faber also discussed different scenarios for future economic growth. Strong economic growth may continue in the United States, accompanied by a spread of high technology and policy reforms that spurs growth in Europe, Japan, and the emerging economies. Alternatively, the U.S. slowdown may turn out to be prolonged and the aggravation of global financial and trade imbalances lead to a period of stagnation. While not favoring either scenario fully, Faber argued that there is a serious risk of deflation, caused by unsustainable levels of debt. He cited the levels of U.S. personal debt and Japanese public debt as examples. Another serious risk to long-term prosperity is from the increasingly unequal distribution of income between countries. Faber pointed out that the total global income among low- and middle-income countries has fallen steadily over the years, which has adverse implications for the growth of world demand.

### **James W. Paulsen**

James W. Paulsen, chief investment officer at Wells Capital Management, noted five key features of the recent U.S. boom: the absence of inflation, a rapid growth in corporate profits, a surge in productivity, low unemployment, and a fiscal surplus. However, Paulsen said, in terms of sales (nominal GDP) growth, the 1990s was the weakest decade since the Great Depression. Thus, the real catalyst for these five key features was deficient demand. The slowdown in demand changed corporate behavior because profits could no longer be increased by raising prices. Cost-cutting implemented through downsizing, restructuring, and outsourcing was the only means to increase sales volume and expand profits. By contrast, in the postwar era prior to the 1990s, economic growth was primarily demand-driven. Demand grew steadily as a result of increased government expenditure and real income growth. Corporations were able to raise prices, employees were able to raise compensation, and a self-reinforcing cycle drove economic growth.



Paulsen stated that price declines in the 1990s were most dramatic in the case of hardware for information technology, but the same pattern applied to other major markets. For example, the growth in auto sales and even in sales of new homes was driven by solid decreases in unit prices. The decline in prices, accompanied by an increase in the number of units sold, led to an acceleration in real GDP. This suggests, said Paulsen, that the recent boom was not the result of successful monetary policies. In fact, an odd cycle has been at work since 1995: monetary policy is tightened as real GDP growth picks up due to inflationary fears, but the additional downward pressure on demand forces firms to cut prices even further and thus stimulates real GDP growth.

According to Paulsen, this pattern of supply-led growth can persist only insofar as firms can continue cutting costs. The productivity boom as well as the boom in mergers and acquisitions in recent years can be understood as stemming from this cost-cutting corporate strategy. The overall economy has become tightly linked with the technology sector and its future prospects will depend crucially on technology's performance. Paulsen argued that, since this sector is currently facing a problem of excess capacity, the central problem facing economic policy today is how to stimulate demand. Monetary policy by itself is unlikely to accomplish this task because of the dramatic changes that have taken place in the financial markets and the financing of corporate investment. Attempts to depreciate the dollar are also unlikely to succeed because of the dollar's status as the world's reserve currency and the weakness in other major currencies such as the yen and euro. However, Paulsen stated, the fundamentals of the U.S. economy are too strong to permit a prolonged slowdown.

### **Peter Hooper**

Peter Hooper, managing director with Deutsche Bank Alex. Brown, discussed the current economic situation and prospects for the future. He stated that the U.S. slowdown will lower world GDP growth this year. The inflation rate in the United States is likely to remain tame during the year, but unemployment may rise significantly by the end of 2001. Near-term indicators such as the National Association of Purchasing Managers index, consumer confidence index, and index of leading indicators all point to a slowdown but not a recession.

Hooper attributed the current slowdown to overinvestment in inventories and capacity, the bursting of the stock market bubble, tight credit caused by declines in the quality of corporate debt, increased energy prices that have cut into disposable income, and a strong dollar. Of these, overinvestment in inventories is the most to blame. The sector most significantly affected by the inventory cycle is technology. The inventory-sales ratio in this sector fell dramatically throughout most of the 1990s, before rising sharply from the latter half of 2000. Significant excess capacity also exists today as a result of a prolonged period of rapid growth in capital stock. Hooper stated that the elimination of excess inventories and capacity is inevitable before recovery can take place.

With regard to consumption spending, Hooper argued that a combination of factors are causing a slowdown. The household sector has accumulated unprecedented and dangerous levels of debt. The stock market boom that had contributed to a dramatic increase in the wealth-to-income ratio has now ended. Hooper also presented evidence showing that declines in consumer confidence and increases in unemployment tend to raise the personal saving rate.

According to Hooper, recent declines have brought major stock market indexes in line with earnings expectations. However, in light of previous historical patterns, the earnings expectations are unrealistic. Further corrections in major indexes are likely, possibly offset to some extent by aggressive interest rate cuts by the Federal Reserve. Unit labor costs have remained tame in the current business cycle as a result of technology-driven improvements in labor productivity, so an expansionary monetary policy will not be inhibited by inflationary

fears. The slowdown in such investments is likely to lower productivity growth and put some upward pressure on labor costs in the near future.

Hooper argued that the external deficit of the United States will sooner or later put downward pressure on the dollar, especially if the slowdown persists longer than currently expected. Such a possibility exists because the rise in personal saving rate and decline in capital investment required to correct the present imbalances are quite substantial. Monetary policy alone cannot restart the growth engine; significant easing of fiscal policy in the form of tax cuts or spending increases will be required.

### **Session 1. The State of the U.S. Economy**

**Robert J. Barbera** of Hoenig and Co. stated that the New Economy view is now defunct. According to that view, still held by Federal Reserve Chairman Alan Greenspan and others, the key to the recent cycle has been a technological revolution. Technological progress elevates the prospective rates of return on high-tech investment, which provides surging opportunities for technologically savvy venture capital and equity investors, which in turn produces a high-tech capital spending boom, raises the growth rate of productivity, and generates technology profits. The result is a soaring stock market and wealth effects that generate greater consumer spending and increased tax receipts. From 1992 to 1997, this view was correct. However, from 1997 to March 2000, a stock market bubble, rather than underlying changes in the real economy, drove the economy: equity cost of capital was effectively reduced to zero, and as a consequence, technology investment boomed, further aided by Y2K problems. As net worth declined, firms paid bonuses with options rather than cash, which allowed profits to rise. Investment grew with profits and consumption rose with the growth in income; the current account deficit increased to offset these increases. Instead of the normal process of earnings driving stock prices, stock prices were driving earnings. In this sense, Barbera argued, if analysts still held on to the New Economy view, then it could be said that the bubble was maintaining the view rather than the view generating the bubble. He also cautioned that a substantial portion of the tax revenues in 2000 was related to the use of stock options, which will not be the case in 2001. Unfortunately, government forecasts have not taken this into account.

According to **David A. Levy** of the Levy Institute, the problem facing the economy is the high level of debt. As is to be expected during a boom, private, nonfinancial sector debt has been growing faster than nominal GDP. However, when debt rises relative to income over a long period of time, debt service requirements also rise and become a larger proportion of income. In Minsky's lexicon, this means that more people are moving from hedge to speculative to Ponzi borrowing positions. Debt has risen sufficiently that boom conditions are required to maintain the rate of profits and the cash flows necessary to service it. An economic slowdown will, inevitably, reduce cash flows and the ability to service existing debt. Levy argued that trends in profitability, business investment, initial unemployment claims, and a number of other economic indicators suggest the beginning of a recession, which is unlikely to be reversed quickly because of the painful adjustments required to overcome the deep imbalances in the current economy. The economy is experiencing four vicious cycles. The first is the usual factors thought of as influencing a business cycle downturn, such as excess inventories and capacity. Second is the stock market wealth effect, which historically has been a minor influence but is now a dominant one. Third are credit conditions, defined as the general willingness and ability of the financial system to make credit available. Of late, junk bond defaults are high, the spreads for bonds and commercial paper widening, and business loans tightening. Fourth is international linkages as they pertain to both globalization and financial stability. Unlike the financial crises of emerging market economies, a U.S. crisis can spark a worldwide economic slowdown that will be hard to contain. The Federal Reserve is in a dilemma because they want to create enough liquidity to head off a recession, but once things stabilize, that much liquidity is likely to launch another surge, which, over the longer run, would further aggravate private sector indebtedness. The only other alternative is to endure a period of contained depression (erratic growth, consolidation of private debt, and reliance on deficit spending). The latter, however, is not politically acceptable.

**Thomas I. Palley** of the AFL-CIO examined the underlying forces behind the strong economic growth in the last two decades and its ending. An important source of aggregate demand growth, though neglected nowadays, was the budget deficit (financed via growing public debt), which persisted until 1997, although its relative importance declined in the 1990s. However, this change was more than offset by a steady decline in the private saving rate and increased private sector indebtedness, which has now reached historically unprecedented levels. Palley noted that households with average or lower income are much more indebted than their richer counterparts, which presents problems for monetary policy. Apart from rendering the financial system fragile by the possibility of defaults and bankruptcies, interest rate reductions may be much less effective than previously in stimulating demand because richer households are not in the market to borrow, and banks may not be willing to lend to indebted, poorer households because of default risk. Investment demand, a crucial component of aggregate demand, has also held up during the boom, partly as a result of strong increases in profits. However, recent evidence pointing to excess capacity in the United States suggests that this trend cannot be expected to continue. Palley identified the extraordinary stock market boom as contributing to aggregate demand not via the wealth effect, but by increasing general consumer confidence and elevating expectations for future gains in wealth. Several indicators point toward a drying up of these sources of aggregate demand and a slowdown in economic growth. Palley outlined a set of policy proposals to counter this trend. They include calls for interest rate cuts, tax cuts, and increases in government spending as short-term measures, and as a long-term measure, development of a trade strategy along with a reformed international financial system that helps U.S.-based producers without hurting those in the developing world. However, for balanced and sustained growth in aggregate demand, the fundamental problem of maldistribution of income in the United States--a shrinking share of personal income received by nonsupervisory and production workers as opposed to an increasing share received by managerial personnel--must be addressed by increasing the minimum wage and promoting collective bargaining.

*[Editor's note: The paper presented by Thomas I. Palley has been published as Working Paper No. 332.]*

Visiting Senior Scholar **L. Randall Wray** of the University of Missouri, Kansas City, discussed the importance of an immediate and substantial change in fiscal policy stance. Such a change is required in order to avoid a deep and lengthy recession. The recent boom has been fueled by unprecedented growth in private sector debt, while the government has run up a surplus and the current account has been in deficit. While it is hard to predict how indebted the private sector can become, the historical experience of the United States and other countries suggests that the current level of indebtedness is unsustainable in the long run. The slowdown currently underway will make it even more so. In this context, the only effective policy tool is fiscal policy. The current thinking about fiscal policy among policymakers and most economists favors tying tax cuts to the realization of projected surpluses. Wray characterized this as unfortunate, because if

fiscal policy does not shift immediately and sufficiently, the economy will slip into recession and the projected surpluses will not materialize. However, the tax cuts proposed by the current administration are only about 20 percent of the required shift in fiscal stance, which, Wray estimates, is roughly 4.5 percent of GDP, considering that the budget is now in surplus and that the current account deficit (as a percentage of GDP) is unlikely to shrink much. He emphasized that this would not lead to an expansionary budget, but only to a balanced one that would not drag the economy down. The real question, therefore, is whether the surpluses should be gotten rid of via a recession, with its painful economic and social costs, or through proactive fiscal policy. Wray said that he favors the latter course over an unflinching commitment to budget surpluses as a goal in itself.

[Editor's Note: A revised version of L. Randall Wray's remarks will be published as Policy Note 2001/5.]

## Session 2. Regulatory Issues in the Financial Structure

**Gillian G. H. Garcia**, an independent consultant formerly employed at the International Monetary Fund (IMF), discussed the role of deposit insurance in financial systems. She noted that deposit insurance in IMF member-nations has grown dramatically in the last 15 years, a period in which 75 percent have faced financial meltdowns. Countries have established systems of deposit insurance to promote financial stability and provide protection to small depositors. Garcia identified international differences in deposit insurance systems. Some systems are publicly funded but privately managed, others privately funded and managed, and still others publicly funded and managed. Garcia cited systems privately managed by bankers as a danger because of a conflict of interest. She also discussed the desirable attributes systems should have, including explicitly defined rules, public awareness, and prompt corrective action, which can reduce moral hazard, and compulsory membership and risk-based premiums, which can diminish adverse selection. According to Garcia, an adequately funded deposit insurance system is essential to instill consumer confidence and to work as an automatic stabilizer. Provision of accurate information and extensive public exposure can also be helpful in this regard.

**Jane D'Arista**, director of programs at the Financial Markets Center, focused her discussion on issues related to debt and its interaction with the financial structure. She noted that the Federal Reserve has abandoned its goal of controlling the money supply directly in favor of controlling interest rates. However, recent years have seen dramatic changes in the transmission of monetary policy as a result of financial structure changes. Of these, the most important are the end of the special role of commercial banks and the growth of institutional investors. The reserves that banks maintain with the Federal Reserve have declined drastically, leading to a decline in the control over short-term interest rates and thereby the growth of credit. Household and nonfinancial and financial corporate debt are currently at unprecedented, unsustainable levels. Allowing the development of debt burdens of the current magnitude, said D'Arista, is evidence of failed monetary policy. She argued that better control over the growth of debt could be achieved by changing to an asset-based reserve requirement system.

## Session 3. The Changing Role of Monetary Policy

**Stephen G. Cecchetti**, professor of economics at The Ohio State University, discussed features of the New Economy and what they mean for monetary policy. According to him, investment in information technology contributed significantly to the economic growth of the 1990s. Two interesting features of the recent growth experience were the lack of inflation as a result of successful monetary policy and significant declines, until recently, in the costs of energy and medical care. The effectiveness of monetary policy in the current slowdown depends on whether the effects of the New Economy are permanent or transitory, but economists have not been very successful in distinguishing quantitatively between the two. Cecchetti also said that the reduced dependence of business investment on bank finance has lowered the effectiveness of interest rate cuts implemented by the Federal Reserve.



Senior Scholar **James K. Galbraith**, professor at the Lyndon B. Johnson School of Public Affairs of the University of Texas, Austin, analyzed the underlying philosophy governing recent Federal Reserve policy by scrutinizing chairman Alan Greenspan's statements before the Congress and speeches. A key component of Greenspan's philosophy is the belief that high levels of economic growth will sooner or later generate inflation. However, according to Galbraith, monetary policy cannot fight potential inflation without pursuing restrictive monetary policy that results in unemployment, which is why the NAIRU doctrine is attractive to mainstream economists. While Greenspan appears to be committed to the doctrine in principle, he should be commended for letting the jobless rate fall to as low as 4 percent without raising interest rates. However, the recent experience of noninflationary growth should have convinced Greenspan that there is no such thing as the NAIRU. Instead, he devised the now-famous New Economy arguments in an effort to account for the absence of inflationary pressures. Galbraith argued that the so-called New Economy was mainly a stock market bubble for which the Federal Reserve bore some responsibility because of its positive pronouncements and refusal to take steps to burst the bubble (such as raising margin requirements). Greenspan and many economists believe that capital markets are the best allocators

of scarce capital resources (at the margin). The speculative excesses of recent years belie that belief and suggest that government can play a positive role in allocating capital resources.

[Editor's Note: The paper presented by James K. Galbraith has been published as Policy Note 2001/4.]

**Bruce Greenwald**, professor of finance and asset management at Columbia University Business School, examined to what extent the recent period of exceptional growth in the United States can be attributed to prudent monetary policy. He argued that those who assign great significance to monetary policy tend to overlook the fact that financial markets do not guide real investment--the latter is driven mainly by corporations' retained earnings. The lack of inflationary pressures during the boom was due to intense international price competition and outright declines in the prices of crucial commodities, such as oil. He also asked why, if Greenspan's policies are so good, other central bankers have not been able to copy them. The United States has been an oasis of prosperity in recent years, while the rest of the world has seen economic stagnation or decline. Available evidence on the transmission



channels of monetary policy indicates that the recent U.S. boom cannot be attributed to successful monetary policy. The real source, argued Greenwald, has been the steady decline in household saving. It follows that the current slowdown cannot be addressed by monetary policy alone because household saving is not very sensitive to interest rate changes. This leaves expansionary fiscal policy as the only effective instrument for stabilization policy.



Visiting Senior Scholar **Jan A. Kregel** of the United Nations Conference on Trade and Development focused his discussion on the implications of continuing budget surpluses and the consequent retirement of Treasury debt for monetary policy. Federal Reserve Chairman Alan Greenspan recently indicated that, if the situation were to persist, the government would have to acquire private financial assets. From a Minskian point of view, said Kregel, even the complete retirement of Treasury debt should not raise any difficulty in the provision of a money supply for a growing economy. Minsky defined the monetary system in the United States as a part of the Treasury, the Federal Reserve System, and the demand deposit departments of the commercial banks. Accordingly, the quantity of money in circulation is not determined by the public, but within the monetary system. Kregel said that from such a point of view there is no reason why currency should not be the liability of a particular commercial bank, just as demand deposits are--that is, that banks be allowed to issue currency. Monetary policy would not be maimed by the retirement of Treasury debt because, according to Minsky, open market operations can be just as effectively conducted by a revamped discount window policy that makes the window open to nonbank financial institutions such as securities dealers and savings and loan associations. Kregel said that Minsky would also recommend that the Federal Reserve focus on stabilizing asset prices by placing a floor under them, with the discount window being the most appropriate way to do this.

**Martin Mayer**, a guest scholar at the Brookings Institution, argued that the recent expansion in the United States has been built on a delicate set of imbalances that offset one another--the negative household saving rate and the budget surplus, and the trade deficit and the inflow of foreign capital. A strong change in any component would have strong adverse implications, but such a change is unlikely. Mayer believes that the current slowdown in investment will reverse itself quickly and economic growth will resume at a satisfactory pace. A distinguishing feature of current overinvestment is that part of it has been financed not by banks or the stock market, but rather trade credits, backed largely by the equity issued by the borrower. This was especially the case for several companies in the information technology sector. Insofar as the stock market boom continued, this system seemed to work fine. However, as technology stocks began their decline, the balance sheets of several corporations engaged in the provision or use of trade credits began to deteriorate. Mayer noted that the fact that trade credits mainly involved technology companies explains why the source and the end of the trouble may be confined to this sector. In today's complex financial system, the effects of monetary policy are not clear-cut. An expansionary monetary policy may have no significant impact or result in higher economic activity, higher inflation, or higher asset market prices. Mayer ended by noting that a major reason for the uncertainty surrounding monetary policy is the diminished role of commercial banks in financial intermediation.

#### Session 4. Issues in International Finance

According to **Robert Z. Aliber**, professor of international finance at the University of Chicago, there is a striking similarity between today's macroeconomic situation in the United States and that of Japan in the early 1990s. Both countries saw very sharp increases in the ratio of wealth to GDP. The main impact of this rising ratio, sometimes called the "wealth effect," was increasing rates of investment and consumption. In Japan, as the wealth effect eventually dissipated, consumption and investment rates declined. Aliber predicted that such a pattern also will occur in the United States, which would result in a slowdown and automatically move the federal budget from its current position of comfortable surpluses to deficits. Aliber argued that the external deficit of the nation is the counterpart of excess saving in Japan and East Asia. It is unlikely to adjust significantly, which would leave the burden of adjustment entirely on domestic investment and consumption rates. Aliber also drew parallels between the current phase of the U.S. economic cycle and two previous epochs: 1870 to 1895 and the 1930s. All three periods were marked by strong deflationary pressures, remarkable increases in productivity, real incomes, and globalization, and fragile financial systems.

**Karin Lissakers**, former executive director of the International Monetary Fund (IMF), stated that the efforts of the IMF to improve crisis prevention have had positive effects. She identified several areas in which the policy frameworks in emerging markets have grown in quality and scope. Several countries have moved from a fixed exchange rate to a floating regime, which allows the exchange rate to serve as a shock absorber. Privatization, the elimination of inefficient state enterprises, improvements in tax structure and collection, and restructuring of expenditure programs have led to better fiscal management. Lissakers also stated that the tendency toward greater central bank independence and professional management of central banks have improved the conduct of monetary policy. The adoption of inflation targeting as a goal has made monetary policy more effective in pursuing price stability. Another area that has shown improvement is the financial sector, which is crucial in containing economic crises. The IMF has encouraged strengthening of regulation and supervision and better management of private and state-run banks. The IMF, said Lissakers, has provided assistance in the adoption of best-practice standards in several crucial areas, such as the collection and reporting of financial and economic data and corporate governance. The introduction of ex ante conditionality--an agreement by which the adoption of best-practice standards entitles a country to a line of credit from the IMF in the event of a future financial crisis--has created incentives for emerging economies. Finally, countries are increasingly recognizing that free trade can contribute to long-run economic growth. However, Lissakers cautioned, improvements in the policy framework do not prevent these economies from being prone to adverse external shocks, such as a possible U.S. downturn.

**Parul Jain**, associate director of the Investment Research and Portfolio Strategy Group at TIAA-CREF, discussed the policy lessons that can be learned from the 1997-1998 East Asian financial crisis. The East Asian economies previously had an enviable record of strong economic growth accompanied by a lack of inflation and budget deficits. There was a key imbalance, persistent current account deficits, which many considered justified due to the high rates of capital accumulation in the region; that is, foreign capital inflows were financing investment activity. However, Jain argued, overvalued currencies, along with financial deregulation, encouraged excessive short-term borrowing. Foreign banks were also willing to lend without adequate analysis of credit quality because for them, market share was often the driving factor. The result was a rapid accumulation of short-term debt, which can be understood by means of the financial instability hypothesis put forward by Hyman Minsky. While the IMF did try to warn against the dangers posed by this trend, the prescribed remedy--currency devaluation and restrictive fiscal and monetary policies--was simply inadequate to prevent the crisis and once it was underway, the application of the remedy worsened it. Jain suggested that a decentralized IMF with a stronger regional focus might be one way to better manage regional financial crises.

*Edited transcripts of the speakers' addresses and more detailed summaries of the sessions will be published in the conference proceedings. Ordering information is given on the inside back cover of this Summary. An audio webcast of the conference is available from What's New section of the Levy Institute website ([www.levy.org](http://www.levy.org))*

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### **Will the Euro Bring Economic Crisis to Europe?**

Philip Arestis and Malcolm Sawyer  
[Working Paper No. 322](#), March 2001

Proponents of the Stability and Growth Pact--the framework of economic policy for the countries of the European Monetary and Economic Union (EMU) that have adopted the euro--have argued that it will bring stable and high levels of economic growth to the member nations. However, according to Visiting Senior Scholars Philip Arestis of the University of East London and Malcolm Sawyer of the University of Leeds, the current policy framework can worsen existing economic problems and create new ones. The policy framework has a deflationary bias that prevents it from ameliorating the high average level of unemployment and the disparities in unemployment across regions within the euro zone. Capitalist economies have a tendency toward periodic financial crises--a tendency that is likely to be exacerbated by the division of responsibilities between the European Central Bank (ECB) and the national central banks, the inability of the ECB to effectively perform its role as a lender of last resort, and the differences among countries' economic and financial structures.

Arestis and Sawyer identify four key elements of the policy framework. First, the ECB is focused solely on price stability for the euro zone as a whole and ignores intercountry differences in monetary conditions. The main policy instrument to achieve this goal is the short-term interest rate, supplemented by announcements regarding the desired growth rate in the broad monetary aggregate M3. Second, the ECB has complete control over monetary policy while the national central banks are responsible for regulation and supervision. The current arrangement does not explicitly require the ECB to function as a lender of last resort, though it does not prevent the ECB from doing so. By assigning price stability as the sole objective of the central bank, the policymakers have ignored the importance of the lender-of-last-resort function in ensuring the stability of the financial system and that fulfilling that function sometimes requires compromising price stability. Third, there is a complete separation between monetary and fiscal policy because the latter is still under the purview of national governments. Fourth, national economic autonomy is severely constricted by the requirement that the government's budget deficit not exceed 3 percent of GDP. Given the typical cyclical swings in the budget deficit, this upper limit effectively means that over the course of the business cycle, the budget is likely to be balanced or in surplus. Worsening the situation is the absence of any significant fiscal stimulus from the budget of the European Union (EU) itself.

According to Arestis and Sawyer, the net effect of the ECB's sole focus on price stability, the separation of fiscal and monetary policy, the severe restrictions on national fiscal policy, and the absence of EU-level fiscal policy is a significant deflationary bias. This bias prevents policy from contributing to the reduction of unemployment or redressing regional disparities in unemployment and economic growth.

The authors argue that the faulty design of the current policy framework opens up a number of sources of potential instability and crises. Advocates of the policy regime argue that the introduction of the euro and the continuing effects of the single market will lead to a convergence in national business cycles and reduction in the extent of asymmetric shocks (shocks that do not impact all of the countries in the EMU). While this may happen in some distant future, available evidence points to the existence of substantial asymmetric shocks and significant divergence in business cycles. The single policy instrument of EMU-wide interest rate and the restrictions on fiscal policy makes the current policy regime incapable of dealing with the risks posed by these factors to economic growth.

Several studies have shown that the effects of a change in interest rate on output vary widely across the EU countries. Similar differences are known to exist in the composition of private sector balance sheets and in banking systems. Researchers have also found significant differences in the responsiveness of money demand to changes in income and interest rates. These differences suggest that the national requirements for money stock growth will be different even if income growth converges across countries and that a given interest rate move by the ECB will invoke differing amounts of change in the demand for money across countries. Differences in the transmission of monetary policy and the interest and income elasticities of the demand for money highlight the inappropriateness of pursuing a policy that sets a single interest rate for the entire euro zone.

Arestis and Sawyer also argue that growth in the mobility of financial capital within the EMU and capital markets raises additional difficulties. Because of differences in underlying economic conditions, the rates of return on assets will differ across countries, but banks will be able to borrow at the same EU-wide interest rate set by the ECB. This creates a potential for asset price bubbles and subsequent crises in the local banking system. A possible increase in the role of the euro as a reserve currency and the conversion of all the member nations' public debt into euros could lead to the growth of stronger capital markets in the euro zone, initiating a shift from bank finance to market finance (corporate bonds and stocks). Such a shift, if it materializes, will be uneven across countries, thus once again highlighting the ineffectiveness of the current one-size-fits-all monetary policy.

### **The Causes of Euro Instability**

Philip Arestis, Iris Biefang-Frisancho Mariscal, Andrew Brown, And Malcolm Sawyer  
[Working Paper No. 324](#), March 2001

The euro--the fledgling currency of the European Monetary Union (EMU)--has fallen in value against the major world currencies since its

introduction in 1999. The decline is also manifest when the currency's value is reckoned against some benchmark. One benchmark is the level that would ensure balanced trade; the euro zone maintains a trade surplus, suggesting that the currency is undervalued. Comparing the euro against its purchasing power parity level (which ensures that the cost of similar commodities is the same in the euro zone as elsewhere) produces similar results. Visiting Senior Scholar Philip Arestis of the University of East London, Iris Biefang-Frisancho Mariscal of the University of East London, Andrew Brown of South Bank University, London, and Visiting Senior Scholar Malcolm Sawyer of the University of Leeds examine existing explanations for the euro's decline, identify their weaknesses, and propose an alternative.

One explanation is that market sentiment turned against the euro after it was launched at an inappropriately high level and that the decline in its value is neither dramatic nor unprecedented when compared against other major currencies in the last few decades. The authors point out that while this argument is intuitively appealing, episodes of currency volatility often have an underlying economic logic. The question, therefore, is why the buoyant outlook for the euro zone and the notion that the new currency's introduction would contribute to a rosy economic future were abandoned by market participants soon after the euro's launch.

Another widely held view is that the shift in market sentiment was brought about by factors external to the euro zone, mainly the strength of the U.S. dollar driven by that country's exceptional economic growth in the late 1990s. The close correlation between the dollar-to-euro exchange rate and the difference between consensus GDP growth projections for the euro area and the United States have been offered as major evidence supporting the view that the euro's decline is attributable to the area's growth disadvantage vis-à-vis the United States. However, the authors argue, proponents of this view often fail to specify adequately the mechanisms that would translate a growth differential into a currency depreciation. More importantly, the growth differential began to evaporate with the upturn in euro zone growth in late 1999 and 2000. It is also worthwhile to note that the euro has fallen in value against the yen while the Japanese economy has experienced sluggish or even zero growth during most of the period under consideration.

According to the authors, the growth differential explanation suggests that the euro's weakness is merely cyclical and as such will "naturally" disappear with the future reversal of the relative cyclical positions of the two regions. This view holds the widening of the growth differential to be purely a result of favorable shocks to the U.S. economy and therefore absolves factors internal to the euro zone of any direct responsibility for the euro's weakness. A more complete explanation of euro weakness must consider not only the exceptional growth in the United States, but also internal factors that lowered investor confidence in the region and kept it on a relatively low-growth trajectory.

The authors maintain that the mainstream view that slow growth in the euro zone is due solely to market rigidities, particularly the supposed lack of "flexibility" in the labor market, has little foundation in theory and fact. The relevant structural factors, they say, are the institutional arrangements and economic policy framework prevalent in the euro zone. The current regime has ushered in a single monetary policy for the entire region, while constraining national fiscal policy and ruling out revaluations of national currencies. This arrangement requires a high degree of convergence in economic performance to be effective; it also requires appropriate coordination between the European Central Bank (ECB) and the system of national central banks (the Eurosystem) through the need to pursue a coherent monetary policy, and to be perceived by financial markets as doing so.

Current indicators of growth, inflation, unemployment, budget deficit, public debt, and output gap (the difference between actual and potential GDP) vary widely among the euro zone countries. Historical records for these indicators over the last two decades suggest that divergence is the norm and that the degree of convergence observed during 1995-1997 was exceptional. The conduct of the ECB and its coordination with the Eurosystem also leave much to be desired. Taken together, these factors suggest that the current policy regime is unlikely to be effective: a transformed institutional setting, allowing the coordination of monetary and fiscal policies and large-scale regional transfers, is clearly needed to solve the problems of unemployment and economic growth in the euro zone.

## **Endogenous Money in a Coherent Stock-Flow Framework**

Marc Lavoie

[Working Paper No. 325](#), March 2001

Post Keynesian macroeconomics has often been criticized for its lack of a rigorous and formal foundation. However, Marc Lavoie of the University of Ottawa argues that the series of models advanced by Distinguished Scholar Wynne Godley are immune to such criticism and provide a framework to assess theoretical claims made by macroeconomists. Lavoie begins by outlining the basic features of Godley's framework and then deploys specific models it inspired to discuss some contentious issues in contemporary Post Keynesian monetary economics.

Godley's approach is described as being based on a stock-flow framework because it takes into account the transactions between the different sectors of the economy (such as households, firms, and government) that result in exchanges of final goods and services for money, and the inevitable effects such transactions have on the stocks of financial assets and liabilities of the different sectors. Modeling within the framework consists of two distinct steps. First, a transactions flow matrix that has transactions (such as purchases of consumption goods by households from firms) along its rows and sectors (such as households and firms) along its columns is specified to record the stock and flow dimensions of intersectoral transactions. Each row of the matrix sums to zero because an outflow of funds from a sector is matched by an equivalent inflow into some other sector. Each column represents the budget constraint of the sector it depicts, and describes the balance between flows of expenditure, factor income, and changes in the stocks of assets and liabilities. Each column also sums to zero because a sector's total spending must equal the sum of its total current income and net asset accumulation. In the next step, behavioral equations are proposed for the different components of expenditure on final goods and services (such as a consumption function) and asset accumulation (such as demand functions for equities or money). However, given that both the columns and the rows of the matrix add up to zero, one such behavioral equation--usually describing the balance between the supply and demand for a financial asset--will be redundant in the sense that its solution is fully determined by the remaining equations.

Following Godley and the general Post Keynesian tradition, Lavoie argues that the asset market that plays the accommodating role is the



money market because there is no theoretically meaningful distinction between the supply and demand for money when the latter is, in the customary fashion, defined as bank deposits. A simple model with three sectors--households, firms, and banks--is developed and it is demonstrated that money supply and demand are necessarily equal, and that the loans supplied by banks to firms are necessarily equal to the amount of bank deposits held by households. In other words, there can be no such thing as an excess supply of credit or money. While discrepancies can occur between the actual and desired amount of bank deposits that households hold, such discrepancies are conceived as resulting from mistaken expectations (regarding household income) rather than an excess supply of credit. The argument is shown to hold irrespective of whether banks in the model advance loans to households for speculative purposes or engage in credit rationing. This demonstration, derived from a model with well-specified asset demand functions, is noteworthy because some Post Keynesian authors have argued that the proposition that there can be no excess supply of credit will prevail only in the absence of such lending by banks.

A different model is developed to demonstrate that the conclusion regarding the excess supply of money will hold even if a government sector is introduced. This model is that of a service economy where firms that do not borrow (hence there are no banks) employ only labor to produce consumption goods. The government imposes taxes and finances its deficit spending, if any, by issuing bonds yielding an exogenously fixed interest rate. The central bank issues government notes and also purchases government bonds. The households in the model can thus own two assets: government notes or bonds. It is shown that, analogous to the previous model with private money, once the transactions flow matrix is correctly specified and the behavioral equations are set up, there is no room for a separate equation governing the supply-demand balance for government notes. An important implication of this finding is that once the government fixes the interest rate it wishes to offer on its bonds, the portion of government deficit that will be monetized is determined endogenously--that is, as a result of the portfolio decisions of the private sector.

Lavoie argues that consideration of a more complete model developed by Godley that includes a more realistically specified banking sector can shed light on the controversy about whether within an endogenous money framework the quantity of credit supplied by banks should be seen as perfectly elastic at a given interest rate or increasing with the interest rate. While some have argued that Godley's model favors the latter position, a closer examination suggests no a priori conclusion: the spectrum of interest rates changes to accommodate a reshuffling of private portfolios, but there is no necessary positive relationship between interest rates and the volume of loans or nominal income. According to Lavoie, the application of Godley's approach to this controversy is illustrative of its power to illuminate unresolved problems in macroeconomic theory.

### **Making EMU Work: Some Lessons from the 1990s**

Jörg Bibow

[Working Paper No. 326](#), March 2001

In explaining the economic performance of the European Union (EU) countries in the 1990s, mainstream economists have focused mainly on labor market "flexibility" and "market rigidities." Visiting Scholar Jörg Bibow of the University of Hamburg argues that such a focus cannot shed much light on the underlying causes of high EU unemployment and that supply-side reforms alone cannot make a significant dent. Instead, he analyzes how faulty macroeconomic policies, especially monetary policy failures, were mainly responsible for the unemployment crisis. Further, the policy regime put in place with the introduction of the euro in 1999 does not appear to provide means to overcome the policy failures of the past.

Following the Maastricht Treaty in 1991, the EU member nations embarked on policies supposedly conducive to bringing about macroeconomic convergence and price stability--conditions that were thought to be essential for the launch of the common currency by 1999. The German Bundesbank was to take the lead in formulating monetary policies and the national governments were to follow restrictive fiscal policies. Bibow concentrates on western Germany--the single largest economy of the EU--and points to the fact that its GDP growth was substantially lower than the United States' throughout the 1990s, even after adjusting for cyclical factors. Comparison of interest rate policy followed by the Federal Reserve and the Bundesbank subsequent to the recessions of the early 1990s shows that while the Fed acted preemptively and aggressively, its German counterpart's actions were poorly timed and inadequate. Monetary conditions indexes (measures of monetary policy stance that combine exchange rate and interest rate changes) for the two countries also confirm that the Bundesbank's stance was far tighter than the Federal Reserve's and, strikingly, further demonstrate that the former's stance remained relatively unchanged over 1990-1995. The disinflationary effects of monetary policy were further aggravated by restrictive fiscal policy resulting in stagnant aggregate demand. According to Bibow, six years of ultra-tight monetary policy, rather than supply-side factors, was mainly responsible for allowing the recession of the early 1990s to continue and deepen throughout most of the decade.

The introduction of the euro in 1999 saw the entrustment of monetary policy for the entire euro zone in the hands of the European Central Bank (ECB) and placement of new restrictions on national fiscal policy. Bibow examines whether the current policy regime can achieve sufficiently high levels of economic growth and overcome scandalously high unemployment. According to him, economic theory suggests that the pursuit of a successful common monetary policy in a region characterized by a substantial degree of divergence requires national governments to have policy instruments at their disposal to modulate the effects of the common policy in a manner appropriate to their specific conditions. In the context of the euro zone, the relevant instrument is countercyclical fiscal policy. However, the current policy regime will not only prevent the successful use of fiscal policy at the national level, but also lead to an inappropriate fiscal stance for the area as a whole because there is no provision for the coordination of national fiscal policies. The likely result is that the policy mix will be dictated by the ECB's strategy, which at present is focused solely on price stability at the expense of achieving growth and reducing unemployment. Only a reversal of this strategy--that is, ushering in a prolonged period of monetary easing--can overcome the current malaise of high unemployment in the euro zone. Unfortunately, there is no mechanism to discipline central bankers, who enjoy unbounded discretion in the current policy regime.

Proponents of the current policy regime have pointed to the Dutch experience in the 1990s as illustrating how labor market reforms and wage moderation can reduce unemployment and revive economic growth. Their experience is often invoked to suggest that the euro zone as a whole follow the same strategy. However, according to Bibow, a closer examination suggests that along with structural reforms,

aggregate demand factors also played an important role in the "Dutch miracle" (faster export and investment demand growth stimulated by currency depreciation and slower nominal wage growth vis-à-vis Germany). More importantly, a fallacy of composition is involved in assuming that the Dutch strategy can be replicated for the euro area as a whole. Competitive cuts in nominal wages within the euro area may lead to outright deflation by lowering aggregate demand at a time when there is widespread underutilization of capacity; internationally, such beggar-thy-neighbor policies are likely to provoke retaliation, choking off any potential gains from temporarily higher exports. Growth led by increasing domestic demand appears to be the only viable solution for the euro zone.

### **On the "Burden" of German Unification: The Economic Consequences of Messrs. Waigel and Tietmeyer**

Jörg Bibow

[Working Paper No. 328](#), May 2001

A widely held view attributes western Germany's dismal economic performance in the 1990s to the "burden" imposed by its unification with the crisis-ridden East. Specifically, it has been argued by some that government deficits, public debt, and tax burdens rose dramatically as a result of unification and thus jeopardized West German economic growth. Visiting Scholar Jörg Bibow of the University of Hamburg subjects this argument to close scrutiny and finds it inadequate. The real reasons, he argues, must be sought in the unsound macroeconomic policies pursued under the leadership of Finance Minister Theo Waigel and Bundesbank President Hans Tietmeyer.

The year in which the Berlin Wall collapsed (1989) and the subsequent two years were marked by robust economic growth in West Germany. As the government absorbed the costs of unification via public borrowing, the budget deficit rose from zero in 1989 to 3 percent of GDP by 1991. The expansionary stimulus due to the deficit was welcome at this juncture and helped Germany to overcome the ripple effects of a serious recession then underway in many other parts of the world. However, under pressure from the Bundesbank, fiscal policy turned severely restrictive between 1992 and 1995. The rationale offered for the shift in fiscal stance was that the growth in public debt due to unification was endangering private capital accumulation and growth. Yet, according to Bibow's estimates, public debt in 1991 was well within the range considered sustainable in economic theory and thus unification per se did not require any tightening of fiscal policy.

Analysis of German fiscal policy shows that the structural deficit (actual deficit adjusted for gaps between potential and actual GDP) declined from 1992, even though the economy fell into a recession in the same year. This policy stance was in stark contrast to the fiscal policy strategies followed in the United States and United Kingdom in response to the early 1990s recession and contradicted elementary economic theory. Restrictive monetary policy made matters worse; once again, in contrast to the monetary policy strategies followed by the Federal Reserve and the Bank of England, the Bundesbank pursued a policy of insufficient and ill-timed interest rate cuts. The monetary conditions index (a measure of monetary policy stance that reflects changes in the interest rate and exchange rate) for western Germany in fact shows that the Bundesbank maintained an ultra-tight monetary policy stance for the entire first half of the 1990s. According to Bibow, the deflationary policy mix maintained during the recession had the result of deepening and prolonging that recession. Slowing economic growth put further pressure on the deficit and the actual deficit (as a percentage of GDP) in 1997 was about the same as it was in 1991. The associated growth in public debt was thus the result of unsound fiscal policy rather than unification. Bibow's estimates indicate that in the absence of these policies, the ratio of public debt to nominal GDP would have been significantly lower today.

Bibow warns that his analysis should not be construed as suggesting that the unification did not pose a substantial fiscal challenge. However, estimates provided by the Bundesbank of the contribution of unification to the growth in public debt burden is inflated due to, inter alia, inclusion of normal borrowing by local governments in the East (the debt per person and debt burden indicators, which were below their Western counterparts), double counting, and lack of adjustment for levels of economic activity. Bibow argues that although unification required fiscal tightening, the timing of tightening was unwise and its extent far too excessive. Conventional arguments as to the inevitability of such policies are therefore dubious at best. An expansionary monetary policy could have compensated for any fiscal tightening required due to unification and thus prevented the sharp increases in unemployment that occurred during much of the 1990s.

### **Put Your Chips on 35**

James K. Galbraith

[Policy Note 2001/4](#)

Legislation enacted in the 1970s (House Concurrent Resolution 133 of 1975 and the Humphrey-Hawkins Full Employment Act of 1978) created a framework for regular reporting by the Federal Reserve to Congress and thus enabled an unprecedented degree of communication between the central bank and the Congress--and through the Congress, between the central bank and the public. The guiding philosophy behind the central bank's actions can be examined by analyzing the Federal Reserve chairman's statements before the Congress and speeches. Senior Scholar James K. Galbraith scrutinizes Alan Greenspan's comments on recent economic growth with the aim of revealing their underlying theoretical presumptions and policy implications.

According to Galbraith, an important element of Greenspan's philosophy is the fear that high levels of economic growth will sooner or later generate inflation. However, such a belief cannot serve as a practical guide because the central bank cannot fight potential future inflation without forcing the economy to suffer from excess capacity and unemployment today and it cannot fight actual inflation without excessively raising interest rates. This is why the concept of the natural rate of unemployment (a level of unemployment at which inflation will not increase) was embraced by Greenspan, as well as by much of mainstream economics. But, argues Galbraith, it is impossible to know what the natural rate of unemployment is and Greenspan should be commended, despite his beliefs, for letting the jobless rate fall as low as 4 percent without raising interest rates.

The lesson to be drawn from the noninflationary growth of the recent past is that there is no such thing as a natural rate of unemployment. However, according to Galbraith, this is not the lesson that Greenspan drew. Instead, he developed his now-famous New Economy arguments in an effort to account for the absence of inflationary pressures. In a number of speeches, Greenspan argued that the current

business cycle was fundamentally different from the norm because of revolutions in information technology. Galbraith argues that the so-called New Economy was mainly a stock market bubble and had revealed itself as such by at least the late fall of 1999. Disappointingly, the Federal Reserve did not take any steps (such as raising the margin requirements) to burst the bubble and, by its pronouncements about the New Economy, might have actually accentuated it.

According to Galbraith, the speculative excesses of recent years challenge a core belief held by Greenspan and many economists: that capital markets are the best allocators of scarce capital resources (at the margin). In fact, they do not occupy any such privileged position and government might do better by directly investing or encouraging investment in schools, public transport, environment, health and cultural amenities.

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## Special Studies

### Conference: After The Bell: Education Solutions Outside the School

*As a part of its continuing engagement with pressing public policy issues, the Levy Institute sponsored a conference on educational policy and the determinants of educational attainment. The conference was organized by Dalton Conley, director of the Center for Advanced Social Science Research, New York University, and an associate professor of sociology at NYU. Brief summaries of the speakers' remarks and the sessions are given here.*

#### Leon Botstein

**Leon Botstein**, president of Bard College, emphasized the value of after-school programs. Such programs are often run by individuals who are not teachers and focus on subjects not given much attention in the formal classroom, such as music and the arts. This gives students the opportunity to interact with adults other than their teachers and to learn in an environment that does not feel like school. Most after-school programs do not emphasize grades, tests, or competition; instead, they provide a more peer-supportive environment.

Botstein said he also opposes the idea of extending the school year because research indicates that more school hours do not improve learning. Instead, he said, summer should be used for programs that motivate participants to learn through demonstration of the usefulness and joy of learning in everyday life. However, part of students' motivation must come from external forces, such as their peers.

Botstein argued that summer programs can be developed without the deficiencies found in formal schools, such as grouping of students by age and the use of achievement tests. Children can learn much from those of other ages, but the formal educational structure does not allow mixing of groups, and in this era of small families, many children have little contact with their older or younger peers. Botstein said that children should be allowed to do what they are capable of doing and not be limited by age.



Achievement tests, said Botstein, do not measure true achievement, but rather the speed of learning. As a result, schools reward those who learn quickly and do not reward those who must work harder to achieve the same results. In addition, much of what is tested is quickly lost because students do not use it in the real world. Botstein said that it is particularly important to find ways to help adolescents sustain what they learn in school, which can best be done by linking learning to life. By nature, children have a wonderment about things and ask many questions. However, the current school structure suppresses their curiosity.

Current popular culture seems to praise ignorance and defines success as "having achieved fame and wealth." It does not consider an educated, middle-class individual as having achieved success. Botstein said that one of the greatest dangers of popular culture is that it no longer views science and the pursuit of knowledge as exciting and rewarding. He suggested that this may have contributed to the decline in American students' interest in studying science. Another negative impact of popular culture today is that teachers are often not portrayed as respected and prominent members of the community.

According to Botstein, schools will never function well if the general culture does not express an excitement and joy about learning. This is a leadership failure--we do not provide a culture that makes children see the value of what they are learning. Botstein said that he believes young adults do value education and know it can help them achieve their goals. The key is for the educational system to address what they want to achieve. At present, this can best be done through after-school and summer programs that can instill a motivation to learn.

#### Session 1. Family Background: Nature or Nurture?

A substantial body of existing literature indicates the importance of family background for education. However, according to **Jere Behrman** of the University of Pennsylvania, these studies are problematic because of measurement errors, lack of causal explanations, inadequate consideration of context, and vague policy relevance. A coherent framework of analysis is needed for investigating the determination of household behaviors related to child education and proposing policy recommendations. In modeling household behavior, it is appropriate to see the problem as one in which the household is trying to maximize its welfare subject to a number of constraints: the amounts of various household resources, market prices, social norms, and political context. The provision of education by schools can be thought of in terms of a production function which has as its "inputs" factors that influence educational outcomes (e.g., the time that children spend in school, their health, and nutrition). Estimates of such a production function can, in principle, yield information about the relative importance of each input. Another type of relation often estimated in the literature also includes the constraints facing the

household. Behrman noted that such estimates are prone to omitted variable biases. In terms of policy recommendations, it is important for the tradeoff between efficiency and equity to be explicitly addressed; however, these considerations are missing in most studies.

Many studies have demonstrated the strong relationship between family socioeconomic status and school attainment. **Miriam R. Linver** and **Jeanne Brooks-Gunn** of Columbia University examined the specific pathways by which income operates to influence school performance among children, based on three large datasets: the Infant Health and Development Project, the Child Development Supplement of the Panel Study of Income Dynamics, and the Child Supplement of the National Longitudinal Survey of Youth. They found that maternal education and family income influenced children's cognitive development from early childhood. Two explanations were offered for this: first, that parents who are economically secure and better educated offer relatively more stimulation at home for their children; second, that low income leads to anxiety and stress, ultimately affecting parental behavior. Linver and Brooks-Gunn also examined the relative merits of two types of intervention aimed at ameliorating the effects of parents' poor income and low education. Their analysis suggests that interventions that involve home visits aimed at parental education lead to an almost immediate improvement in the children's family environment. Center-based interventions result in increased scores on standardized IQ tests. Thus, well-designed and flexible intervention programs are required.

Discussant **J. Lawrence Aber** of Columbia University stated that these studies represent two different aspects of the notion that intervening variables moderate the effect of income on student achievement. Behrman explicated this view with a discussion of macropolicy issues while Linver and Brooks-Gunn focused on micropolicy. A limitation of Behrman's approach is that it considers only the level of income while the direction of change in income and the predictability of income are also important for educational outcomes. While controlling for external influences is important, it is also important to recognize the context in which children's behavior is studied. (For example, research has shown that some problem behaviors have a survival value in dangerous situations.) Aber argued that the main problem with Linver and Brooks-Gunn's analysis is that it does not control sufficiently for socioeconomic status. He also suggested that it would be useful to separate the effects of the two potential influences on parental behavior—human capital endowments and parental stress—in terms of their effects on children's educational achievement.

## Session 2. Family Background, Part II: Intergenerational Capital

**Mary Patillo-McCoy** of Northwestern University discussed the reasons for the black-white test score gap. Previous studies had demonstrated that even after controlling for socioeconomic status, the effect of race on standardized test scores remained significant. Patillo-McCoy investigated the test score gap between middle class whites and blacks to investigate the hypothesis that one determinant was the "lateness" of blacks' entry into the middle class. She argued that children's test scores can be conceived of as driven by a three-generational process in which grandparents' characteristics, such as education and involvement with offspring, have a direct as well as an indirect (via shaping the characteristics of parents) impact. Longitudinal data for the study were collected in a suburb of Washington, D.C. Statistical analysis of the data demonstrates that for both races, the effect of grandparents' educational attainment on test scores disappears once parents' educational attainment is taken into account; however, for black children, a high degree of interaction with poorly educated grandparents has a negative impact. Patillo-McCoy cautioned that this finding should not be interpreted as suggesting that poorly educated black grandparents have an undesirable effect on their grandchildren, because the result may merely be indicative of the long-lasting effects of the racial oppression the older people endured. Moreover, grandparents' involvement has positive effects on other aspects of children's well-being, such as self-esteem and mental health.

Parental age has often been ignored when investigating the impact of intergenerational transfers of resources. According to **Brian Powell** of Indiana University, this variable could positively affect children in terms of resource availability: older parents are better off financially, emotionally and intellectually more mature, and more prepared for parenthood, resulting in greater investment in cultural capital. On the other hand, older parents could negatively affect their offspring because of the greater possibility of functional impairment, greater generational gap, and imminent retirement from working life. Powell examined these alternative hypotheses mainly using data derived from the National Education Longitudinal Study of 1988. The approach was to examine the effect of maternal age at the time of childbirth, after controlling for a set of factors (such as income and race) on a variety of indicators grouped into three types of investment in children: cultural (e.g., visits to museums), economic (e.g., saving for education), and social (e.g., PTA membership). Powell found that for almost all of the resources investigated, there was a positive relationship between maternal age and resource allocation. A similar result emerged from models that also included paternal age. While the impact of parental age is not as important as that of parental income or education, its significance suggests that research on educational disparities is likely to benefit by paying careful attention to this factor.

Discussant **Eric Hanushek** of Stanford University commended the speakers for raising important issues. However, he argued that Patillo-McCoy's findings may be based on a sample that suffers from severe selection bias because blacks with lower education had lower response rates. There are also other measurement issues, such as scaling of grandparents' involvement. The study's most important limitation is that it does not take into account school quality in explaining the test score gap. School quality matters because, although the gap in educational attainment between blacks and whites in the age group 25-29 has shrunk steadily (suggesting that parental gap in education has been falling over time), the test score gap between children has not diminished. With regard to Powell's study, Hanushek commented that for a full understanding of the issues, the effects of father's age and family structure need to be considered more comprehensively. He also pointed out a number of problems with the data used, such as identifying only those who plan to send their children to college as performing economic investment in children. More importantly, the investment variables considered by Powell are mostly in terms of attitudes, plans, and activities; a discussion of how these relate to actual outcomes, such as children's academic achievement, is lacking.

## Session 3. Summer Learning

There have been many recent studies on the efficacy of summer school programs in increasing cognitive gains in disadvantaged children. According to **Doris Entwistle** of The Johns Hopkins University, evidence indicates that the relationship between summer activities and school performance may be more complex. The participants in the study were 790 children in eight integrated, six predominantly white, and six predominantly black schools. Some parents (3 percent of the sample) were also randomly selected for participation. The children were tracked through the first five years of school. All students in the Baltimore school district are administered the California Achievement Tests (CAT) twice a year, in October and June. Changes in the performance of each child in the study over the summer (October score minus the previous June score) and over the school year (June score minus the October score of the previous year) were

computed. Statistical analysis revealed that all children gained an equal amount on the CAT over the school year; however, children with lower socioeconomic status (SES) lost ground over the summer. Parental expectations seemed to be a significant factor in determining children's performance on the test in October in the high SES group but not in the low SES group. Entwisle suggested that this might be because poor parents entertain unrealistic expectations for the performance of their children, who in turn are not able to fulfill them. The children feel "punished" when they disappoint their parents and this triggers a cycle of underachievement.

**Barbara Heyns** of New York University offered a critical overview of the state of current research on summer learning. Several studies indicate that 80 percent of the difference in children's academic achievement can be attributed to summer gains. Policymakers have indicated an interest in summer learning in order to reduce differences in learning across social groups, help children retain and practice their learning skills, ascertain the appropriate use of school resources, and increase the effectiveness and flexibility of learning. Summer school has often been ineffective in addressing learning disparities across social groups because better-off parents more often take advantage of it. Further, some recent research on the effectiveness of summer school in hastening cognitive development indicated mixed findings. According to Heyns, summer programs vary widely in content, with some targeting certain areas of academic performance and others offering varied classes aimed at all-around development. Thus, even though policymakers have hastened to increase funding for summer programs, it is not clear which aspects of these programs are beneficial to students.

Discussant **Michael J. Handel** of the University of Wisconsin, Madison and Levy Institute offered an alternative explanation for Entwisle's finding that high parental expectations affected children's performance among high socioeconomic status (SES) but not low SES families. He suggested that low SES parents, regardless of their expectations, may be less engaged with their children or less aware of activities that could lead to better test performance. In other words, high expectations may not mean the same thing in low and high social class samples. Handel suggested that perhaps the best and cheapest way to deal with the "summer effect" is to encourage parents to engage their children intellectually during the summer and help them in that process. With respect to Heyns' presentation, he argued that its central message was ambiguous. While some studies show that summer learning may be the crucial determinant of differential academic achievement, others indicate that it plays a much less important role. Handel professed confusion at such a mix of results.

#### **Session 4. Structured Activity outside School**

**Reginald Clark** of Clark and Associates and **Alexes R. Harris** and **Walter Allen** of the University of California, Los Angeles argued that well-organized after-school programs can lead to better academic and personal outcomes for black children. Their conclusion is based on a study of 266 black elementary- and secondary-school boys before, during, and after different programs. Effectiveness was judged in terms of several areas of individual development—physical, sexual, intrapersonal (motivation and goal-setting abilities), spiritual, emotional, ethical, cognitive, and social (interpersonal skills). Specific attributes of programs that encouraged growth in one or more areas were considered successful. Results from the study indicate that after-school programs generally enhanced children's intellectual development. A low child-staff ratio, larger center size, and a variety of flexible curriculum activities led to academic success, more positive perceptions about the program by children and parents, and better familial relationships. These effects were especially strong for economically disadvantaged early adolescents who lived in public housing. Children in after-school programs had higher self-confidence, were less socially isolated, and demonstrated a lower level of behavioral problems.

Recent research has indicated that paternal involvement in child rearing has positive effects on children's behavioral and cognitive development. **Jean Yeung** of New York University discussed fathers' interactions with their children in two-parent households and the impact of paternal involvement on various aspects of children's lives. The data used for the study were derived from the Child Development Supplement of the Panel Study of Income Dynamics. The data show that time spent by fathers with their children varied from as little as 12 minutes to 9 hours a week. On average, fathers spent more time with their children on weekends (6.3 hours) than on weekdays (2.5 hours). Most of this time was spent playing, with caregiving being the second most popular activity. The least amount of time was spent on household activities and teaching. Fathers spent proportionately less time than mothers on all activities except play, but the difference between them decreased on the weekends. Yeung also conducted regression analysis to assess the importance of various factors on the time spent by fathers with their children. The findings suggest that father's income and length of the working day had a negative effect on weekdays. Surprisingly, over the weekend, father's income had no effect; however, both father's education and mother's education had a positive effect. Yeung argued that her research indicates that while paternal involvement in child rearing has increased in recent years, in most two-parent families, the bulk of the responsibility falls on the mothers.

Discussant **Sanders Korenman** of Baruch College (City University of New York) commended the analysis presented by Clark, Harris, and Allen for making a valuable contribution to the understanding of the development processes of African American boys. However, he stated that from the perspective of public policy it is important to know whether the positive aspects of the programs they identified may apply equally well for nonblacks. Korenman also felt that an ideal program that combines the best practices of different programs will not necessarily work, because it ignores the context of and dynamic interplay between different program components. He also cautioned that correlation does not imply causation. Korenman stated that he found Yeung's presentation very interesting because it highlights the shifts in familial roles in recent years. He thought it striking that even with several of the mothers perhaps not working full time, the time that fathers spent with children was not substantially less than the amount of time spent by mothers. The employment status of the mother should thus be included in the full model and the impact of this interaction on children's development studied.

#### **Session 5. Work and Academic Progress . . . Academic Progress and Work**

According to **Richard Arum** of New York University, examining the school-business nexus can shed light on why vocational education works in some cases and does not in others. He studied the prevalence of school-assisted job placement programs in the United States and their effectiveness in facilitating school-to-work transitions and shaping early labor market outcomes. The data used show that school-assisted job placements are rare but more common for women than for men, especially when the women are exposed to high levels of vocational course work in high school. School placement also tends to place women in clerical jobs, while this does not hold for men. Regression analysis showed that for women, getting their first job via school placement reduced the percentage of time unemployed in the two years immediately following high school and increased annual earnings. No such effects were observed for men. Arum speculated that the gender difference was due to the fact that differences in occupational skills tend to be related to sex segregation of occupations. Blue-collar occupations—the dominant category taken by male high school graduates and dropouts—are often learned on the job and schools have less information about them. Another factor might be related to the differences in job search method: while men tend

to network with others engaged in blue-collar jobs, women have relatively fewer contacts who can help them find jobs.

**Rob Warren and Emily Forrest** of the University of Washington discussed trends in the employment situation of high school students. Rates of employment for adolescents increased from 1940 to 1980 but have remained flat since then. Sex differences in employment rates narrowed during this period and have since disappeared. Employment rates for black adolescents have remained flat over the years and risen for white adolescents. Regression analysis indicated no significant relationship between socioeconomic status and employment rates, though poorer youth worked more hours per week. Considering only employed teens, sophomore and senior girls and black seniors of both sexes tend to work a greater number of hours per week relative to white boys. Thus the population of intensively employed (15 or more hours per week) students has become more diverse over time. Trends also indicate that the effect of sophomore year employment on the high school dropout rate has changed, with more adolescents who work intensively for pay staying in school in recent years. Warren and Forrest stated that they plan to extend their study by examining the kinds of jobs students perform, stratification of jobs by sex and race, and post-high school outcomes.

Discussant **Christopher Jencks** of Harvard University stated that the regression results presented by Arum suggested only a marginal effect for vocational course work on the labor market outcomes for girls. One way to explain this finding would be to argue that high school vocational courses have no real bearing on future employability because if they did matter, everyone would be taking them. Schools also may be effectively functioning as identification mechanisms, recommending their best students to local businesses, and thus students employed via school-assisted placement have higher incomes and spend less time unemployed. In his comments on the study by Warren and Forrest, Jencks stated that the lack of any relationship between SES and student work may be due to the fact that most jobs available to high schoolers are located in high SES neighborhoods. This could also explain why children from lower SES backgrounds work longer hours: they commute to high SES neighborhoods to work and the effort is worthwhile only if they put in extra time. Jencks expressed surprise at the finding that there was little relationship in recent years between working and dropping out of school. One explanation for this, he speculated, is that today these jobs offer no advancements and hence students view schooling as more important. Jencks ended by suggesting that researchers need to focus on which of these children's activities are being replaced by paid work.

### **Part-Year Operation in 19th-Century American Manufacturing: Evidence from the 1870 and 1880 Censuses**

Jeremy Atack, Fred Bateman, and Robert A. Margo

[Working Paper No. 327](#), March 2001

The growth of manufacturing played a central role in the economic development of 19th-century America. During the latter half of that century, improvements in transportation, geographical extension of markets, and technological and organizational changes gave rise to economic incentives for increasing the length of time for which a typical manufacturing establishment operated annually and minimizing "downtime." However, existing research in this area relies on partial and limited quantitative evidence regarding downtime. In this study, Jeremy Atack of Vanderbilt University, Fred Bateman of the University of Georgia, and Senior Scholar Robert A. Margo attempt to fill the gap in existing research by using unpublished data contained in the surviving manuscripts of the 1870 and 1880 censuses of manufacturing. According to the authors, although the data have some problems, they are the best available nationally representative and comprehensive source of information for examining the extent of part-year operation and its determinants.

Information regarding part-time operation is extracted from answers given by manufacturing establishments to questions in the censuses. From these, the authors estimate--on the assumption that a full-time equivalent work year consisted of 309 days, or about 26 days per full-time equivalent month--the average number of full-time equivalent months, percentage of establishments operating full-year (12 months of full-time equivalent operation), and average number of full-time equivalent months among establishments operating less than full-year. The principal conclusion from the estimates is that roughly 60 percent of establishments operated full-year. The remainder operated, on average, for 9.25 to 9.5 months. Previous research on downtime in the late 19th century, based on samples of workers or households, has generally concluded that the likelihood that a worker would experience unemployment at some point during a year was relatively high, but the duration of unemployment was relatively brief. According to the authors, their finding that about 60 percent of establishments operated full-year suggests that this conclusion should be viewed with some skepticism.

Using regression analysis, the authors examined the relationship between part-year operation and establishment-level information reported in the samples: industry, location, and other characteristics such as size and capital intensity. Large, capital-intensive establishments can be assumed to have had better access to transportation and marketing networks and relatively lower average variable costs at higher levels of capacity utilization. Therefore, full-year operation was expected to increase with size (as measured by the number of employees) and capital intensity. This expectation was borne out by the estimates. The age and gender composition of the workforce (as measured by the percentage of child and women workers) was found to be negatively related to full-year operation, probably because some of the children were attending school and because young women preferred to take their downtime in a continuous form (that is, a month or longer) rather than on an ongoing basis (evenings, Sundays, etc.). Establishments belonging to seasonal industries, such as agricultural processing, and establishments located in rural areas were also found to have a greater tendency toward part-time operation. Overall, the results suggest that part-year operation was diminishing in importance in the late 19th century as employment became increasingly concentrated in larger, more capital-intensive establishments located in urban areas and less subject to seasonal variations.

The authors hypothesize that if, in general, workers preferred full-year employment, then those in part-year establishments would have demanded and received a wage premium. Previous research on such compensating differentials has relied on samples of workers or families; it is interesting to examine the hypothesis using the more comprehensive data at hand. Regression results show that the average annual earnings of workers in full-year establishments were higher because they worked more days than those in part-year establishments, but the average monthly earnings (average annual earnings divided by the number of full-time equivalent months of operation) for workers in part-year establishments were found to be higher. This compensating differential was significant even after controlling for other factors such as location and industry, and, for a subsample in 1880, even after distinguishing between the wages of common laborers and mechanics. Its existence suggests that the growth in annual real wages may not have been in tandem with the growth of length of the work year. The authors believe that the growth in the extent of full-year operation contributed to higher capital accumulation and faster technological progress in manufacturing, thus providing an engine of endogenous growth.

## **Reporting of Two or More Races in the 1999 American Community Survey**

Jorge H. Del Pinal, Leah M. Taguba, Arthur R. Cresce, and Ann Morning  
[Working Paper No. 329](#), May 2001

The federal government mandates the collection of race data in the decennial census. However, until the 2000 census, individuals could only classify themselves as belonging to one race. The new directive has raised several issues ranging from civil rights legislation to the determination of health status by race. In this study, Jorge H. del Pinal, Leah M. Taguba, and Arthur R. Cresce of the U.S. Census Bureau and Ann Morning of Princeton University analyze the data from the 1999 American Community Survey (ACS) which also allowed individuals to list more than one race.

The ACS was conducted by the Bureau in 36 counties across the country, but is not a nationally representative sample. Yet, the authors argue, the ACS data may offer a clue as to the picture of race in America that would emerge from the 2000 census, particularly with respect to the multiracial population. The estimates from the data showed that the area with the highest percentage of people reporting two or more races was Yakima County, Washington, with 4.5 percent. This is, strikingly, also one of the counties in the ACS with the highest percentage of American Indians and Alaska Natives (about 5 percent). The estimate for the percentage of multiracial population was not statistically different from that for Bronx County, New York (3.8 percent)--the county with the lowest percentage of whites (21 percent) in the ACS. The lowest percentage of people reporting more than two or more races was in Madison County, Mississippi (0.2 percent)--the county with the highest percentage of blacks (46 percent) in the ACS--but its percentage of multiracial individuals was not statistically different from that obtained for Schuylkill County, Pennsylvania, the county with the highest percentage of whites (98 percent).

While there are a potential 57 combinations of the six major racial groups in the ACS, the authors found that 9 out of every 10 people reporting multiple races reported only two races and most of the balance reported three. Hispanics were more likely than other groups to report more than one race, with one of the choices being "some other race." For example, a respondent reporting his race as white and ethnicity as Mexican was classified simultaneously as "white" and "some other race." Removing those who checked "some other race" and another category substantially reduced the percentage of multiple-race responses. American Indian and White, Asian and White, Black and White, and American Indian and Black were found to be the most common double-race combinations.

A comparison of the distribution of the population by race when all were assigned to only one identifiable race and when those who reported two or more races were assigned to "some other race" showed little difference. According to the authors, this suggests that the level of complexity introduced by allowing individuals to report more than one race is not as daunting as was expected by some analysts. Another concern expressed was that the placement of the question on Hispanic origin ahead of the question on race might cause the multirace response rate to decline. However, the data from the ACS indicate that this concern was misplaced because the response rate to the race question by Hispanics as well as non-Hispanics was quite high.

## **Financing Health Care: There Is a Better Way**

Walter M. Cadette  
[Policy Note 2001/3](#)

Several observers have drawn attention to the recent sharp increases in health care costs along with a steady rise in the number of uninsured. According to Senior Scholar Walter M. Cadette, the main difficulty with reforming the health care system is not the difficulty of designing an adequate institutional structure for the provision of health care but the lack of political leadership to implement bold reforms. The root cause of the problems today is that those who pay for others' health care--government and employers--are revolting against the costs they never expected to become so high. Cadette discusses the origins and dimensions of this problem and what can be done about it.

The existing system of health care financing is, for the most part, based on a link between employment and health benefits. This is attractive to employers because health benefits are a form of tax-free compensation that allows employers to leverage compensation costs. Such a system leaves out the working poor (engaged in jobs without health benefits) and those who do not work. Medicare and Medicaid were designed to fill those gaps, but do so only in part; by and large, the working poor and their children were left out and had to rely on the charity budgets of hospitals. Nevertheless, the system appeared to work fairly well until the 1980s. Employers and the government did not impose any ceiling on health care costs. As a result, consumers of health care never had to consider the price of a service when deciding whether to use it.

The transformation of health care technologies, the result of a combination of subsidized financing and the economic weakness of the early 1980s, began to put increasing strains on health care financing. Medicare gradually switched from cost-based reimbursement to a fixed-fee system subject to political manipulation; employers, meanwhile, began to switch to managed care, through which they negotiated the costs of health benefits provided to their employees. According to Cadette, these changes led to a dramatic deterioration in the financial situation of most hospitals, forcing them to economize on costs and leading to compromising the quality of care provided.

Following the recent shift to fiscal tightening, further pressures have been placed on federal funding of health care. Cadette argues that as the proportion of elderly in the population increases in the coming years, the government's share of the nation's health care bill will grow from its current level of 50 percent to 70 percent. This, in effect, makes nonprofit hospitals regulated public utilities, but it is uncertain how they will meet their expenses and raise capital for continued improvements. It is possible that they will be forced to adopt a marketplace ethic and segment the demand curve for health care (similar to the airline industry), thus providing only the type and quality of care that consumers can afford.

Cadette proposes a two-pronged approach to overcome the current problems. The link between health insurance and employment, he

says, should be replaced by a system of private insurance in which individuals buy the type of insurance coverage they need, with those needing help with premiums receiving it via an income-scaled tax credit. The insurance market would move to high-deductible policies, which would act as a powerful cost-control force. The other element of the proposal is to scale Medicare subsidies to income. Currently, those who have good jobs receive tax-free health benefits, while the working poor are left out and affluent seniors receive Medicare funding on the same footing as the elderly poor. According to Cadette, his proposed approach will rid the system of these inequitable features.

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## Publications and Presentations by Levy Institute Scholars

### Philip Arestis Visiting Senior Scholar

*Publications:* "Recent Banking and Financial Crises: Minsky versus the Financial Liberalisationists." In R. Bellofiore and P. Ferri, eds., *Financial Keynesianism and Market Instability: The Economic Legacy of Hyman Minsky, Volume 1*. Northampton, Mass.: Edward Elgar, 2001.

*Presentations:* "Is There a Trade-Off between Inflation and Output Gap?" (with G. M. Caporale and A. Cipollini), Beyond Inflation Targeting, Meeting of the Money, Macro and Finance Group, South Bank University, London, March 22; "Research in the U.K.," University of Zagreb, Croatia, April 5; "Growth Theory: New Evidence from Panel Data" (with P. O. Demetriades and B. Fattouh) and "Threshold Effects in the U.S. Budget Deficit" (with A. Cipollini and B. Fattouh), Royal Economic Society, University of Durham, U.K., April 9-11; "Finance, Growth, and Crises," University of Ljubljana, Slovenia, April 18; "Reflections on the Experience of the Euro" (with Malcolm Sawyer), Conference on Financial and Monetary Integration: Lessons from Europe for the Americas, Kalamazoo College, May 11-12.

### Walter M. Cadette Senior Scholar

*Publications:* "The Economics of Health Care Funding." *Quarterly Commentary*, First Quarter, 2001; Review of Andrew J. Rettenmaier and Thomas R. Saving's *The Economics of Medicare Reform*. *Eastern Economic Journal* 27 (2001).

*Presentation:* "Financing Health Care: There Is a Better Way," Annual Henry George Lecture at St. John's University, Jamaica, N.Y., April 3.

### Robert A. Margo Visiting Senior Scholar

*Presentations:* "Productivity in Manufacturing and the Length of the Working Day: Evidence from the 1880 Census," Department of Economics, Rutgers University, New Brunswick, N.J., April 16; "Rising Wage Dispersion across American Manufacturing Establishments, 1850-1880," Center for Population Economics, University of Chicago, May 4; "The Wage Effects of the Civil War," conference in honor of Stanley Engerman, Department of Economics, University of Rochester, June 9.

### Dimitri B. Papadimitriou President

*Publication:* "Minsky's Analysis of Financial Capitalism" (with L. Randall Wray). In R. Bellofiore and P. Ferri, eds., *Financial Keynesianism and Market Instability: The Economic Legacy of Hyman Minsky, Volume 1*. Northampton, Mass.: Edward Elgar, 2001.

*Media:* Interview with *Market Call*, CNNfn, April 18.

### Malcolm Sawyer Visiting Senior Scholar

*Publications:* "Kalecki on Imperfect Competition, Inflation, and Money." *Cambridge Journal of Economics* 25:2 (2001); "Minsky's Analysis, the European Single Currency, and the Global Financial System." In R. Bellofiore and P. Ferri, eds., *Financial Keynesianism and Market Instability: The Economic Legacy of Hyman Minsky, Volume 1*. Northampton, Mass.: Edward Elgar, 2001.

*Presentations:* "Economics of the Third Way" and "The NAIRU, Aggregate Demand and Investment," University of Lecce, Italy, April 2-3; "The Decline of the Euro," "An Alternative Growth and Stability Pact for Europe," and "Economics of the Third Way," Trinity College, Hartford, Conn., April 18-20; "Reflections on the Experience of the Euro" (with Philip Arestis), Conference on Financial and Monetary Integration: Lessons from Europe for the Americas, Kalamazoo College, May 11-12; "Monetary Policy and Endogenous Money," Conference on Post Keynesian Economics, Notre Dame University, May 13-14; "The NAIRU as a Barrier to Full Employment," Centre of Full Employment and Equity, University of Newcastle, Australia, June 13-14.

### Edward N. Wolff Senior Scholar

*Publication:* "Has Japan Specialized in the Wrong Industries?" In Magnus Blomstrom, Byron Ganges, and Sumner La Croix, eds., *Japan's New Economy: Continuity and Change in the Twenty-First Century*. New York: Oxford University Press, 2001.

*Media:* Interview for *Money Weekly*, Canadian Broadcasting Corporation, March 27.

### L. Randall Wray Visiting Senior Scholar

*Publication:* "Minsky's Analysis of Financial Capitalism" (with Dimitri B. Papadimitriou). In R. Bellofiore and P. Ferri, eds., *Financial Keynesianism and Market Instability: The Economic Legacy of Hyman Minsky, Volume 1*. Northampton, Mass.: Edward Elgar, 2001.

*Presentations:* "Policy for the Coming Recession," Singer Island, Fla., March 19-20; "Fiscal and Monetary Policy for the Coming Recession," Wayne State College Economics Forum, Wayne, Neb., April 12; "Incarceration of the Surplus Population: America's Solution to the Unemployment Problem," Association for Institutional Thought, Reno, Nev., April 20.

### Jörg Bibow Visiting Scholar

*Publication:* "Comment." In J. Hölscher, ed., *50 Years of the German Mark: Essays in Honour of Stephen F. Frowen*. New York: Palgrave, 2001.

*Presentations:* "The Stability-Oriented Monetary Policies of the European Central Bank," Monetary Policy in a World with Endogenous Money and Global Capital, Berlin, March 23-25; "Easy Money through the Back Door: The ECB versus the Markets," Skidmore College, Saratoga Springs, N.Y., May 1, and Canadian Economics Association, McGill University, Montreal, May 31-June 3; "What



Has Happened to Monetarism?" History of Economics Society, Wake Forest University, Winston-Salem, N.C., June 29-July 2.

**Willem Thorbecke Research Associate**

*Presentations:* "The Rise and Fall of the Inflation Risk Premium," Federal Reserve Board, Washington D.C., April 3, and the Washington Area Finance Conference, American University, Washington D.C., April 14; "Modeling the Socioeconomic Impact of the Crisis: The Case of Indonesia," World Bank, Washington, D.C., May 10.

**Lynndee Kemmet Resident Research Associate**

*Presentation:* "Private versus Public Financing of Economic Development: The Politics of Economic Development in a Local Region," New York State Political Science Association, New Paltz, N.Y., May 4-5.

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