

The Jerome Levy Economics Institute of Bard College

# Summary

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## CONTENTS

[Letter from the Executive Director](#)

### Institute Research

#### Program: Employment Policy and Labor Market Structure

##### Summaries of New Working Papers

- [The Political Economy of Corporate Governance in Germany](#)
- [The Japanese Financial Crisis, Corporate Governance, and Sustainable Prosperity](#)
- [Education's Hispanic Challenge](#)
- [E Pluribus Unum : Bilingualism and Language Loss in the Second Generation](#)
- [The Romance of Assimilation: Studying the Demographic Outcomes of Ethnic Intermarriage in American History](#)

##### Seminars

- [The Emergence of a National Labor Market in the United States](#)
- [Fashion, Immigration, and the Economics of Ready-to-Wear](#)
- [Help or Hindrance: The Economic Implications of Immigration for African Americans](#)

##### [Scholars](#)

#### Program: Restructuring in the Financial Services Sector

##### Summaries of New Working Papers

- [The Development and Reform of the Modern International Financial System](#)
- [The Hierarchy of Money](#)
- [The Asian Disease: Plausible Diagnoses, Possible Remedies](#)
- [East Asia Is Not Mexico: The Difference between Balance of Payments Crises and Debt Deflations](#)

##### Workshop

- [Workshop on Monetary Theory and Policy](#)

##### Seminar

- [Money and National Sovereignty in the Global Economy](#)

#### Eighth Annual Hyman P. Minsky Conference on Financial Structure

- [The Fragility of the International Financial System: Options for Policy](#)

##### [Scholars](#)

#### Program: Federal Budget Policy

## Summary of New Working Paper

- [Public Capital and Economic Growth: Issues of Quantity, Finance, and Efficiency](#)

[Scholars](#)

## Program: International Trade and Competitiveness

[Scholars](#)

## Special Projects

### Summary of New Working Paper

- [An Important Inconsistency at the Heart of the Standard Macroeconomic Model](#)

### Seminar

- [From Hammarapi to Leviticus: Who Shall Collect the Land's Rent—the Palace or the Creditors?](#)

[Scholars](#)

## Institute News

[New Publication: Policy Notes](#)

[New Scholars](#)

[Presentations and Publications by Levy Institute Scholars](#)



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

S Jay Levy, *Chairman*  
Dimitri B. Papadimitriou, *Executive Director*

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## Letter from the Executive Director

*To our readers:*

*This issue of the Summary includes activities in three research programs and special projects. I would especially like to call your attention to the summary of the Eighth Annual Hyman P. Minsky Conference on Financial Structure. At the conference, economists, bankers, and officials from the Federal Reserve Board and the International Monetary Fund debated the causes and remedies of the Asian crisis. Also on the Asian crisis are working papers by Visiting Senior Scholar Jan A. Kregel and Martin Mayer of the Brookings Institution. Other working papers in the financial structure program summarized here are Senior Scholar L. Randall Wray's on the development of the international financial system and Cambridge University Visiting Scholar Stephanie Bell's on the role of debt in monetary circulation. Other activities in this program included a workshop on monetary theory and policy and a seminar by John Smithin, of York University, on the ability of smaller nations to maintain independent monetary and fiscal policies in the new global economy.*

*Five working papers are summarized in the program on employment and labor market structure. Research Associates Mary O'Sullivan and William Lazonick, both of INSEAD and the Center for Industrial Competitiveness at the University of Massachusetts Lowell, each discuss an example of successful corporate governance, O'Sullivan in Germany and Lazonick in Japan. Effects of immigration on the U.S. labor market is the subject of three working papers and three seminars. The working papers are by Senior Scholar Joel Perlmann; Georges Vernez, of RAND; and Alejandro Portes, of Princeton University, and Lingxin Hao, of The Johns Hopkins University. The seminars were led by Robert A. Margo, of Harvard University; Nancy L. Green, of L'École des Hautes Études en Sciences Sociales; and Frank D. Bean, of the Population Research Center at the University of Texas, Austin. One working paper is summarized in the federal budget policy program. Research Associate David Alan Aschauer, of Bates College, examines the effects of different aspects of public capital investment on economic growth. Activities summarized under special projects are a working paper by Distinguished Scholar Wynne Godley and Anwar Shaikh, of the New School University, about an inconsistency in the standard macroeconomic model and a seminar by Michael Hudson, of New York University, on Bronze Age finance and debt cancellation.*

As always, I invite your comments on the [Summary](#).

*Dimitri B. Papadimitriou  
Executive Director*

[Back to Contents](#)

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## Institute Research



### Program: Employment Policy and Labor Market Structure

#### Summaries of New Working Papers

##### **The Political Economy of Corporate Governance in Germany**

Mary O'Sullivan

Working Paper No. 226, February 1998

Research Associate Mary O'Sullivan, of INSEAD and the Center for Industrial Competitiveness at the University of Massachusetts Lowell, is investigating systems of corporate governance to find which lead to successful decisions for individual firms and for an economy as a whole. She believes that success requires a form of corporate governance that generates conditions that permit cumulative and collective learning, provides financial commitment to innovative investment, and integrates human and physical resources in the development and use of technology. She warns that because both the real and financial sectors are in a continual process of change, a successful system of governance cannot be determined in the abstract. Strategies that work at one time may not work at another. In her examination of corporate governance in Germany, she therefore makes a detailed study of postwar German economic history.

According to O'Sullivan, financial commitment to innovative investment in Germany has relied on arrangements that have been in place since before World War II: strong managerial control, intercompany shareholding networks, and banks' support of corporate management. Although banks and some insurance companies have been among the largest shareholders in German industry, they have largely acquiesced to managerial control. Furthermore, major industrial enterprises in Germany have had the ability to generate internal finance, which has freed them to focus on innovation.

A movement toward industrial democracy in the postwar period, although it fell short of its goals, succeeded in winning for workers the most extensive formal system of employee representation in the world. Two key elements of this system have been employee representation on supervisory boards and worker councils that are elected by blue-collar and white-collar workers and are designed to allow labor to participate in and receive information about management.

The German system of training has produced workers who are highly skilled but not inextricably tied to one type of work, which means that technological change has not threatened German workers to the same extent as it has threatened British and American workers. At the same time, worker and management skills have been highly integrated in the sense that managers have emphasized technological know-how rather than management itself as a separate skill.

The German system of organizational control has fostered a system that spreads the gains of success and the cost of rationalization. Workers and firms have shared the benefits when the firm is profitable and the costs when the firm needs to restructure to stay competitive. This has allowed Germany to adapt to changing economic realities without major labor strife. The government has contributed by helping to pay the costs of reduced work hours and early retirement packages to prevent major layoffs. However, some of the cost of rationalization has been borne by immigrant laborers, known as "guest workers," who have been used as a buffer to insulate German workers from employment shocks.

According to O'Sullivan, German manufacturers, like American manufacturers, have been threatened by Japanese competition since the 1970s. The German focus on high-quality products, however, has saved them from direct confrontation with the Japanese, and they have kept a competitive edge in high-end automobiles, telecommunications, and pharmaceuticals.

In the 1990s the German system of corporate governance faces four main challenges: rising unemployment, increased international competition, an aging population, and the cost of reunification. In 1992 the country plunged into its worst recession since World War II. These challenges are straining all aspects of industrial relations, which had been stable for decades. O'Sullivan believes that German high-technology firms will continue to be successful, but doubts that they will be able to make up for losses in the medium-technology sector. She believes that employers are failing to see that organizational integration is the key to meeting these challenges. Employers instead blame high wages, short working hours, labor market regulations, and high taxes for their failures. The reputation of German investors as patient capitalists seems to be slipping away as they opt for short-term shareholder gain rather than investment in innovation. This, O'Sullivan warns, could undermine the foundations on which German success rested in the past.

[Back to Contents](#)

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## **The Japanese Financial Crisis, Corporate Governance, and Sustainable Prosperity**

William Lazonick

Working Paper No. 227, February 1998

Before the Japanese stock market crash of 1990, Japanese industry was a phenomenal success. A recent unemployment rate of 3.5 percent, although low by world standards, is the highest Japan has experienced since the current mode of calculation began in 1953. Japan's industrial dominance, sustained prosperity, and commitment to lifetime employment seem to be in danger. Research Associate William Lazonick, of INSEAD and the Center for Industrial Competitiveness at the University of Massachusetts Lowell, takes issue with this perception. He finds that the Japanese economy is in a better position than the United States to achieve sustainable prosperity, which he defines as "the spreading of the benefits of economic growth to more and more people over a prolonged period of time."

In any industrialized economy major corporations, by virtue of their prior success, control vast amounts of productive resources and financial returns. According to Lazonick, because institutions--corporate entities, organizations, strategies, and practices--have deep historical roots and are undergoing a continuous process of

change, simple talk about the benefits of free markets or profit-maximizing behavior cannot substitute for careful analysis of how institutions and markets interact to generate economic development. He accomplishes this in a detailed study of postwar and recent Japanese economic history.

According to Lazonick, the United States and Japan are both contending with international competition and intergenerational dependence, but are responding to them differently. U.S. and Japanese corporate enterprises are making investments in organizational learning--a necessary first step toward sustainable prosperity. However, the prevalence among U.S. corporations of downsizing their labor force and distributing profits to their stockholders could mean that the investment in organizational learning in the United States is insufficient to generate sustainable prosperity. In Japan sustainable prosperity is promoted by the strategy of retaining and reinvesting profits and reallocating labor in order to sustain a commitment to lifetime employment. Lazonick believes that Japan is in a position to emerge from recession stronger than before because the "retain and reallocate" strategy supports a system of investment for the future, while the "downsize and distribute" strategy yields only living off the past.

Japanese corporations committed themselves to a promise of "lifetime employment" for most male employees shortly after World War II, when Japan was experiencing labor unrest and popular dissatisfaction with the family-dominated corporate arrangements that had existed until then. The commitment forces Japanese corporations to respond to downturns by reallocating labor to other uses rather than laying off workers. In response to recent pressures of international competition, firms may offer employees early retirement incentives, relocate them to subsidiaries (where they may receive lower pay), or even keep them on company payrolls with little or no productive work to do.

The institution of cross-shareholding--the holding by corporations of one another's stock--was started by Japanese corporate managers in the early postwar period in an effort to protect firms from takeovers and the influence of outsiders, such as shareholders. This practice has grown over the years to include 65 percent of corporate stock. It gives corporate management the largest voice at shareholder meetings, freeing corporations from pressure by activist shareholders to downsize and distribute. Lazonick asserts that the complex web of cross-shareholding protects the lifetime employment policy and the goals of the firm to employ its labor productively and to sustain prosperity for its employees, in contrast to the American goal of maximizing shareholder returns. The Japanese media have reported investor fears that the stock market crash and the recent recession would lead to a disintegration of cross-shareholding, but, according to Lazonick, there are no real signs that this is happening.

According to Lazonick, the Japanese stock market crash occurred not because of weakness in the Japanese industrial base, but because the speculative bubble of the late 1980s finally burst. The crash was preceded by an enormous increase in stock prices and land values, which was caused by massive buying pressure from banks, who had more money to invest in financial assets as corporations turned increasingly toward internal financing. Japanese corporations remained strong through the crash, having raised money by issuing new stock during the bubble period and not panicking and unloading their cross-held shares in the bear market. Lazonick believes that foreign direct investment could provide the needed outlet for bank funds in the near future.

Japan has the most rapidly aging population in the world because it has the world's longest life expectancy and one of the lowest birth rates. The government has attempted to deal with the problems associated with an aging population by increasing the retirement age. A legal requirement to retain older workers conflicts with firms' efforts to ease the cost of downsizing by offering early retirement incentives, but it has benefits as well. Older workers tend to be highly skilled corporate assets and raising the retirement age gives employers incentives to invest and reinvest in worker training. The skill of the Japanese labor force is becoming increasingly important as manual labor--in Japan as in America--is increasingly being outsourced to nations with lower wages, such as Thailand and China.

Lazonick concludes that although there has been pressure on the retain and reallocate strategy, lifetime employment and cross-shareholding are likely to hold it firmly in place for the foreseeable future. Corporate Japan is responding to changing conditions, not by reneging on its commitment to lifetime employment, but by moving toward greater flexibility within the lifetime employment context.

*Editor's note:* The following three working papers are all part of the Levy Institute's ongoing study of the effects of immigration on the U.S. labor market.

[Back to Contents](#)

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## **Education's Hispanic Challenge**

Georges Vernez

Working Paper No. 228, March 1998

According to Georges Vernez, of the RAND Corporation, the increase in the size of the Hispanic population in the United States poses a challenge for the education system. While the economy increasingly demands a more educated workforce, Hispanics, who are the most educationally disadvantaged ethnic group, are growing six times more rapidly than the general population. The Hispanic portion of the U.S. population grew from 4 percent to 10 percent between 1970 and 1992, and by 2005 Hispanics are projected to surpass African Americans as the largest minority group in the United States. In absolute numbers the Hispanic population grew from 10 million to 27 million between 1970 and 1996. More than half of the nation's Hispanics live in California and Texas, another 20 percent live in New York and Florida, and within those states most live in a few metropolitan areas. This population concentration means that only a few school districts bear almost the entire cost of educating the nation's Hispanic children.

Two family characteristics are consistently associated with educational attainment: the level of education of parents and the material resources available to support the education of the children. Hispanic parents have a lower level of education than any other group and Hispanic income is lower than any other group except African Americans. Hispanic children are underrepresented in preschool. On average, by age 13 Hispanic children are two years behind non-Hispanic white students in English and four years behind in science. Hispanic high school students are less likely to be enrolled in college preparatory courses. The cumulative effect is that Hispanics, especially those of Mexican ancestry, are less likely to attend and complete college than any other ethnic group. Only 7 percent of Mexicans aged 25 to 37 have completed college.

The reduced likelihood that native-born Hispanics will complete college does not point to a rapid assimilation into the U.S. economic mainstream. Vernez admits, "We still do not know quite when, where, and how to intervene on a systemwide scale to effectively change past patterns of relatively low educational achievements." The solution is difficult because the cause of the disparity is a combination of school, parent, cultural, and structural factors, including inadequate school financing, school segregation, low socioeconomic status of parents, and low educational level of parents. According to Vernez, "The upgrading of the educational attainment of Hispanic children will require intervening beyond the classroom and probably will require experimenting with more involvement of parents and communities. . . . Effort will have to be sustained over the long term. As of today, recognition that the problem even exists is a hurdle that has not yet been overcome."

[Back to Contents](#)

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## ***E Pluribus Unum:* Bilingualism and Language Loss in the Second Generation**

Alejandro Portes and Lingxin Hao

Working Paper No. 229, March 1998

Opponents of immigration have raised an alarm about the supposed "linguistic fragmentation" caused by immigration. According to Alejandro Portes, of Princeton University, and Lingxin Hao, of The Johns Hopkins University, however, the danger is not that English will lose its position as the dominant language, but that the children of immigrants will lose their bilingual abilities. The authors find that the descendants of immigrants to the United States tend to switch rapidly to English only, and nearly all knowledge of the parental tongue disappears by the third generation. Portes and Hao contend that bilingual fluency promotes cognitive



development and is an asset in the job market.

Portes and Hao studied the determinants of bilingual ability in the second generation by surveying 5,266 eighth- and ninth-grade children in the Miami and San Diego areas. The children surveyed were both native-born children of immigrants and foreign-born children who had lived in the United States for at least five years. Children were studied at schools in the inner city and in the suburbs and at schools with both high and low concentrations of immigrants. The authors found that knowledge of English is near universal across all nationalities in the sample, with less than 7 percent reporting inability to speak and read English well. Among children who can speak English and the parental language, the preference for English is dominant in all groups except Mexican-Americans, and in that group 45 percent prefer English. Only 16 percent of the sample report themselves fluent in their parents' language.

Portes and Hao used a series of multivariate regressions to test the effects of individual, family, ethnic, and contextual factors on parental language retention, English monolingualism, and fluent bilingualism. They find that female students are more likely to be bilingual. The length of U.S. residency has a strong effect on the acquisition of English, an equally strong effect on the loss of the ability to speak the parental language, and no effect on achieving fluent bilingualism. Mexican-Americans are most likely to retain their parents' language as primary, Cubans and other Latins are most likely to become bilingual, and Asians are most likely to shift to English monolingualism. Family factors most associated with achieving fluent bilingualism are high socioeconomic status, intact families, and use of the native language at home. Among school factors, a high concentration of children of Latin origin tends to increase retention of Spanish, while a high concentration of Asians tends to decrease retention of parental language. Portes and Hao suggest that this may happen because Latin children all share the same parental language and this encourages its use, while different groups of Asian children do not have a language in common and therefore the use of parental languages is discouraged.

Portes and Hao conclude that it is a mistake for U.S. schools to promote English monolingualism. Nativist fears of linguistic fragmentation are unfounded; rather, our English-speaking society could benefit if sizable groups retain fluency in a second language.

[Back to Contents](#)

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## **The Romance of Assimilation: Studying the Demographic Outcomes of Ethnic Intermarriage in American History**

Joel Perlmann

Working Paper No. 230, March 1998

Little research has been done on the role of intermarriage in the blending of peoples in the American past, and even less has been done on the effect of past intermarriage on the ethnic identity of today's Americans. Senior Scholar Joel Perlmann sees value in studying intermarriage to show fault lines in society (social distance is larger across some divisions than others) and to examine the effect intermarriage ultimately has on assimilation. Perlmann asks, Is it assimilation that causes intermarriage or intermarriage that causes assimilation? As he sees it, the causality works in both directions: weakened ethnic allegiances are a source of intermarriage and intermarriage weakens ethnic allegiances.

According to Perlmann, one can study ethnicity by asking people with which ethnic group they identify, as the Census Bureau does, or by attempting to find precise information about the origins of people's ancestors, as a genealogist does. There are disadvantages to both methods. The self-reporting of ethnic ancestry tends to vary significantly and gives no information about the timing of intermingling, and genealogical information is difficult to obtain.

Perlmann uses census data obtained from the Public Use Microdata Samples produced by the University of Minnesota to extend our knowledge from the genealogical perspective in order to examine ethnic intermingling. Perlmann defines the ethnicity of second-generation Americans in two different ways, which he calls "simplified" and "maximally inclusive." Taking Italian-Americans as an example, the "simplified," or most

restrictive, definition of a second-generation Italian-American is an individual born in the United States to parents both of whom were born in Italy. The "maximally inclusive" definition is an individual born in the United States to parents one or both of whom were born in Italy.

The choice of definition does not make a large difference in identifying the second generation. Based on his examination of the 1940 census, Perlmann says that 84 percent of those who qualify as a second-generation Italian-American under the maximally inclusive definition also qualify under the simplified definition. However, in the third generation the picture is much different. Under a maximally inclusive definition a third-generation Italian-American is a U.S.-born individual with at least one U.S.-born parent and at least one Italian-born grandparent. Under the simplified definition a third-generation Italian-American is a U.S.-born individual with two U.S.-born parents and four Italian-born grandparents. Using a sample of 12- to 16-year-old Italian-Americans in the 1960 census, Perlmann found that only 24.3 percent of those who qualify as a third-generation Italian-American by the maximally inclusive definition also qualify by the simplified definition. Therefore, the effort at conceptual simplification, which works well in the second generation, collapses by the third generation.

Perlmann cautions, however, that reading the 24.3 percent figure as a measure of ethnic intermingling would be a mistake. If many of the native-born grandparents are themselves of Italian descent from immigrants who arrived earlier, the portion of third-generation Italian-Americans who are of purely Italian ancestry regardless of generational standing may be higher. Perlmann estimates the proportion of sample members who had only Italian origins by assuming that 75 percent of cross-generational marriages<sup>1</sup> were to Italian spouses and that children of the second generation followed the intermarriage patterns of the children of immigrants. Using this method he estimates that the percentage of sample members with only Italian ethnic origins is 42.3 percent; to put it another way, nearly three out of five grandchildren of Italian immigrants aged 12 to 16 in 1960 were the products of ethnic intermingling.

It is common knowledge that there has been considerable ethnic mixing in American history, but Perlmann shows the rapidity with which this has occurred. The intermingling is so rapid because even relatively low levels of intermarriage in the first and second generations lead to remarkably high proportions of third-generation members who are of mixed origin. While a marriage of two group members to each other produces one marriage, the marriage of two group members to two people outside of the group produces two marriages. If only 10 percent of first-generation marriages are out-group, 18 percent of second-generation children will be of mixed ancestry. Then, if 20 percent of the second generation marries outside the group, nearly 50 percent of the third-generation children will be of mixed ancestry. Only modest rates of intermarriage can create a heavily mixed population in only a few generations.

According to Perlmann, the analysis of ethnic mixing in U.S. history allows us to draw conclusions about racial mixing in the United States in the future. Because Census Bureau predictions of the future makeup of the United States ignore the modest rates of intermarriage, its estimates that in a few generations the United States will be  $x$  percent white and  $y$  percent nonwhite are inaccurate. There is every reason to believe that in a few generations a great many Americans will have both nonwhite and white ancestors, just as many third-generation Italian-Americans have both Italian and non-Italian grandparents.

## Note

1. Cross-generational marriages are marriages between people whose ancestors arrived in the United States at different times in the past. For example, a marriage between an Italian immigrant and a native-born American with two native-born parents and four Italian-born grandparents would be a cross-generational marriage between first- and third-generation Italian-Americans.

[Back to Contents](#)

## Seminars

### The Emergence of a National Labor Market in the United States



Robert A. Margo

Robert A. Margo, a visiting professor of economics at Harvard University and a professor of economics at Vanderbilt University, led a seminar at the Levy Institute on April 9 on his cliometric research into early U.S. labor markets. According to Margo, cliometrics (the application of econometrics to the study of history) is essential to understanding the emergence of current economic conditions.

The United States had national markets for many goods, as evidenced by the equalization of prices, well before the Civil War, but it did not have a national labor market, as evidenced by wage variation, until after the Second World War. One of the mysteries in economic history is why wages in the South were 20 percent below wages in the North until the Second World War despite the fact that there were no legal barriers to mobility of goods, labor, or capital.

Margo has been involved in an ongoing research project to remedy the lack of data on pre-Civil War wages. He has uncovered military payroll reports for civilians hired to work on various military installations throughout the country for the years 1821 to 1860. His study of wages paid to common laborers, artisans, and white-collar workers in different regions has yielded interesting results. Returns to education were already evident before the Civil War, but this fact was not generally recognized by policymakers until the turn of the century. Wage rates were higher in the Midwest in the 1820s and 1830s but fell in line with wages in the Northeast quickly in the 1840s, reflecting a high demand for labor during the early period of midwestern settlement and a quick integration of the labor markets thereafter. But, the South was left out. Why remains a mystery. One reason suggested is that immigration provided needed labor for the North, shutting out migration from the South. Another reason may be the lack of education and infrastructure investment in the South. Yet another may be the lack of industry in the South, which might have resulted from the concentration of southern investment in agriculture.

[Back to Contents](#)

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## **Fashion, Immigration, and the Economics of Ready-to-Wear**

Nancy L. Green

Nancy L. Green, of L'École des Hautes Études en Sciences Sociales in Paris, has been studying the experience of immigrant workers in the garment industry in New York and Paris. In her April 17 seminar at the Levy Institute, she said that much has been written about costume, but less about fashion and even less about production in the fashion industry. A number of features make the industry unique and interesting. People want clothes that show their individuality, but they don't want to look so different that they don't fit in. Manufacturers must both mass produce and differentiate their products while not making the differences too shocking. Also, whether fashion works its way up from individuals or down through the manipulation of a conspiracy of capitalists, it dictates products and independent manufacturers have to keep up with it.

According to Green, clothing types range from the most to the least standardized. The most standardized are men's work clothes. The least standardized are women's fashionable clothes with women's house clothes and more masculine styles, such as business attire, being somewhat more standardized.

Ready-to-wear clothing began to replace custom-tailored and homemade clothing in the early nineteenth century following the introduction of standardized military uniforms. Mass measurement of soldiers showed manufacturers that they could produce a limited number of standard sizes that would fit almost everyone. The department store, the sewing machine, and the popularization of the business suit all contributed to the growth of ready-to-wear clothing in the nineteenth century.

The enormous amount of variability in the fashion industry had both pluses and minuses for immigrants. Seasonal production and the absence of the need for heavy machinery allowed for the development of contracting, subcontracting, and piecework home production. The farming out of production and low start-up costs gave immigrant entrepreneurs a way to launch small businesses, but also created risks for entrepreneurs

and workers alike. The "ethnic entrepreneurs" did tend to hire from their own ethnic groups, but there is still debate over whether they were friend or parasite to the workers they employed. By the end of the nineteenth century sweatshops had become commonplace in the fashion industry.

According to Green, the fashion industry division of labor by gender has typically been a female workforce with male entrepreneurs. The ethnic makeup of the industry labor force has changed greatly over the years with successive waves of immigrants. The Italians and Jews, who were predominant before the First World War, were replaced by blacks and Puerto Ricans in the interwar years and by Central Americans and Asians in the postwar period. But, contemporary accounts of immigrant workers are surprisingly similar to accounts at the turn of the century.

[Back to Contents](#)

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## **Help or Hindrance: The Economic Implications of Immigration for African Americans**

Frank D. Bean

Many researchers have examined the effects of immigration on society as a whole, but the Population Research Center at the University of Texas at Austin is among the first to focus on its effects on African Americans. In a seminar at the Levy Institute on April 30, Frank D. Bean, who is director of the center, stated that, taking into account all of the economic costs and benefits of immigration, estimates show that it produces a net gain of \$10 billion per year for the U.S. economy. That is about \$40 per person. However, that figure is an average, and in reality some gain and some lose. According to Bean, the winners tend to be people who own capital and have a high level of education; the losers tend to be people without capital and with little education. He estimates the loss among this group to be \$100 per person.

A possible cause for the loss among African Americans is that immigrants compete with them for blue-collar and entry-level jobs and for minority scholarships. African Americans may also be hindered by a skewing of certain kinds of social and economic statistics that is caused by an influx of immigrants. For example, the decline in housing segregation that has been recorded in recent decades may reflect the moving of immigrants into African American neighborhoods and not the moving of nonwhites into white neighborhoods. Bean suggests that losses may be reduced if socioeconomic mobility can be improved in the United States and says that something is needed to accomplish the goals that had been expected of affirmative action, especially now that even commitment to affirmative action has been reduced.

[Back to Contents](#)

## **Scholars**

Research Associates **William J. Baumol** and **Edward N. Wolff** are conducting a research project entitled "Protracted Frictional Unemployment as a Heavy Cost of Technical Progress." They argue that there is more substance to the public's fears that new production techniques can threaten jobs than is acknowledged by either neoclassical or Keynesian economists. They note that neoclassical economists, who believe that the market tends automatically to bring the economy back to full employment or at least to a natural rate of unemployment, seem inclined to believe that this process wipes out any joblessness created by technological change with a modest delay. The Keynesian economists, who believe that the level of employment can be adjusted by macroeconomic policy, are inclined to believe that policy is capable of eliminating the joblessness engendered by labor-saving innovation.

Baumol and Wolff suggest that the rapid pace of technological change can have two profound employment effects. First, it can materially increase frictional unemployment. Second, it can affect some classes of workers more than others because of the sunk-cost attributes of retraining workers to enable them to use the constantly emerging novel techniques. The least-educated workers; older, former jobholders; and women, particularly of childbearing age, are likely to be the groups most affected by the pace of change, suffering declining relative

wages or protracted and possibly lifetime unemployment. Weighing the evidence of the human cost of protracted unemployment, Baumol and Wolff note that it is simply not true that unemployment of one person for five years is somehow equivalent to unemployment of ten persons for six months each. In their research they are exploring the costs of joblessness beyond the loss of income, considering divorce, mental illness, suicide, violence in the home, and other social costs. The research will conclude with an appropriate public policy response. Baumol, who received a Ph.D. from the University of London, is director of the C. V. Starr Center for Applied Economics at New York University and senior research economist and professor emeritus at Princeton University. Wolff, who received a Ph.D. from Yale University, is a professor of economics at New York University.

Research Associate **Barry Bluestone** is the Frank L. Boyden Professor of Political Economy at the University of Massachusetts Boston, a senior fellow at the university's John W. McCormack Institute of Public Affairs, and the founding director of its Ph.D. program in public policy. He has also taught economics at Boston College and was director of the Social Welfare Research Institute. On partial leave from the university in 1995, Bluestone was a member of the senior policy staff of Congressman Richard Gephardt and continues to serve as a policy adviser to the Democratic leadership in both the House and the Senate. He contributes regularly to academic and popular journals; among his books are, with Benjamin Harrison, *The Deindustrialization of America* (1982) and its sequel, *The Great U-Turn: Corporate Restructuring and the Polarizing of America* (1988). Bluestone received a Ph.D. from the University of Michigan. He is the author, with Teresa Ghilarducci, of Public Policy Brief No. 28, *Making Work Pay*, and, with Stephen Rose, of Public Policy Brief No. 39, *The Unmeasured Labor Force*.

Visiting Scholar **Mathew Forstater** is engaged in projects on employment and federal budget policy. He is using a historical, interdisciplinary approach to examine the potential role of full employment policies in the face of deficit reduction and continual technological change. Forstater is an assistant professor of economics at Gettysburg College. He received a Ph.D. in economics from the New School University.

Senior Scholar **James K. Galbraith** is a professor at the Lyndon B. Johnson School of Public Affairs and the Department of Government at the University of Texas at Austin. His research for the Levy Institute concerns determinants of global inequality. Galbraith has served in several positions on the staff of the U.S. Congress, including executive director of the Joint Economic Committee, and has been a guest scholar at the Brookings Institution. His writings include *Created Unequal: The Rise of Wage Inequality in America* (Free Press, 1998), *Balancing Acts: Technology, Finance and the American Future* (Basic Books, 1989), and *Macroeconomics*, with William Darity Jr. (Houghton-Mifflin, 1992). Galbraith received a B.A. from Harvard University and a Ph.D. from Yale University and studied economics as a Marshall scholar at King's College, Cambridge University. He is the author of Public Policy Brief No. 36, *Dangerous Metaphor: The Fiction of the Labor Market*.

Research Associates **Robert Haveman** and **Barbara Wolfe** are conducting research that addresses the relationships between economic activity, underemployment, and human capital in the United States from 1973 to 1990. They endeavor to (1) document the growth of human capital in the U.S. economy since the early 1970s, (2) estimate inequality in the distribution of human capital within the working-age population and document any changes in inequality, (3) explore patterns of utilization of human capital within the working-age population (that is, changes in the overall utilization rate of human capital during the past 20 years) and the contribution of shifting patterns of human capital utilization among age, gender, and ethnic groups to changes in the overall capacity utilization rate, (4) identify factors that have determined measured changes in the growth, distribution, and utilization of human capital, and (5) explore the duration and determinants of underutilization over time.

If the objective of policy is to increase the utilization of human capital and, therefore, economic activity so that every race, gender, education, and age group in the working-age population is working close to its capacity, then it is important to understand the aggregate level of underutilization and its distribution within the working-age population. Does the greatest potential lie in reducing economic inactivity among younger or older workers, among males or females, or among less-educated or more-educated workers? The answers to these questions will indicate whether policies targeted at youths (such as Job Corps and youth employment policies), older workers (changes in Social Security and disability benefits), or young women (changes in

welfare policy) are likely to be more effective in increasing economic activity. Haveman is the John Bascom Professor of Economics and Public Affairs at the University of Wisconsin, Madison; he received a Ph.D. from Vanderbilt University. Wolfe is a professor of economics, preventive medicine, and public affairs at the University of Wisconsin, Madison; she received a Ph.D. from the University of Pennsylvania.

Research Associate **David R. Howell** focuses on the implications of changes in industry characteristics, especially the adoption of information technologies, for employment, skill requirements, and earnings. Specifically, he is examining the effects of recent employment restructuring on young workers by race and gender. His results thus far imply a strong link between changes in the rates of labor market discouragement and changes in job opportunities, job quality, and educational requirements. Howell is an associate professor of economics at the Robert J. Milano Graduate School of Management and Urban Policy of the New School University. He received a Ph.D. in economics from the New School. He is the author of Public Policy Brief No. 29, *Institutional Failure and the American Worker*.

Research Associate **William H. Lazonick** is conducting research in the areas of global competition, corporate governance, employment, and the distribution of income. Much of the research focuses on the skill-base hypothesis, which posits that human resource investment can take one of two forms: a broad and deep skill base, in which skilled work is conducted by many people at many different levels of the organizational hierarchy, or a narrow and concentrated skill base, in which skilled work is conducted by a small and elite portion of an organization's workforce. Lazonick is exploring how a difference in skill bases has affected industrial competition between the United States and Japan and whether such skill-based competition has affected U.S. employment. He is also examining statistics on U.S. income distribution from the perspective of the skill-base hypothesis to find (1) the degree of international competition in specific industries and (2) the governance of strategy and learning in a successful U.S. enterprise group. Lazonick is university professor and co-director of the Center for Industrial Competitiveness at the University of Massachusetts Lowell and a visiting scholar at the Euro-Asia Centre of INSEAD (European Institute of Business Administration). He received a Ph.D. in economics from Harvard University. He is the author, with Mary O'Sullivan, of Public Policy Brief No. 37, *Investment in Innovation* .

Research currently conducted by Resident Scholar **Oren M. Levin-Waldman** focuses on restructuring the welfare and unemployment insurance systems to achieve greater efficiency, equity, and effectiveness in the delivery of services and on developing a methodology for analyzing public policy that relies on the application of political philosophy as well as cost-benefit analysis. Recently, he has been examining the effects of a change in the minimum wage, worker displacement due to plant closures, welfare reform and the potential for workforce development, and political realignment in the electorate. Levin-Waldman received a Ph.D. in political science from Temple University. He is the author of Public Policy Brief No. 21, *The Consolidated Assistance Program*; No. 26, *Making Unemployment Insurance Work*; and No. 31, *A New Path from Welfare to Work*. He is also author of *Reconceiving Liberalism: Dilemmas of Contemporary Liberal Public Policy* (University of Pittsburgh Press).

Research Associate **Mary O'Sullivan** is an assistant professor of strategy at INSEAD, a research associate at the Center for Industrial Competitiveness at the University of Massachusetts Lowell, and a faculty associate at Harvard University's Center for European Studies. In work with STEP Group in Oslo, she has engaged in research on European corporate governance for the TSER Innovation Systems and European Integration project. She concentrates on industrial development, particularly in relation to corporate governance, innovation, skill formation, and finance and is currently studying the relation between corporate governance and economic performance in the United States and Germany. O'Sullivan received a bachelor of commerce from University College Dublin, an M.B.A. from Harvard Business School, and a Ph.D. in business economics in a joint Harvard Business School and Harvard Economics Department program. She is the author, with William Lazonick, of Public Policy Brief No. 37, *Investment in Innovation*.

Executive Director **Dimitri B. Papadimitriou**, along with Senior Scholar L. Randall Wray, is currently conducting research to assess the effect of demographic shifts--specifically, the aging of the population--on the labor market in light of the current slow growth in labor force participation rates and based on different ranges of productivity growth. Papadimitriou and Wray will then evaluate the need to revise public policies concerning the retirement age, the Social Security program, and macroeconomic employment policies. They also will

continue their work in the program on restructuring in the financial services sector on the appropriateness of using existing price indexes as targets for monetary policy and will apply their findings to OECD countries. In addition to his duties as executive director, Papadimitriou is executive vice president of Bard College and Jerome Levy Professor of Economics at Bard. He received a Ph.D. in economics from the New School University. He is the author of several Public Policy Briefs: with Hyman P. Minsky, Ronnie J. Phillips, and L. Randall Wray, No. 3, *Community Development Banking*; with Phillips and Wray, No. 6, *A Path to Community Development*, and No. 12, *An Alternative in Small Business Finance*; with Wray, No. 15, *Monetary Policy Uncovered*, and No. 27, *Targeting Inflation*.

Senior Scholar **Joel Perlmann** is guiding a research initiative entitled "Ethnicity and Economy in America--Past and Present." The initiative focuses on the processes by which immigrants and their descendants are assimilated into U.S. economic life. It is hoped that this work will shed light on current policy issues related to immigration, such as international competitiveness, the labor market, income distribution, and poverty.

Perlmann is engaged in three research projects to further this initiative. The first, "The Jews Circa 1900: Social Structure in Europe and America," focuses on social characteristics that help explain the rapid socioeconomic rise of eastern European Jewish immigrants who entered the American economy at the turn of the century. Perlmann is using census data that were previously unavailable or not machine readable to examine social and economic characteristics of eastern European Jewish populations who emigrated to the United States and those who remained in Europe.

Perlmann's second project, "Assimilation and the Third Generation," explores the assimilation of immigrants into the socioeconomic mainstream of the United States and the social and economic experiences of their native-born children. Special attention is paid to a few large groups whose absorption seemed especially slow and painful during the first and second generations: Irish immigrants who arrived in the mid nineteenth century, Italians and Poles who immigrated between 1880 and 1920, Mexicans who arrived throughout much of this century, and southern-born blacks who migrated to the North. Perlmann uses census data in new ways in order to identify and trace second- and third-generation Americans.

Perlmann's third project, "The New Immigration's Second Generation," conducted with UCLA professor of sociology Roger Waldinger, reviews literature that deals with the economic progress and difficulties faced by children of immigrants today and compares their experiences with those of children of turn-of-the-century immigrants.

Perlmann, who also holds the post of Levy Institute Research Professor of History at Bard College, received a Ph.D. in history and sociology from Harvard University. He is the author of Public Policy Brief No. 35, *Reflecting the Changing Face of America*.

Senior Scholar **L. Randall Wray** is currently working on several projects in the areas of aging, employment, and monetary policy. He is studying policies to promote full employment, focusing on Hyman Minsky's "employer of last resort" proposal, and the endogenous money approach to macroeconomics. Wray and Executive Director Dimitri B. Papadimitriou are conducting research to assess the effect of demographic shifts--specifically, the aging of the population--on the labor market in light of the current slow growth in labor force participation rates and based on different ranges of productivity growth. Papadimitriou and Wray will then evaluate the need to revise public policies concerning the retirement age, the Social Security program, and macroeconomic employment policies. They also will continue their work in the program on restructuring in the financial services sector on the appropriateness of using existing price indexes as targets for monetary policy and will apply their findings to OECD countries. Wray has been an associate professor at the University of Denver and a Fulbright Research Scholar at the University of Bologna. He received a Ph.D. from Washington University in St. Louis. He is the author of several Public Policy Briefs: with Hyman P. Minsky, Dimitri B. Papadimitriou, and Ronnie J. Phillips, No. 3, *Community Development Banking*; with Papadimitriou and Phillips, No. 6, *A Path to Community Development*, and No. 12, *An Alternative in Small Business Finance*; with Papadimitriou, No. 15, *Monetary Policy Uncovered*, and No. 27, *Targeting Inflation*.

[Back to Contents](#)

# Program: Restructuring in the Financial Services Sector

## Summaries of New Working Papers

### **The Development and Reform of the Modern International Financial System**

L. Randall Wray

Working Paper No. 225, January, 1998

Senior Scholar L. Randall Wray advocates reform of the international financial system in response to what he sees as an international financial crisis. He presents an updated version of Keynes's bancor proposal based on a Post Keynesian view of money.

According to Wray, the orthodox view of money presented in every money and banking textbook is historically incorrect and logically flawed. According to orthodox theory, money developed to facilitate barter and it is still primarily a medium of exchange that serves to ease the underlying barter exchange that is the real economy. If there is too much money in circulation relative to commodities it will lose its value. Thus, the primary role of the central bank is to control inflation by controlling the money supply.

The orthodox view of international money is also based on the barter paradigm with no role in the real economy ascribed to money. Under a fixed exchange rate, or unified monetary system (UMS), orthodox theory predicts that domestic price adjustment will quickly rectify trade imbalances. Under a flexible exchange rate, or nonunified monetary system (NUMS), orthodox theory predicts that exchange rates will take care of the adjustment so that domestic prices and employment will not be affected. The resulting uncertainty about exchange rates is largely ignored, and orthodox economics recommends that controlling domestic inflation should be the primary goal of policymakers.

Wray contrasts the orthodox view with the Post Keynesian view in which the primary function of money is not as a medium of exchange but as a unit of account. According to this view, money did not develop to facilitate barter but was created to keep account of debts. Money is simply a liability. Wray uses Babylonia as an example of an early monetary system in which credit was initially denominated in wheat. Thus, wheat became the first money, not by state decree and not as a substitute for barter, but by the act of a lender extending credit to a borrower. Markets did not create money; money created markets as a place where agents could obtain the means of retiring debt.

According to Wray, the money supply is not limited by gold reserves, foreign currency reserves, or the amount of commodities produced domestically. There is no limit to the amount of credit one person can extend to another, and so there is no limit to the amount of money that can be created. The function of gold reserves is simply to ensure that the issuer of credit money will not default. The need for governments to hold gold reserves has been relieved by the creation of central banks, which have become the apex of a pyramid of liabilities. Central banks extend credit to private banks, which extend credit to firms and individuals. Only central banks have the power to create demand for their own liabilities. They issue liabilities in the form of paper money and impose taxes that must be paid in terms of the government's money. Thus, the government can retire its own debt at will, eliminating the risk of government default and eliminating the rationale for holding gold reserves. This position gives central banks the power to increase the stability of the capitalist system by acting as the lender of last resort. To do so, governments must be prepared to increase the availability of credit when reserves are low. Therefore, any effort to maintain gold reserves is counterproductive.

Wray presents this exposition as evidence that the policy of controlling the money supply by controlling the quantity of bank reserves is logically flawed. The supply of reserves does not determine the quantity of money supplied; instead, the money supply depends on the quantity of private IOUs issued, which depends on the economic condition of their issuers. Similarly, he asserts that a stable economy cannot be maintained if private



banks are allowed to issue money. This would make it impossible for the central bank to act as a lender of last resort and necessarily lead to runs on banks.

Wray contends that floating exchange rates behave in the international economy much as money issued by private banks would behave in the domestic economy. Speculative runs into and out of a currency can easily swamp flows of a currency arising from its medium of exchange function. Thus, the introduction of a flexible exchange rate regime led to increased government involvement as coordinated intervention became necessary to stem appreciation or depreciation of a currency.

Wray proposes a unified monetary system with an international lender of last resort to set a floor to the value of each national unit of account relative to the international unit of account. Adjustments to maintain capital flows and current account balances could be made by a different discount rate for each nation, by inflation or deflation, or by occasional movements of exchange rates. Exchange rate movements, however, must be kept to a minimum to keep speculation from recurring. Keynes made a similar proposal in which an international unit of account (the *bancor*) would be used to settle international accounts. To maintain "market discipline," nations that ran persistent trade surpluses or deficits would be penalized. Wray's proposal differs from Keynes's in that it is designed to eliminate expected currency appreciation, thereby decreasing the returns to liquidity and raising the relative returns to capital investment, which in turn would stimulate world demand.

Wray concludes that a fixed exchange rate UMS with an international lender of last resort will have many benefits. It will eliminate currency speculation and thereby eliminate expected currency appreciation or depreciation in determining asset prices and encourage the use of forward contracts. It will remove the need for nations and individuals to hold gold or foreign currency reserves for speculative or precautionary purposes. It will establish a method of dealing with trade imbalances that does not rely on austerity. It will remove the need for international coordination to influence exchange rates. It will eliminate the tendency toward stagnation in world economies and thus allow central banks to focus on output stability rather than price stability.

[Back to Contents](#)

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## **The Hierarchy of Money**

Stephanie Bell

Working Paper No. 231, April 1998

Economists have debated money issues for centuries: What is its origin? What is its function? What gives it value? Cambridge University Visiting Scholar Stephanie Bell examines two theories of money to see which conforms to Hyman Minsky's treatment of money as a balance sheet phenomenon. According to Minsky, money expresses a social relation; it represents a debt relation or a promise to pay that exists between people and cannot be identified independently of its institutional usages. Money is created when one party is willing to go into debt and another is willing to hold the debt. The debt is held as an asset by the creditor and a liability by the debtor. It is because money, then, is both an asset and a liability that Minsky suggests treating it as a balance sheet operation.

According to Bell, a debate that began in the sixteenth century between the "Metallists" and the "Anti-Metallists," or "Chartalists," has been revived again and again by economists of various schools of thought. Metallists (and their modern descendants, the Monetarists) present the following history of the development of money. Although it may come to serve other functions, money originated as a medium of exchange, arising spontaneously in the private sector to eliminate the inefficiencies of barter. Society settled on precious metal as a medium so that money would have some "intrinsic value" and the medium gradually developed from "unworked" precious metals to metallic currency to paper money because of convenience. The state played a supporting role in this process by vouching for the quality and quantity of the precious metals in coins or as backing for non-pure coins or paper money. Metallists contend that paper money can retain its value when its convertibility is suspended if people expect convertibility to be restored. The fact that metallic backing has been permanently discarded but paper money still circulates is difficult for Metallists to explain. Walras attempted to explain it by suggesting that money could be reduced to a pure number, a *numeraire*, or

a symbol for real goods in the economy. From this idea derives the modern Monetarist approach that analyzes exchange as if it occurred in a simple barter economy where money serves only as a medium of exchange.

According to Bell, however, this treatment of money is not consistent with historical events. There is little evidence that barter economies ever existed. In some areas early coins were denominated in values too large to have allowed them to function as a medium of exchange, and the use of coins in exchange appears to have been an accidental consequence of their development, not the reason for it.

Anti-Metallists, or Chartalists, view money primarily as a unit of account and as a means of payment. The state, not the market, is at the center of the creation of money. The state has the power to demand that certain payments be made to it and to determine the medium in which these payments must be made. As Adam Smith put it, "a prince, who should enact that a certain proportion of his taxes should be paid in a paper money of a certain kind, might thereby give a certain value to this paper money" (*An Inquiry into the Nature and Causes of the Wealth of Nations*, 1776). Friedrich Knapp's development of this theme (in *The State Theory of Money*, 1924) states the Chartalist approach to money in its general form. It is not the metallic content of money that gives it value; what makes a currency valid as money is a proclamation by the state that it will be accepted at its pay offices.<sup>1</sup> Money originates with the state and is independent of the need for a medium of exchange.

According to Bell, Keynes and Minsky used a similar approach to money. Minsky's balance sheet approach is consistent with Chartalist theory. To Minsky all money is a balance sheet creation: currency is an asset to the individual and a liability to the state itself. The use of precious metals for exchange does not involve a balance sheet operation and so is not monetary exchange in the sense Minsky used the term. Keynes distinguishes between the description or title of money and the thing that answers the description. In the United States the title of money is the dollar, but different things--demand deposits, commercial paper, and every stamp, airplane ticket, prepaid phone card, and subway token--answer that description, and the different things have different levels of acceptability.

Any promise to pay or IOU is money; anyone can create money, but not everyone can get his or her money accepted. What makes a form of money acceptable as means of payment is the proclamation that it is convertible into the promise of someone higher in a hierarchy or pyramid of debt. Whatever is accepted by the state in payment of taxes is the decisive money at the top of the pyramid. Only the state can determine what will be acceptable as money because only the state can force the acceptance of its liabilities. Demand deposits occupy the second tier of the pyramid because the government guarantees that they will be accepted at par with hard currency. The promises of firms and households occupy the third and fourth tiers because there is at least some chance that they will not trade at par with government money. They may require interest payments to compensate for the risk associated with holding less liquid assets.

In sum, "Not all money is created equal." Although government, banks, firms, and households can create money denominated in the same unit of account, these monies are not equally acceptable. Only the state, by its power to enforce tax laws, can issue promises that will circulate widely as a means of payment and medium of exchange.

## Note

1. The word "chartal" is derived from the Latin *charta*, with the meaning of "ticket" or "token." A token, coin, warrant, or ticket becomes a means of payment independent of its material with its use proclaimed by legal ordinance requiring that taxes be paid in that medium.

## [Back to Contents](#)

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## **The Asian Disease: Plausible Diagnoses, Possible Remedies**

Martin Mayer

Working Paper No. 232, April 1998

Martin Mayer, author and guest scholar at the Brookings Institution, sees the Asian crisis as a textbook case of Hyman Minsky's "financial instability hypothesis." Over periods of prosperity, confident expectation of a steady stream of profits produces a willingness to take risks that would have been considered unacceptable at another time. Conservative hedge financing gradually develops into speculative ventures until large segments of the economy are greatly extended on credit. Any disturbance then can turn these financial positions into insolvency. This view was not widely accepted by financial economists, who tend to blame trouble on exogenous shocks or government failure, because they could not find historical illustrations since the Great Depression to fit the theory. But, the rapid decline of the "Asian miracle" into the "Asian disease" is a clear example of economic euphoria and rude awakening.

According to Mayer, profits were weak before the crisis, but investment was spurred by the belief that profits would inevitably follow because Asian growth was three or four times faster than European or North American. Banks, looking for new credit instruments to maximize commissions, created derivatives, which mix interest-rate, credit, and foreign exchange risks into an amorphous "total return" that converted what otherwise would have been seen as suspect investments into high-rated instruments. Derivatives are designed to pass on the responsibility of risk assessment to the lender and to make the risk more difficult to assess. The mathematical models used to create derivatives use only financial data, without reference to the real economy, in the belief that sufficient diversification decreases the need for knowledge about any particular market. In Mayer's view such risk-shifting instruments ultimately shift risks onto those less able to bear them.

As Mayer sees it, one cause of the crisis was the commitment of Asian nations to violate "the law of one price." The Thai government attempted to maintain stable exchange rates while the interest rate in Thailand was significantly higher than the interest rates in the developed nations. This caused an inflow of capital to Thailand, but it exerted a downward pressure in the futures market for the Thai baht as investors attempted to hedge their currency position. Thai borrowers extended themselves on dollar-denominated credit, which they expected to pay off with a baht-denominated income stream. This could work as long as the Thai government was able to support the baht, but in a world with so much capital mobility, the Thai government was unable to defend its currency peg when it came under major pressure.

Now that the initial crisis has occurred, the problem of distributing the losses begins. Mayer believes that loss distribution becomes a political matter and the burden tends to fall on those who lack the political ability to escape. Typically, governments socialize the liabilities and privatize the assets; that is, governments assume responsibility for paying off a failed bank's creditors and resell bank assets at distressed prices. This, Mayer warns, is a necessary step because the wisdom of the market is "the government sells at the bottom." Governments cannot simply wait for prices to improve before they sell because prices will continue to deteriorate until the governments sell. Once the first overvalued assets of a failed bank are auctioned off at depressed prices, the market can begin to reestablish a price.

Mayer speaks of two main risks in the banking system: the lack of transparency caused by instruments such as derivatives and the moral hazard in cross-border banking created by central banks. Because banks know that the central bank will take care of their liabilities, they engage in risky behavior. This can be sustained until the market loses faith that the central bank knows what it is doing. Mayer concludes that banks are inappropriate vehicles for development lending. The short-term credit they offer is inappropriate for the long-term needs of developing nations. He hopes that technology will help by easing capital flow and making banks more like brokers than investors, which will mean they will no longer be too central to the system to fail and so will be less likely to lead to this kind of crisis again.

[Back to Contents](#)

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## **East Asia Is Not Mexico: The Difference between Balance of Payments Crises and Debt Deflations**

Jan A. Kregel

Working Paper No. 235, May 1998

Visiting Senior Scholar Jan A. Kregel argues that the Asian financial crisis is not a typical balance of payments crisis like the peso crisis of 1994. The Mexican crisis spread throughout Latin America but produced no real threat to the developed nations. The Asian crisis sparked a crash of world financial markets and creates a clear risk of deflation and perhaps a global depression similar to that of the 1930s. What is it that makes the Asian crisis unique, and how is it possible that one of the most successful development areas suffered a virtual collapse in less than one year?

According to Kregel, in Mexico the rapid liberalization of domestic markets caused imports to grow at an unsustainable rate. Foreign borrowing and capital inflow allowed domestic banks to lend to finance household consumption; the result was an increasing payments deficit, more nonperforming loans, falling private savings, low domestic investment, slow growth, and rising unemployment.

In Asia countries had a trade surplus or close to it, and there was little increase in imports of consumption goods. The crisis was set off by a decline in growth of exports to developed countries, a global development over which domestic policymakers had little or no control. But, even so, the external account deficit should not have been large enough to cause a crisis. The real source of the problem lay in events years earlier when excessive capital inflows caused by high domestic interest rates and stable exchange rates allowed for increased liquidity in the banking sector. With nowhere else to go, capital flowed increasingly into real estate at inflated values. Much of the foreign debt was dollar denominated, which meant that a domestic government could act as lender of last resort only by using its foreign currency reserves. Using its reserves left the government with inadequate foreign exchange reserves to support the domestic currency. Kregel attributes this outcome to a failure of free capital markets to allocate capital optimally and a failure of free-market banking systems to channel capital inflows to productive use. Some economists have attributed the crisis not to market failure but to Asian governments' maintenance of pegged exchange rates for too long. Kregel responds, however, that this implies that businesses are incapable of identifying the risks of exchange rate misalignments.

The crisis began in Thailand and quickly spread through southeast Asia and then to northeast Asia as investors revised their expectations about exchange-rate-adjusted returns throughout the region. The first phase of the crisis came to a close in November 1997, by which time most countries in the region had allowed their currencies to float; Thailand, Indonesia, and Korea accepted IMF conditional loans, and a number of other countries introduced policies similar to the IMF conditions. In one year, or rather in only a few months, the region had to reimburse lending equal to the accumulated reserves of the previous seven years.

Kregel compares reimbursement on such a scale to a massive bank run. No bank can repay all its deposits at once and no nation can repay all its short-term borrowing at once. The result was a collapse of the currency and a substantial disruption of the real economy. Kregel contends that the problem was not domestic policy, but the sudden reversal of the excessive capital inflows and a fall in global demand. The crisis was not one of excessive consumption but of excessive savings. Domestic investment was increasingly substituted for export sales as global demand slowed down.

Kregel sees the treatment the IMF prescribed as worse than the disease. The IMF mistook the crisis for a traditional excessive-consumption balance of payments crisis and applied the same measures it used in the peso crisis, including tight monetary and fiscal policy to keep interest rates up and increase demand for the currency. However, the tight policy meant that Asian firms trying to replace financing lost in the capital flight had to pay higher interest rates, and firms looking for a substitute for falling global demand found little domestic demand. This pushed domestic firms into insolvency. What followed was a Minskian debt deflation: Firms are forced to sell assets to avoid bankruptcy, but the attempt to sell assets by all firms drives down the price of assets, increasing the likelihood of bankruptcy. In such a case there is no interest rate high enough to stop the sale of domestic investments and domestic currency. The higher interest rates only make bankruptcy more likely.

The IMF did eventually relax its conditions, but, according to Kregel, by then the Asian economies had deteriorated to the point that it is unlikely there will be positive growth in the region in 1998 or perhaps 1999. He would have recommended low interest rates along with the rescheduling of foreign loans to stop the rush to sell assets and buy foreign currency. Policies like these are beginning to be implemented in Korea, but much of

its productive capacity is closed as a result of bankruptcy. Eventually, domestic prices will fall enough to justify reopening the bankrupt firms, but when the reopened firms try to use their new price advantage on the international market, they could attract allegations of dumping from the industrialized world and possibly increased pressure for trade protection. If so, Kregel claims, the possibility of a repeat of the crisis of the 1930s is not out of the question.

[Back to Contents](#)

## Workshop

### Workshop on Monetary Theory and Policy

The Levy Institute hosted a workshop on monetary theory and policy on February 25. The morning session was entitled "Monetary Theory and History of Thought." Levy Institute Senior Scholar L. Randall Wray discussed the history of the Chartalist approach to money--the view that money gets its value not from metallic backing or from the quantity theory but from the fact that taxes must be paid in currency. Ed Nell, of the New School University discussed the implications of monetary circulation, most importantly, that it is the money prices established in the state budget that are crucial in establishing and maintaining the value of currency. Riccardo Bellofiore, of the University of Bergamo, examined the history of the circuit theory of money in Wicksell, Schumpeter, and the early works of Keynes.

In the afternoon session, "Monetary Policy and Applications," Alain Parguez, of the University of Besancon and ISMEA, discussed the ramifications of the circuit theory of money, particularly how it implies a role for the government as employer of last resort. Bernard Vallageas, of Université Paris-Sud, discussed the application of a matrix model to input-output analysis of profits. Levy Institute Visiting Senior Scholar Jan A. Kregel, of the University of Bologna and The Johns Hopkins University, discussed the Asian crisis as an example of Hyman Minsky's financial instability hypothesis.

[Back to Contents](#)

## Seminar

### Money and National Sovereignty in the Global Economy

John Smithin

Policymakers in small and medium-sized countries are becoming concerned that globalization and international economic integration threaten a small government's ability to control many kinds of domestic policy, including environmental standards, labor legislation, monetary policy, fiscal policy, and social protection. On March 3 at the Levy Institute John Smithin, of York University in Toronto, discussed his assessment of the constraints that economic and financial integration places on the independent conduct of domestic public policy.

Smithin finds that it is important to distinguish among the different elements of the integration process--trade liberalization, technology transfer, and financial integration. He believes that financial integration is by far the most important of these and that the ability to maintain an independent monetary policy is a prerequisite for conducting independent policy in all other areas. Financial integration occurs most obviously through international trade agreements such as the European Monetary Union, but it also occurs through increased global capital mobility caused by a combination of technical change and deregulation. One concern is that when capital mobility is great, the capital account drives the current account, meaning that the real economy of exports and imports adjusts itself to financial imperatives rather than the reverse.

[Back to Contents](#)

## Eighth Annual Hyman P. Minsky Conference on Financial Structure

## **The Fragility of the International Financial System: Options for Policy**

The conference was held on April 23 and 24. The remarks of the featured speakers and the five sessions are summarized below.

### **Alice M. Rivlin**

Alice M. Rivlin, vice chair of the Board of Governors of the Federal Reserve System, stated that the goal of the Federal Reserve Board is to create "a better class of financial crisis," that is, although no one can prevent a financial crisis, an appropriate response can make it less costly. Toward this end she offered three prescriptions. The first is increased transparency to provide more information to investors, lenders, market supervisors, and government authorities. The second is sustained oversight, including clear rules for supervision and an independent, well-managed central bank capable of monitoring capital markets. The third, and more controversial, prescription is that private creditors must help pay the costs of crises. Finding mechanisms for burden sharing that do not make the problem worse is difficult. Suspension of debts and workouts could inhibit capital flows if they are too common. But the mechanisms must be found because the cost of resolving crises is outrunning resources for that purpose and the bailout of creditors with official resources creates moral hazard.

Once a crisis hits, the role of the supervisory agency is to isolate, stabilize, and prevent the contagion from spreading. Burden sharing is important because the world trading system has become an international community with multinational firms, banks, and supervisory agencies such as the IMF. This cross-border trade can benefit everyone, but it also creates risks that will affect everyone.

### **Martin Mayer**

According to Mayer, author and guest scholar at the Brookings Institution, almost all governments believe that they cannot allow their banking system to fail. Central banks intervene to save the banking system because they have to support the monetary system and they have allowed the banking system to control the monetary system because it is linked to the lending system. The idea of "too big to fail," however, creates moral hazard because bankers know that central banks will bail them out if their loans go bad. But, in a crisis central banks panic, too, attempting to save unsound as well as sound banks and seizing solvent banks along with insolvent banks. According to Mayer, "What really makes a crisis is the realization in the market that central banks don't know what they are doing."

The origin of the Asian crisis was the attempt by southeast Asian countries, especially Thailand, to maintain a fixed exchange rate while their interest rates were higher than anywhere else. This attracted foreign capital, but put downward pressure on the forward currency market as lenders attempt to hedge their exposure to the baht. The crisis began when enough pressure built up so that the Thai government could no longer support the baht. Once a crisis begins, "the big guys get out before the haircut," shifting the risks onto those least able to bear them. What is needed is an international agency to step in, suspend payments, provide currency for day-to-day transactions, and figure out how to solve the problem from there.

### **Session 1. International Banking Crises: Causes and Solutions**

James Barth, Lowder Eminent Scholar in Finance at Auburn University, spoke about the need for bank supervision. Out of about 180 countries in the world, 130 have had serious banking problems since 1980. Banks' roles vary from country to country, but Barth found no correlation between what banks are allowed to do and how often they have crises. Glenn Yago, director of capital studies at the Milken Institute, stated that the difficulty of turning over short-term financial debt was a leading indicator of the Asian, Latin-American, and U.S. Savings and Loan crises. Lawrence R. Uhlick, executive director and general counsel of the Institute of International Bankers, reminded the audience that good bank supervision must be in place before a crisis begins. However, good supervision cannot prevent a crisis and if economic policies lead to deteriorating banking conditions, bankers will pull back, whether or not there is good supervision.

### **Session 2. The IMF, the World Bank, and the Global Lender of Last Resort Function, Part I**



Karin Lissakers, executive director for the United States at the International Monetary Fund, said that the role of the IMF is to keep its members from responding to a crisis in a way that would be dangerous to themselves and other members. They have to contain the crisis, stabilize their currency, and restore growth. The IMF has been criticized both for forcing too much austerity onto countries in crisis and for not forcing enough austerity. However, according to Lissakers, had it not acted as it did in the Asian crisis, there would have been a deeper currency depreciation, moratoriums, and trade restrictions, and what would have followed would have been similar to the crisis that led to the Great Depression. Now, with IMF conditions, currencies are stabilized and recovery can begin. Lissakers admitted that the IMF creates moral hazard for member nations, but claimed that the costs of crises are lower with the IMF than they would be without it.

According to Yukio Yoshimura, executive director for Japan at the International Monetary Fund, the cause of the crisis was a macroeconomic imbalance in Thailand, a bubble economy with a booming asset market, and a capital accounts deficit. This made managing the exchange rate difficult, leading to panic and an extreme reaction in the markets. He asserted that future crises can be avoided by tight fiscal and monetary policy responses to currency depreciations, strong financial supervision in coordination with international organizations, and a greater capital account control. Long-term capital investment is essential because short-term capital investment can be destabilizing, and an explicit global lender of last resort is needed.

### **Session 3. The Asian Crisis, Its Impact on the U.S. Economy, and the Role of the IMF**

Levy Institute Distinguished Scholar Wynne Godley warned that IMF forecasts that the Asian crisis will remain self-contained are too optimistic. As a result of the crisis, the U.S. current account deficit could rise by as much as 1 percent of GDP. Another factor is that the main force behind the expansion begun in 1991 is the continuing rise in private sector spending relative to private sector income. In other words, borrowing has been at unprecedented levels, and this cannot go on for long. Godley projects that growth could fall to 1 percent within the next 18 months and perhaps go negative.

Albert Fishlow, Paul A. Volcker Senior Fellow for International Economics at the Council on Foreign Relations, was more optimistic than Godley in his belief that South Korea and most of East Asia will recover quickly and only Indonesia will face a persistent crisis because of its political problems. He admitted that the United States will absorb some of the cost in the form of an increase in the trade deficit of perhaps 1 percent of GDP, but he sees no long-run difficulty for the U.S. economy.

James K. Glassman, holder of the DeWitt Wallace–Reader's Digest Chair in Communications in a Free Society at the American Enterprise Institute, criticized the IMF for lending money to cover bad loans and for creating moral hazard. He said there is too little oversight of the IMF and it has stretched its mandate far beyond its original function. The IMF should limit itself to being a lender of last resort at penalty rates and with simplified conditionality.

### **Session 4. The IMF, the World Bank, and the Global Lender of Last Resort Function, Part II**

Martin J. Gruenberg, senior Democratic counsel of the Senate Committee on Banking, Housing, and Urban Affairs, asked that his comments be off the record. Stijn Claessens, principal economist in the Economic Management Department of the World Bank, listed lessons to be learned from the Asian crisis. First, nations must pay attention to both macroeconomic and microeconomic issues, because microeconomic weaknesses can occur even under strong macroeconomic policies. Second, the financial system needs more transparency. Many governments and investors were unable to take proper action as the crisis developed because they did not have enough information to make decisions. Third, governments and international agencies responding to the crisis must consider the impact of the crisis on ordinary citizens. Fourth, there is great risk in relying on short-term capital flows to finance loans.

Robert Z. Lawrence, Albert L. Williams Professor of International Trade and Investment at the John F. Kennedy School of Government at Harvard University, said that nations should now consider what role they want the IMF to play and how much power they want it to have. Some researchers and policymakers argue the IMF should be the lender of last resort, but the IMF does not have the unlimited funds this function demands, it lacks the information to determine which loans are sound and therefore should be paid off, and it is highly

unlikely that independent nation-states would be willing to give it the authority the role requires.

Charles D. Toy, vice president and general counsel of the Overseas Private Investment Corporation, said OPIC can help Asian nations through their current crisis. OPIC mobilizes private capital growth projects in developing nations and insures investors against losses due to political circumstances. This guarantee can help restore investors' confidence and encourage them to return to Asia.

### **Session 5. Minskian Financial Instability in Asia.**

Levy Institute Senior Scholar L. Randall Wray discussed Hyman Minsky's financial instability hypothesis and anti-laissez-faire theorem. The hypothesis states that stability leads to instability as income streams generate expectations of future profits, which lead market participants to take credit positions that are risky but appear sound in light of the recent income streams. The anti-laissez-faire theorem states that in an inherently unstable economy, government intervention is necessary to reduce the severity and likelihood of crises.

Levy Institute Visiting Senior Scholar Jan A. Kregel, of the University of Bologna and The Johns Hopkins University, related the work of Hyman Minsky to the Asian crisis. Minsky had asked, "Can 'it' happen again?" meaning can a debt deflation similar to the one that caused the Great Depression happen again. According to Kregel, "it" did happen in 1997 in Asia. Just as Minsky's financial instability hypothesis predicts, under expectations of continuing high growth, Asian banks borrowed in dollars and lent in domestic currency, building up positions that were increasingly risky until the bubble burst. Once the crisis began, the banks' assets were nonperforming loans and banks looked bad to foreign investors. All of this can occur without moral hazard--the often cited cause of risky financial activity. Firms and investors wanted to sell to cover their loans, but this only depressed prices and made bankruptcy more likely. Kregel cautioned that the crisis is not over because Asian countries simply cannot make enough by exporting to pay off their debts.

Attorney and economic consultant Walker Todd warned that the "small" cost of the Asian crisis to the United States of "only" 1 percent of GDP is an enormous cost that will be felt severely. He asserted that public IMF funds are being used to bail out private profiteers, not to rebuild the devastated economies or to help the people in the nations in which the crisis occurred. He advocated denying funds to the IMF until its mission is reformed.

### [Back to Contents](#)

## **Scholars**

Cambridge University Visiting Scholar **Stephanie Bell** is applying Hyman P. Minsky's accounting procedures to an analysis of reserve accounting at the Federal Reserve. She is studying the relationship between government deficit spending and bank reserves and the implications of this relationship for monetary and fiscal policy. Bell received a B.A. in economics and a B.S. in business finance from California State University at Sacramento and an M.Phil. from Cambridge University.

Visiting Senior Scholar **Jan A. Kregel** is studying financial markets and institutions from a Keynesian perspective. He is currently working on the operating procedures to be adopted by the European central bank in coordination with the national central banks after the creation of economic and monetary union in Europe and the relation of the procedures to employment policy. Kregel is a professor of economics at the University of Bologna and an adjunct professor of international economics at The Johns Hopkins University Paul H. Nitze School of Advanced International Studies. He is a senior adviser for the Trade and Development Report of the United Nations Conference on Trade and Development (UNCTAD). Among his major published works are a series of books in the field of post Keynesian economic theory. Kregel received his training in economics at Rutgers University and Cambridge University.

Research Associate **Willem Thorbecke** is investigating the effects of monetary policy on various sectors and segments of the economy. Employing impulse response functions and social accounting matrices, Thorbecke is tracing the effects of monetary policy on different socioeconomic groups during specific time periods (such as the 1979–1982 Volcker deflation and the 1994 preemptive strike against inflation). By examining whether

cyclical downturns disproportionately affect different types of workers employed by firms of various sizes, Thorbecke will shed light on how monetary policy affects financial markets and the economy and on how the burden of contractionary policy is distributed among members of society. Thorbecke is an associate professor of economics at George Mason University. He received a Ph.D. in economics from the University of California at Berkeley. He is the author of Public Policy Brief No. 38, *Who Pays for Disinflation?*

[Back to Contents](#)

## Program: Federal Budget Policy

### Summary of New Working Paper

#### **Public Capital and Economic Growth: Issues of Quantity, Finance, and Efficiency**

David Alan Aschauer

Working Paper No. 233, April 1998

There is a large body of theoretical and empirical research examining the importance of the quantity of public capital for economic growth. For the most part, empirical research suggests that there is a positive role for public capital, there is a negative role for taxation and debt, and the effectiveness of public capital depends critically on its efficiency.

Research Associate David Alan Aschauer, Elmer W. Campbell Professor of Economics at Bates College, develops a common framework to investigate the importance of three aspects of public capital: "how much you have," "how you pay for it," and "how you use it." His approach is an elaboration of the neoclassical growth model with a Cobb-Douglas production function and constant returns to scale across all inputs and, therefore, diminishing returns to scale for any one input, including capital. The data set covers 46 low- and middle-income countries over the period 1970 to 1990, with data for real gross domestic product per capita adjusted for purchasing power parity, average ratio of gross private investment to output, average ratio of gross public investment to output, and percentage of working-age population in secondary school (as a proxy for human capital).

In examining quantity, or "how much you have," Aschauer finds that empirical results appear to be consistent with the predictions of the neoclassical growth model because the steady-state private physical capital stock is highly positively correlated with output growth. Including a measure of human capital along with physical capital in the production function improves the explanatory power of the model. Aschauer finds that a 1 standard deviation increase in physical capital and in human capital boost growth by 0.25 and 0.51 standard deviation (or 0.5 and 1 percent per year), respectively. Aschauer calculates the ratio of the marginal product of private physical capital to the marginal product of public physical capital to be 1.36, which is evidence that a reallocation of physical capital from public to private use would have a positive effect on growth.

To examine finance, or "how you pay for it," Aschauer estimates various specifications of the growth model with government debt as a variable, finding that in each such specification public debt is negatively associated with growth. He estimates the growth sensitivity of public capital to be 0.34 and of public debt to be -0.69 and finds that the growth-maximizing level of public capital equals 49 percent of output. The actual average level of public capital in the sample countries, however, was 132 percent of output. If that public capital is financed by debt, which has a negative effect on growth, the average country in the sample appears to have accumulated an excessive amount of public capital.

Aschauer then turns to estimating the effect of the efficiency of public capital, or "how you use it." He uses a normalized index of efficiency indicators including mainline faults per 100 telephone calls, electricity generation losses as a percentage of total power output, percentage of paved roads in good condition, and diesel locomotive availability as a percentage of total rolling stock for transportation. He finds that a 1 standard deviation increase in efficiency induces a 0.49 standard deviation increase in growth.

Aschauer concludes that it is important to take all three aspects of public capital into account to assess its effect

on growth. For example, because public debt and public capital are positively correlated but have opposite effects on growth, leaving either one out of the equation will bias the results. Aschauer finds that a 1 percentage point increase in either the quantity or the efficiency of public capital is estimated to increase growth by 0.29 percentage point per year, but a 1 percentage point increase in debt is estimated to decrease growth by 0.57 point per year. Thus, an increase in public capital financed by external debt will have a neutral or a negative effect on economic growth.

[Back to Contents](#)

## Scholars

Research Associate **David A. Aschauer** is pursuing research interests in two areas of fiscal policy. The first line of research builds on his long-term investigation of the effect of federal expenditures (especially infrastructure investment) on economic growth and development. Aschauer is developing a new methodology for research in this area to provide further empirical evidence linking public capital and the performance of the national, state, and local economies. In his second line of research Aschauer is examining the desirability of a productivity budget for the federal government. He examines reasons for the use of public sector debt rather than current taxation for the financing of public expenditures that raise long-term productivity growth. Aschauer is Elmer W. Campbell Professor of Economics at Bates College. He received a Ph.D. from the University of Rochester. He is the author of "Public Capital and Economic Growth" in Public Policy Brief No. 4, *Public Infrastructure Investment: A Bridge to Productivity Growth?*

Policy Advisor **Edward V. Regan** is actively engaged in issues of corporate finance, pension fund and institutional investment, and financing public infrastructure. Regan, who served for 14 years as comptroller of New York State, is now chairman of the Municipal Assistance Corporation (MAC) for New York City, a member of the Financial Accounting Foundation, a contributing editor with *Directorship*, and a member of the Levy Institute Board of Advisors. He is the author of Public Policy Brief No. 16, *Infrastructure Investment for Tomorrow*.

[Back to Contents](#)

## Program: International Trade and Competitiveness

### Scholars

Two accounting-based models form the foundation of much of Distinguished Scholar **Wynne Godley's** research. The first model tracks the evolution of the U.S. economy using a consistent system of stocks and flows (such as income, production, and wealth). This system of information makes it possible (1) to identify significant trends and magnitudes, suggest policy responses to problems, and gauge economic outcomes and (2) to assess the economic implications of different policy regimes. Godley's findings from this model are to be published as an annual Levy Institute publication. The second model is a "closed" world model in which 11 trading blocs--of which the United States, China, Japan, and Europe are 4--are represented. This model is based on a matrix in which each bloc's imports are described in terms of exports from the other 10 blocs. From this information and using alternative assumptions (for example, about growth rates, trade shares, and energy demands and supplies), past trends can be identified and the patterns of trade and production analyzed to reveal any structural imbalances.

With Resident Scholar **George W. McCarthy Jr.** and Gennaro Zezza, of the Institute Economic, Financial University Degli, Godley is writing an economics textbook, tentatively titled *Stock-Flow Economics*. The book is based, on a number of models, including a theoretical model as well as the U.S., U.K., and world models. Godley was a member of HM Treasury's Panel of Independent Forecasters, the so-called Six Wise Men. He is a professor emeritus of applied economics at Cambridge University and a fellow of King's College. He is the author of Public Policy Brief No. 23, *A Critical Imbalance in U.S. Trade*.

[Back to Contents](#)

# Special Projects

## Summary of New Working Paper

### **An Important Inconsistency at the Heart of the Standard Macroeconomic Model**

Wynne Godley and Anwar Shaikh  
Working Paper No. 236, May 1998

The standard neoclassical macroeconomic model, in its basic version, is Walrasian in the sense that, for a solution to be obtained, prices have to be found that simultaneously clear the markets for labor, output, money, and bonds. This structure is implied wherever it is stated (as in countless textbooks) that the bond market may be "dropped" from consideration because, by "Walras's law," if three of the markets clear, the fourth must clear as well. Distinguished Scholar Wynne Godley and Anwar Shaikh, of the New School University, probe the internal logic of the standard macroeconomic model and find a serious inconsistency.

The problem resides in the apparently innocuous assumption, invariably made in neoclassical texts, that all the income of firms is instantaneously distributed to households. Because there is no other instrument available in the model, profits can be distributed only in the form of interest payments on bonds issued by firms. However, since interest rates are determined in the money market, interest payments will generally differ from aggregate profits, which are determined by the stock of capital and its marginal productivity.

Godley and Shaikh show how a change in this faulty assumption can improve the model's logical consistency; that change is to write real household income as the sum of real wage and interest income so that the value of new bonds issued by firms differs from the value of the investment expenditures they plan to make. While this correction seems minor, its consequences are not. Although the full employment core of the model is preserved under this modification, the dichotomy between real and nominal variables is broken. The authors demonstrate that "an increase in the money supply" need not produce an equivalent rise in prices; indeed, under plausible parameters, it can actually cause a fall.

According to Godley and Shaikh, this problem is largely ignored in the literature, partly, perhaps, because so few neoclassical writers on macroeconomics explicitly incorporate a "Walras's law" equation, describing the consistency of agents' plans, into their models. The problem is noted in several passages in Don Patinkin's seminal text, but is buried in footnotes. Patinkin attempts to maintain a forced equality between aggregate household income and aggregate household value added by making a series of ad hoc behavioral assumptions without commenting on the contradictions to which these give rise.

[Back to Contents](#)

## Seminar

### **From Hammarapi to Leviticus: Who Shall Collect the Land's Rent--the Palace or the Creditors?**

Michael Hudson

On March 6 at the Levy Institute Michael Hudson, of New York University, spoke on his extensive research into the role of debt and debt forgiveness in ancient civilizations. Biblical prophets and ancient historians bitterly decried usury (which they defined as any interest on debt), but modern historians have neglected the role of interest-bearing debt when discussing the collapse of ancient civilizations. Debts preceded money, not the other way around, as is often supposed by modern economists.

Interest-bearing debt began in Mesopotamia in the third millennium B.C.E. Debts accrued as a result of fees owed for sharecropping rents, public services, and mercantile advances by temples or the palace. Ancient



interest rates were set arbitrarily and remained fixed for many years rather than fluctuating with supply and demand. Recognizing that debt-burdened economies tended to veer further and further out of balance, Mesopotamian rulers periodically canceled agrarian debts and reversed land forfeitures. They were able to do this because most of the debts were ultimately owed to the palace itself.

The custom of debt cancellation was adopted by the Israelites during their captivity in Babylonia, became codified in Leviticus, and was eventually adopted by early Christians. According to Hudson, debt cancellation was an accepted measure to prevent economic polarization. It was generally recognized that the burden of debt and interest led to the foreclosure of land rights and to debt bondage, which would polarize the society. The existence of dispossessed citizens would make the kingdom vulnerable to foreign invasion. Eventually, however, those who could acquire wealth and power through forfeiture were able to change the structure of debt to make it irreversible.

[Back to Contents](#)

## Scholars

Senior Fellow **Walter M. Cadette**'s areas of special interest include health care, international trade, and regulation of financial institutions. In addition to his work at the Levy Institute, he is chairman of the Holy Cross Health System's investment review committee. Cadette is a retired vice president and senior economist of J.P. Morgan & Co. Incorporated and was editor of and contributor to its publications *Global Data Watch* and *World Financial Markets* . He received an M.A. from Georgetown University and did further graduate work in economics and finance at New York University. He is author of Public Policy Brief No. 30, *Prescription for Health Care Policy* ; No. 34, *Safeguarding Social Security*; and, with S Jay Levy, Public Policy Brief No. 40, *Overcoming America's Infrastructure Deficit*.

Research being conducted by Research Associates **Kris Feder** and **Michael Hudson** assesses the extent to which capital gains accrue as economic rent and, based on this estimate, the distribution of benefits of a capital gains tax cut to the real estate industry. In one study, Feder and Hudson calculate a value for economic rent in order to assess the effect of rent on consumer budgets. National Income and Product Accounts (NIPA) statistics show that rental housing has remained a steady 4 percent of national income since World War II, while the imputed rent for owner-occupied housing has risen from 4 to 8 percent. Bureau of Labor Statistics data show that during the same period rental costs have risen from 21 to 25 percent of disposable personal income. Feder and Hudson's initial findings suggest that the real estate gains of landlords and bankers during this period have been made at the expense of consumers and state and local governments. Their preliminary analysis from a second study, on the neglected role of real estate in the capital gains debate, reveals that 60 percent of capital gains accrues as real estate gains. Therefore, a reduction in the capital gains tax rate would benefit primarily the real estate industry, rewarding land speculation more than new direct investment.

Feder is an assistant professor of economics at Bard College. She received a Ph.D. in economics from Temple University. Hudson is a visiting scholar at New York University. He received a Ph.D. in economics from New York University. Feder and Hudson are co-authors of Public Policy Brief No. 32, *What's Missing from the Capital Gains Debate?* and, with G. J. Miller, *A Philosophy for a Fair Society* (Shepherd-Walwyn).

[Back to Contents](#)

## Institute News

### New Publication: Policy Notes

The Levy Institute announces a new series--Policy Notes. Designed to supplement and complement our more scholastic working papers and our longer Public Policy Briefs, the Policy Notes series will in effect be an ongoing journal, allowing us to issue articles as they are written and in response to events as they arise. The



notes will expand our ability to present up-to-date research findings and timely policy statements by Levy Institute research scholars and other contributors on a wide range of topics. The notes will appear in print and online (on our web site, [www.levy.org](http://www.levy.org)).

In the first note Research Associate Thomas Karier, of Eastern Washington University, addresses the question, Are the effects of college-level education on income and financial independence positive enough to make it worthwhile for states to extend support to qualified welfare recipients to enable them to pursue such education?

[Back to Contents](#)

## New Scholars

The Levy Institute extends a warm welcome to four scholars. **Steven M. Fazzari** is now a senior scholar. His current research project, provocatively titled "A Penny Saved May Not Be a Penny Earned," examines the paradox of thrift and the conventional loanable funds theory of investment to study the means by which wealth is accumulated and the effect of this accumulation on personal and aggregate saving. Fazzari then explores public policies that would best stimulate capital accumulation, especially in light of current demographic trends that will reduce the proportion of the available workforce in the total population.

**James K. Galbraith**, of the Lyndon B. Johnson School of Public Affairs and the Department of Government at the University of Texas at Austin, is a senior scholar. He will be examining issues pertaining to employment and inequality, especially determinants of global inequality.

**Philip Arestis**, of the University of East London, and **Malcolm Sawyer**, of the University of Leeds Business School, are visiting senior scholars. They will concentrate on aspects of the European Union related to monetary union, such as the historical and institutional framework of the EMU, the shaping of new institutions such as a European central bank, deflationary consequences of the EMU, and the type of institutional framework necessary to generate higher levels of employment.

[Back to Contents](#)

## Presentations and Publications by Levy Institute Scholars

### Executive Director Dimitri B. Papadimitriou

*Presentations:* "Zero Unemployment with Price Stability," Simon's Rock College, March; keynote address, "The Real Effects of the Asian Crisis," Athenian Policy Forum, York University, Toronto, May 28.

### Distinguished Scholar Wynne Godley

*Publication :* "Why the World Could Still Catch Asian Flu," *The Observer* , April 26.

### Senior Scholar Joel Perlmann

*Publication:* with Roger Waldinger, "Second Generations: Past, Present, and Future," *Journal of Ethnic and Migration Studies* 24, no. 1.

*Presentation:* "Intermarriage and Multiraciality," Sociology Department, University of California at Los Angeles, May 28.

### Senior Scholar L. Randall Wray

*Publication:* "Zero Unemployment and Stable Prices," *Journal of Economic Issues* 32, no. 2 (June 1998); *Money and the Modern Era: Price Stability Through Full Employment* (Elgar, forthcoming).

*Presentations:* Presidential address: "Is Keynesianism Institutionalist?" Association for Institutional Thought, Denver, April 16; "Money and Taxes: The Chartalist Approach," Transformational Growth and Full Employment Conference, New School University, April 20.

### **Visiting Scholar Mathew Forstater**

*Publication* : "Institutional Approaches to Full Employment, Continued," *Journal of Economic Issues*, December 1998.

*Presentations* : "Toward a New Instrumentalist Macroeconomics," Functional Finance and Full Employment Conference, New School University; "Functional Finance and Money as a Creature of the State," Post Keynesian Summer Workshop, University of Tennessee, June; "Reintroduction to Economics, Philosophy, Methodology, and Economics," University of New Hampshire, June.

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

*Publications* : "Plant Closings: Is WARN an Effective Response?" *Review of Social Economy* 56, no. 1 (Spring 1998).

### **Assistant Director / Washington Liaison Sanjay Mongia**

*Publication* : "Book Review, Peter Kwong's *Forbidden Workers: Illegal Chinese Immigrants and American Labor* ," *Immigration Review* , Spring 1998.

### **Cambridge University Visiting Scholar Stephanie Bell**

*Presentation* : discussant at Western Social Science Association Annual Conference, Denver, April; "Appropriate Monetary Policy for Full Employment," Post Keynesian Summer Workshop, University of Tennessee, June.

### **Research Associate Karl Widerquist**

*Presentations* : "An Efficiency Argument for the Guaranteed Income," Canadian Economic Association, Ottawa, Ontario, May 29; "A Voting Paradox and the Budget Deficit," Society for Social Choice and Welfare, Vancouver, British Columbia, July 2-6; "Reciprocity and the Guaranteed Income," Basic Income European Network, Amsterdam, September 10-12.

## **New on the Levy Institute Web Site**

The Levy Institute is starting to run its working papers on its web site ([www.levy.org](http://www.levy.org)). See the publications section of the site for abstracts of the papers and to read or download the papers. Look also for the *Summary* and other Levy Institute publications, including feature articles on current topics.

### **[Back to Contents](#)**

[Home](#) | [What's New](#) | [Publications](#) | [Research Programs](#)  
[Forecasting Center](#) | [About the Institute](#) | [Keyword Search](#) | [Using Our Site](#)