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Laurence H. Meyer, member of the Board of Governors of the Federal Reserve System, speaks to the press at the Levy Institute's Ninth Annual Hyman P. Minsky Conference on Financial Structure

- **Senior Scholar James K. Galbraith reminds economists that they have a responsibility to question prevailing views.**

- **Visiting Senior Scholar Malcolm Sawyer points out that the monetary system created under the European Union lacks the elements that Minsky said were necessary to maintain financial stability.**

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

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Editor: Lynndee Kemmet
Text Editor: Judith Kahn
Photography: Don Hamerman, Douglas Baz

Ninth Annual Hyman P. Minsky Conference on Financial Structure

Structure, Instability, and the World Economy: Reflections on the Economics of Hyman P. Minsky

The Levy Institute held its Ninth Annual Hyman P. Minsky Conference on Financial Structure on April 21--23 at Blithewood. The onset of the economic crises in Asia, Russia, and Latin America has led to new and renewed interest in the work of Hyman P. Minsky, especially his financial instability hypothesis. The hypothesis is perhaps his best-known work and stands out as immediately relevant to the crises. The objective of this examination of his work is to determine the extent to which current domestic and global economic events coincide with the types of instabilities he described and to analyze his policy recommendations to alleviate instability. Brief notes on the participants' remarks are given here. Transcripts of the major addresses and summaries of the sessions will be published in the conference proceedings.

Wynne Godley

Wynne Godley, distinguished scholar at the Levy Institute, stated that although the United States remains in a period of expansion, there are features of this expansion that he finds disturbing. In the face of budget surpluses and worsening trade performance, the expansion has been driven by consumer spending. However, the unprecedentedly large and growing gap between private expenditure and private income means that consumer spending has been financed by an unprecedentedly high and growing level of borrowing. Such a trend cannot continue, but without it a period of stagnation will set in.

Session 1. Minsky and the Good Society

This session was moderated by Visiting Scholar **Mathew Forstater** of the Levy Institute. Participants were **Murray Weidenbaum,** chairman of the Center for the Study of American Business, Washington University in St. Louis; **Charles J. Whalen,** senior economist at the Institute for Industry Studies at Cornell University and Fulbright professor of economics at Zhongshan University in the People's Republic of China; and **Edward J. Nell,** Malcolm B. Smith Professor of Economics at New School University.

Weidenbaum argued that too much government intervention in a capitalist economy—an overabundance of environmental, social, and labor regulations—can act as a barrier to private sector job growth while not even achieving the regulations' goals. He recommended that government remove some of these regulations. Whalen discussed the importance of Minsky's theory of capitalist development. Minsky noted that one must understand that there are different stages of capitalism in order to formulate effective economic policy. Minsky identified five stages in the U.S. economy—merchant, industrial, banker, managerial, and money-manager. Whalen noted that the United States may be on the verge of entering a sixth stage, which he termed global finance. Nell argued that while some economists see underemployment as a complex problem, it is actually quite simple—people cannot find jobs because businesses do not need more workers because consumers are not demanding more products and services. Nell said the idea of government acting as an employer of last resort could be a good market-driven solution with the government meeting the demand for jobs.

S Jay Levy

Baby boomers envisioning a retirement of leisure may find themselves counting pennies instead, warned Levy Institute chairman S Jay Levy. Because the working-age population will not keep pace with the swelling numbers of retirees, there will not be enough workers to produce the goods and services needed by baby boomers. As competition for workers leads to wage increases and inflation, the increasing costs of goods and services will eat up retirees' savings much faster than they had anticipated. Levy recommended that in order to avoid this scenario, it might be necessary to raise the retirement age and to loosen immigration restrictions to expand the working-age population.

Session 2. Monetary and Financial Policies

Session 2 was moderated by President **Dimitri B. Papadimitriou.** Participants were **James Tobin,** Sterling Professor of Economics Emeritus at Yale University; **C. A. E. Goodhart,** Norman Sosnow Professor of Banking and Finance at the London School of Economics; and **Jan Toporowski,** reader in economics at South Bank University.

Left to right: James Tobin, Sterling Professor of Economics Emeritus, Yale University; C.A.E. Goodhart, Norman Sosnow Professor of Banking and Finance, London School of Economics; Jan Toporowski, reader in economics, South Bank University

Tobin discussed several items in Minsky's "agenda for reform" of financial systems, including his suggestions that the government should act as an employer of last resort and that the Federal Reserve should take responsibility for all aspects of the financial system. Although Tobin agreed with Minsky on several points, he noted that some of his suggestions may not be practical. For example, if people are constantly revolving in and out of a government workforce, it may be difficult for the government to use that workforce for constructive work. Goodhart said that in his work as a member of the Bank of England's Monetary Policy Committee, he drew on Minsky's research into monetary theory in developing interest rate policy. Goodhart's research, which aims to help policymakers predict inflation, indicates that asset and stock prices are not good predictors of inflation but housing prices are. Toporowski argued that changes in the structure of capital markets mean that it has become harder for policymakers to use interest rates to regulate the markets. Financing methods used by business and government have made them less affected by interest rate changes, which now affect mostly the household sector.

Session 3. Interrelationships between Finance and Investment
Resident Scholar **Jamee K. Moudud** moderated session 3. Participants were **Robert Pollin,** professor of economics and co-director of the Political Economy Research Institute at the University of Massachusetts Amherst; Senior Scholar **Steven M. Fazzari,** professor of economics at Washington University in St. Louis; and **Perry Mehrling,** associate professor and chair of the Economics Department at Barnard College.

Pollin suggested the adoption of a securities transaction tax as a reform that would contribute to avoiding financial instability. Some researchers assert that such a tax would increase volatility, but Pollin argued that it would not only decrease volatility but also would raise government revenues. Fazzari presented recent empirical research that provides increased support for Minsky's work on the links between investment and finance and the central role finance plays in the performance of modern economies. That aspect of Minsky's work was long ignored by mainstream economists, but since the early 1980s economists have begun to see its importance. Mehrling presented his findings from an empirical analysis (based on Minsky's theories of financial instability) of corporate liquidity. He found that corporate liquidity is undergoing a change from external sources to internal sources and he suggested that research should be done on how this change may affect financial systems.

Session 4. Irrational Exuberance
This session was moderated by Senior Scholar **L. Randall Wray.** Participants were **Robert J. Barbera,** executive vice president and chief economist at Hoenig & Co.; **Frank A. J. Veneroso,** Veneroso Associates; and **Robert W. Parenteau,** director and economic strategist at Dresdner RCM Global Investors.

Barbera explained that the long period of economic expansion in the United States has led many people to believe that policy changes and improved business management have eliminated the dangers of boom-and-bust cycles. However, if one applies Minsky's theories to a global scale, it can be seen that those cycles are alive and well. Barbera argued that the Federal Reserve reacted properly in the fall of 1998 when it acted essentially as a global lender of last resort by easing monetary policy aggressively; he suggested that it should take on that role more permanently. Veneroso stated that the theory of adaptive expectation helps explain why economic agents (both firms and households) engage in behavior that leads to overinvestment and indebtedness. In a long period of expansion people forget about the busts, come to expect that high returns will continue, and finance investments with debt. Parenteau added that adaptive expectation also helps explain why some firms keep investing when interest rates are going up and some lenders keep making loans even as they see clients' debt mounting.

David A. Levy
David A. Levy, Levy Institute vice chairman and director of forecasting, said that the work of Hyman Minsky will continue to be relevant because Minsky recognized that the economy is not mechanical, as in most economic models, but is organic in that it changes and adapts. One of the important lessons to be derived from Minsky's work is that nothing is inevitable. Things can

happen that can move an economic or financial system toward crisis or that can avert crisis. The real significance of Minsky's work has sometimes been overlooked because people have focused only on pieces of it. When all of those pieces are put together, the sum is more profound than the parts. Levy believes, based on some of the lessons from Minsky, that the Asian crisis was only the starting point of a global crisis that is not yet over. There is evidence that the global financial system may experience further crises this year.

Session 5. International Institutional Restructuring
Assistant Director **Frances M. Spring** was moderator. Participants were **Thomas I. Palley,** assistant director of public policy at the AFL-CIO; **Andrew Cornford,** senior economic advisor on macroeconomic and development policies in the Division of Globalization and Development, United Nations Conference on Trade and Development; and **Lawrence R. Uhlick,** executive director and general counsel of the Institute of International Bankers.

Palley disagreed with the belief that financial crises can be averted by reforming the financial system to emphasize openness and transparency. Although more openness and transparency would be good, information has been available in the past and there is no reason to believe that people will act more rationally if they have more information. Palley suggested that the financial system be reformed in ways that seek to alter people's behavior, such as by making speculation expensive. Cornford doubted that improvements in regulation and supervision of financial institutions and systems alone will improve stability and prevent future crises. Some form of world financial authority might help bring stability, but creating such a system will be politically difficult. Uhlick said he doubts a world banking authority could provide stability even if one could be created. Regulations already in place can be effective in dealing with a crisis, but the difficulty is identifying a problem before it develops into a full-blown crisis. Rather than creating a world authority, it would be better to reform current regulatory systems by placing the authority to regulate banks in the country in which a bank's main branch is located and formulating a consistent global policy regarding regulatory authority.

Laurence H. Meyer
Laurence H. Meyer, member of the Board of Governors of the Federal Reserve System, said that in his effort to understand the causes of and possible solutions for the Asian crisis, he turned to Minsky's work. Important among the lessons he learned is that crises cannot be reformed away—they are part of capitalism. Vulnerabilities can be reduced but not eliminated. Stability itself is destabilizing because periods of stability and boom cause people to take greater risks. Capitalism is unstable in both domestic and global forms. Meyer asserted that the Asian crisis resulted from both the internal weakness of countries involved and the global system. A difficulty for developing nations is that often they enter the global capitalist system before they have developed the structures necessary to deal with the instabilities of capitalism. The development of these structures must go hand in hand with entry into the global system.

Another lesson to be learned from Minsky's work is that flexible exchange rates may be best in normal times, but once a crisis hits, fixed rates are sometimes best. Also, intervention alone is not enough; monetary policy must work with other economic policies. Meyer offered several suggestions to reduce vulnerabilities of the financial system, including reform of corporate governance to enhance crisis management and prevention, reform of bank supervision to deal with changing bank technology, and development of international standards and a system to encourage and monitor compliance.

Session 6. The Financial Instability Hypothesis
The moderator for session 6 was Senior Scholar **L. Randall Wray.** Participants were **Piero Ferri,** professor of economics at the Università degli Studi di Bergamo; **Paul Davidson,** holder of the Holly Chair of Excellence in Political Economy at the University of Tennessee; **H. Peter Gray,** professor emeritus of economics and finance at Rutgers University; and **Stephen Rousseas,** Dexter M. Ferry Emeritus Professor at Vassar College.

Ferri discussed three important themes emerging from Minsky's work: a dynamic vision of the economy based on an endogenous explanation of the business cycle, the use of a nonlinear model based on ceilings and floors, and the importance of evolution and innovation in financial phenomena. Minsky did not deal as thoroughly with globalization, and that is an area that needs more research today. Davidson stated that both efficiency and liquidity should be goals of financial markets in capitalist economies. Some form of international clearing union would be the best route for reform of financial systems to maintain both. Gray is applying Minsky's theory to a world of integrated markets. He noted that people seeking to reform the international financial system must keep in mind Minsky's basic points that systems and institutions change, uncertainty will always be present, and systems and situations vary from one country to another. Rousseas emphasized the importance of Minsky's work in showing how financial innovation can undercut monetary policies. He also warned that current support for tightening monetary policy and reducing the role and size of government may make it politically difficult to implement policies that averted a crisis in the 1960s—when the Federal Reserve acted as the lender of last resort and big government stepped in.

Martin Mayer
Martin Mayer, scholar at the Brookings Institution, said that few people realized how hard the financial system had been hit by the Asian crisis. Last fall the system was near collapse before the Federal Reserve stepped in to save it. Drawing on his analysis of the Asian crisis and on Minsky's work, Mayer said that when there is a crisis, there is gridlock—people hold onto their money and there is no movement in the system. One thing that is then needed is someone who can force banks to lend in order to get the system moving again. Another lesson to be learned is that trying to increase transparency may not be a way to prevent future crises. Despite their rhetoric, bankers do not like transparency and as long as banks play a major role in the system, they will continue to do much in secret. However, banks are likely to play less and less of a role in the future. One can already see a transition in the world financial system from banks to capital markets.

Crisis management when prevention fails will require "standstill" agreements to encourage the continuation of normal economic life. Mayer said that governments, when developing policy in this period of the financial system's transition to markets, must keep in mind that markets are human activities. Economic theories can be used to help guide policy but they should not control it.

Session 7. Global Financial Crises: "It" Happened Again in Latin America
Session 7 was moderated by President **Dimitri B. Papadimitriou.** Participants were Visiting Senior Scholar **Jan A. Kregel,** professor in the Department of Economics at the Università degli Studi di Bologna and adviser to the United Nations Conference on Trade and Development; **David Felix,** professor emeritus of economics at Washington University in St. Louis; and **Norman Gall,** executive director of the Fernand Braudel Institute of World Economics.

According to Kregel, many economists predicted that a crisis in Brazil would follow in the wake of the Asian crisis, but a financial meltdown has yet to occur and many are now saying that Brazil has escaped. He contends that the Brazilian financial structure in fact does face several problems with which it is incapable of dealing and it could yet fall into a crisis. Felix said that the fact that much of what has happened recently should not, in theory, have happened indicates that there is a need to modify economic theories as they relate to the financial system. He suggested that some of Minsky's work can be useful, especially if it is incorporated into some of the work of Keynes. Gall explained that structural problems in the Brazilian financial system could result in a financial crisis and that at the core of Brazil's fiscal problems is the huge government expenditure on pensions. Many are not optimistic about the chances of reforming a corrupt pensions system in which government officials receive lucrative pensions because those who must reform the system also benefit from it.

Edward M. Gramlich
Both monetary and fiscal policymakers can act to slow the economy or give it a boost. But which of these two groups of policymakers should act and when? According to Edward M. Gramlich, member of the Board of Governors of the Federal Reserve System, the answer varies. For example, if exchange rates are flexible, monetary policy can act as a powerful stabilizer and fiscal policy may be ineffective, but the reverse is true when exchange rates are fixed. Timing is difficult because cycles do not last and policies designed to affect them must hit at the right moment. In general, monetary policies can have a much faster impact than fiscal policies.


Edward M. Gramlich

Fiscal policy is best used to raise national saving. Although private saving is low, saving by business and government has been on the rise. History shows that tax policy is not effective in encouraging private saving, so if one wants to increase overall national saving, the best method is to run a budget surplus. Monetary policy is best used to stabilize the economy. One method is to control inflation rates. Gramlich said this may not be a bad policy, but he suggested a better one. One could argue that today's inflation and unemployment rates are where they should be, and so monetary policy should work to keep the rates about where they are now rather than attempting to hit some set target rates. Monetary policy should focus on aggregate demand growth rates rather than on inflation.

Richard S. Carnell

Richard S. Carnell, assistant secretary for financial institutions of the U.S. Department of the Treasury, said that we have experienced cycles of boom and bust in the past and we will experience them again. They are a product of human nature and will not change, and the banking system will continue to be vulnerable to them. As part of efforts to maintain stability, the Federal Deposit Insurance Corporation was created and the Federal Reserve stands ready to intervene. But the security that these institutions provide encourages banks to take risks and encourages people to speculate. Thus, policies that seek to create stability can lead to instability. Policies to provide security for the system as a whole are needed, but they should not overprotect banks and people who take risks. Depositors should be protected before creditors are protected. Policymakers should not believe that some banks are too big to fail. Government must weigh the costs and benefits of intervention and accept that fact that sometimes we must have short-term instability in order to have long-term stability.

Session 8. Global Financial Crises: "It" Happened Again in Asia

Assistant Director **Frances M. Spring** moderated this session. Participants were **Martin H. Wolfson,** associate professor at the University of Notre Dame; **Gary Dymski,** associate professor of economics at the University of California, Riverside, and research associate at the Economic Policy Institute; **Robert Z. Aliber,** an instructor in international finance at the University of Chicago; and **Philip F. Bartholomew,** chief economist on the Democratic Staff, Committee on Banking and Financial Services, U.S. House of Representatives.

Wolfson said although Minsky's financial instability hypothesis was developed for a domestic system, it can be placed in a global context. The Asian crisis was a financial, not a currency, crisis. Many aspects of Minsky's theory—speculative and Ponzi finance, low perceived risk, and an unpredicted event that disrupts stability—can be seen in the Asian situation. Institutional changes in the global financial system, such as liberalization of financial markets, deregulation, and macroeconomic policies aimed at attracting foreign investment, created the situation that led to the crisis. Dymski said neoclassical views of the Asian crisis, especially the asset bubble theory, have not been successful in explaining the crisis, even as economists alter their theories to make them fit. In his analysis of the crisis, Dymski applied Minsky's approach but modified it to include cross-border financial flows. Because of cross-border financial flows, Minsky's prescriptions for recovery—the lender of last resort and big government—may be difficult to apply.

Aliber said that to understand the Asian financial crisis one must analyze the situation in each country involved. All, except Korea, were in a stage of Ponzi finance internally and some were also in this stage externally. The U.S. trade deficit also played a role in the crisis. Bartholomew argued that the Asian crisis was not contagious. One country's fall did not cause the fall of another; rather, several were in trouble at the same time. Although Japan did not cause the crisis, there is a link between its problem and problems in other countries. Japan recognized its problems as early as 1995 and reacted by reducing its lending to other Asian nations. According to Bartholomew, the global financial crisis is not yet over and may still spread to other nations, especially those that are big borrowers, such as Brazil and Russia.

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The Levy *Report* Interview

James K. Galbraith Discusses the State of the American Economy and the Field of Economics

James K. Galbraith

James K. Galbraith is a senior scholar at the Levy Institute and a professor at the Lyndon B. Johnson School of Public Affairs and the Department of Government at the University of Texas at Austin. In his work at the Institute, he examines issues pertaining to employment and inequality, especially determinants of global inequality. His publications include *Created Unequal: The Rise of Wage Inequality in America* (sponsored by the Twentieth Century Fund and published by the Free Press in 1998), *Balancing Acts: Technology, Finance and the American Future* (Basic Books, 1989), and *Macroeconomics,* with William Darity Jr. (Houghton-Mifflin, 1992). On February 6 he spoke with President Dimitri B. Papadimitriou about the directions U.S. policy should take and about the role of the economist in the development of policy. Excerpts from their discussion follow.

Papadimitriou: You have always supported the use of economic and fiscal policy to bring about economic growth and a more equal distribution of wealth.

Galbraith: I feel that government policy plays a critical role in the health of the economy, for good or ill, and that understanding that role, interpreting it for the larger public is, professionally, what the economics community ought to do. But because so much of what is written about economic policy has a conventional flavor to it, there is a confusion between virtuous thinking and good economics, and that confusion works much to the detriment of good economics. So much of what is publicly discussed as economics (for example, in the financial pages of the press) revolves around issuesÑbalancing the budget, promoting saving, keeping the government from interfering with the efficient operation of a free marketÑthat are formulated as a part of the political discourse. One of the important roles of an economist is to look into the substance of the claims involved in that discussion and to stick, as much as one can, strictly to what one thinks is analytically sound and empirically supported.

Papadimitriou: You must be disappointed with the Federal Reserve's focus on controlling inflation rather than on the rate or level of unemployment.

Galbraith: No, my view is that this ongoing dialogue about the supposed trade-off between inflation and unemployment has contributed to a constructive result. Alan Greenspan, who certainly held fairly conventional views about the role of monetary policy (the prevailing economic ideology being that the Federal Reserve should fight inflation and do nothing else), has, over the last four years, embarked on a cautious experiment of allowing the unemployment rate to go below the so-called natural rate, below estimates of what economists four years ago felt would produce a steadily rising rate of inflation. I was, I am happy to say, not one of those who agreed with the idea of a natural rate of unemployment. And there were other dissenters, some here at the Levy Institute as well as Bob Eisner, who was certainly the greatest dissenter. Alan Greenspan, to his credit, has proved us right and appears to have accepted for practical purposes the implications of that lesson.

Papadimitriou: I think you are quite right. Even those economists who believed in the natural rate of unemployment have come to the conclusion that it is not fixed, but can go lower or higher depending upon economic and other conditions.

Galbraith: Shifting your ground that way is, to my mind, a bad form of intellectual sloppinessÑto have stated at one point that you believe there is labor market equilibrium that will produce a given natural rate and then to state, for example, as Ned Phelps does, that there are some other variables that move the thing back and forth. What's the basis for believing that as opposed to coming to the conclusion that the whole idea was wrong in the first place? The original hypothesis has been refuted and to make up a qualification of it in order to keep the concept in play, when there's no evidence for it whatsoever, seems to me to be intellectually shallow.

Papadimitriou: Chairman Greenspan speaks about the Federal Reserve as if its goal is still price stability, but in his speeches he acknowledges that there is inequality of income and wealth. Yet the Federal Reserve does not appear to be doing anything to use monetary policy as an instrument to bring about the sort of changes that might reduce inequality. Do you have some views about that?

Galbraith: Here is what Greenspan actually said on thisÑit is something I quote at the beginning of my book, *Created Unequal.* "There has been a significant widening of income spreads, largely as a function of technology and education. The premium of college education over high school and high school over high school dropouts has become stronger. It is a development which I feel uncomfortable with. There is nothing monetary policy can do to address that, and it is outside the scope, as far as I am concerned, of the issues with which we deal."

That's been Greenspan's position. Of course, I completely disagree, and my book makes the case that monetary policy is critical to lower unemployment. This is not a personal position of Greenspan's; it is a deficiency of the economics profession. The idea of a natural rate of unemployment, too, was a deficiency, an error of the economics profession, and one that, incidentally, Greenspan for years expressed skepticism about. So again, I wouldn't put this on Alan Greenspan, and I hope that he will prove to be as flexible on inequality as he has been on unemployment.

Papadimitriou: The Humphrey-Hawkins Act does set a rate of unemployment that is acceptable within a framework of price stability, which is 4 percent.

Galbraith: Actually, Humphrey-Hawkins sets an interim target for unemployment, but goes on to say that once that target is achieved, even further progress toward what might come to be redefined as full employment might be possible. I think the attitude of the bill is that we'll take 4 percent unemployment and 3 percent inflation, which is roughly where we are right now, and then we should look around and see whether 3 percent or 2 percent unemployment might be feasible. But the act is not so brash as to declare that some lower number is or is not going to be achievable.

Papadimitriou: If we were to rewrite the bill now, what should it say, given the fact that we have 1.6 percent inflation and 4.3 percent unemployment?

Galbraith: I would set a 3 percent unemployment target now and let policy work toward that goal, and then I would revisit the issue when we got the 3 percent.

Papadimitriou: So you believe the American economy can grow much faster than it is growing now?

Galbraith: Well, not necessarily. Of course, the American economy has been growing much more rapidly than people thought it could and has consistently done so for three or four years. This has happened mainly because there were a lot of low-grade jobs that were upgraded and a lot of people on the margin of the labor force who could come into the labor force, so labor force growth has been substantially higher than people expected it to be. I think the economy has the ability to grow for quite a while before it exhausts either of these two phenomena, and after they are exhausted, it seems at least plausible that a higher rate of productivity growth might be achieved for a while.

Do I believe the American economy can in principle grow faster? Certainly faster than the 2.3 percent that was a fetish of economists a few years ago. How much faster? I don't know. In the early part of this expansion I favored much more rapid growth in the first few years. I based that on the experience of past recoveries that posted much faster growth rates than this one had, particularly in the early stages. I'm not sure that that idea was wrong; in fact, I still think it is probably right, that if we'd started off this recovery twice as fast, we would be much further along today.

Now that we're on a slow-but-steady growth track, it may be that the prudent thing to do is to take policy steps that preserve current growth. The real test of good policy from this point forward is, can we avoid slowing down? Can we maintain, say, 3 or 4 percent growth and a modest further reduction of unemployment accompanied by a large upgrading in the job mix and improvements in the income distribution over the next, say, five years? But growth and policies for growth face a number of other dangers: large changes in policy in short periods of time tend to be reversed because of political resistance, the international situation is extremely dangerous, the financial situation is substantially unstable, and the government is about to commit several follies in its fiscal policy by committing itself to running large surpluses, which could impose a drag on the economy. At the same time, it is not at all clear that the Federal Reserve has the leverage to keep the next five years on the same track. So it seems to me one has to look at this situation again with fresh eyes.

The inequality issue is the most serious single failing of the economics profession. I think that failing comes from something that is basic to the way economics is taught and the way people think about it, which is the division between macroeconomics and microeconomics. Typically, in first-semester economics the student reads about microeconomics: the way markets are supposed to work, supply and demand, the way prices and wages are set in theory. That is the story that relates wages to individual productivity. Then the textbook for the first semester is put on the shelf and one for the second semester is brought out. That textbook is about macroeconomics: inflation, unemployment, the long-run rate of growth, exchange rates. If you look in the index of the macroeconomics textbook, the word "distribution" doesn't appear. It is as though macro and micro were a left hemisphere and a right hemisphere of economics with the connection between them cutÑno interchange, no exchange. That is obviously unsatisfactory.

We must recognize that macroeconomics and things that affect macro results, such as the unemployment rate, must also affect the distribution of income. And that's the argument of my book. It lays out a market structure analysis that provides the fulcrum about which macroeconomic policy can work on distribution issues. The implication of my argument is that there is essentially a seamless connection between unemployment and inequality in the wage structure. That's an implication that can be readily tested against the data, and the data appear to support it with extraordinary clarity. Again, this is a criticism that I am leveling against the entire economics profession, not against any particular faction, but one that goes against some of the most pervasive notions in policy discussion.

A notion one hears all the time in Europe is that the problem that Europe faces is inflexible labor markets and that if only they had more flexible labor markets, if only they got rid of the structure of regulation and allowed inequality to increase, they would have falling unemployment. In other words, if they could have rising inequality, they would have falling unemployment. This is something that one simply does not observe. What one sees in the United States is that when unemployment goes up, inequality goes up; when unemployment goes down, inequality goes down.

Papadimitriou: The problem of inequality is important, but we don't see anyone, at least in the policy-making arena, discussing the issue. Why not? Certainly in the 1960s, in the Kennedy programs and in Johnson's Great Society, we had policies that dealt specifically with issues of inequality, with changing the poverty rate. During that era there were some dramatic improvements. But now, 30 years later, we say those programs didn't work and the government grew too large. As members of our profession, how do we become policy advocates? How do we bring about a change for a better society?

Galbraith: Let me offer a small revision to the scene you've just set. I would say that since the early 1990s it has become clear to policymakers that this issue is in fact important to the public. It has become clear because the public by and large has made it clear. On those occasions when particular issues force their way to the surfaceÑsuch as in the fight over raising the minimum wage a couple of years agoÑthe striking fact is the near unanimity of public opinion in favor of measures to reduce the inequality at the very bottom of the wage structure. The people like the idea of a middle-class society. They don't like the idea of a world in which a class of extreme wealth lives isolated in its gated communities and chauffeured limousines and in which the middle class has the entire burden of caring for a very large number of poor. They like the idea of a society in which fewer people are poor and fewer people are rich. That's a sensible instinct. It's not just economics. It's sound from the standpoint of civil society, from the standpoint of having a politics that is inclusive and not divisive.

I think there are political voices that have tried to respond to that desire for less inequality, and I think President Clinton is one of them. Alan Greenspan clearly is not, even though he probably has done more to improve income distribution, by allowing the unemployment rate to go down, than anybody else. Clinton has addressed inequality in his *Economic Report of the President* and in his speeches, but, following the advice of his economists, he has tried to have it both ways. He has tried to be for more equal income distribution and for the Reaganite ideal of unfettered markets. That is a circle you cannot quite square.

The makeshift effort to square it has been to assert that the cause of income inequality is a skills gap and educational deficiencies. So Clinton has proposed initiatives aimed at upgrading skills and improving education. These are not in themselves bad things; in fact, they're quite good. But today's income gap is not due largely to a skills gap. Rising inequality is not caused by computers. The fallacy here is the failure to distinguish between the number of tickets in a lottery and the structure of the prizes. By giving people scholarships and upgrading their credentials you are passing out tickets to a lottery, but you are by no means ensuring that prizes will be fairly distributed or evenly distributed. You are only ensuring that more people will have a chance at competing for the prizes that happen to exist.

In my work I look at precisely these questions: What is the structure of the prizes and how can that structure be made more equal? The problem with the answer is that, politically, it raises some uncomfortable topics. It suggests, for example, that monetary policy is not something that can be isolated in the domain of fighting inflation, but has to be considered as part of the picture of the structure of our society and our income structure. It says that the minimum wage is not something simply for a handful of teenagers, but is actually quite fundamental to setting a lower bound on what people are paid. The answer says that we need to think carefully about public jobs.

Public jobs created the American middle class in the postwar period and it has been an assault on public jobs that has eroded the American middle class in the 1980s and 1990s. The last *Economic Report of the President* provides a nice example of the difficulty of coming to grips with hard facts and uncomfortable thoughts. The report points out accurately that this expansion is the only fairly long expansion in the postwar period that has occurred without any growth of government. The Reagan expansion had a substantial growth in government and in the military. The Kennedy-Johnson expansion had a substantial growth in government. What the report avoids saying, however, is that precisely because government did not contribute to employment, the whole expansion has been carried by the private sector, carried by private investment and consumption. This expansion has been only half as big and half as strong as the average in the postwar period. It also has been one in which income inequality as a whole did not come down as much as in earlier expansions because we did not have the growth of good middle-class jobs that the public sector provides. I'm not ideological about thisÑI don't disparage the private sector, I don't particularly love the public sectorÑbut it seems to me that an economy has to have a balance of both.

Let's put it another way. Let's go back and look over the whole course of the twentieth century. In most people's view, the twentieth century has seen a great conflict between capitalism and communism, but that view is one of the great half-truths of our time. If we think that the conflict has been between pure free-market capitalism and, let's say, industrial-strength Stalinist communism, then we have to conclude that capitalism lost. Capitalism lost in the period from 1929 to 1932 and never returned in the form in which it had existed up to that point. Communism, on the other hand, did not collapse until the 1980s. What the formerly capitalist societies produced in the experimentation of the 1930s and the institution building of the 1940s was the mixed economy, an economy with capitalist institutions and with a solid social welfare system, limits to inequality of income and wealth, and commitments to economic stability. No one should be surprised that by mixing the two systems, the private and the public, you get a stronger system.

Papadimitriou: Then why is there such broad support for small government? Conservatives have always espoused limits on government power, authority, and size. But today many liberals are also against big government.

Galbraith: I think the liberal view suffered psychological trauma through the 1970s and 1980s and faced a relentless hammering by ideological conservatives. People adjusted their rhetoric in a way that is regrettable. People felt a need to believe in the notion that we live either in a free-market economy or in a socialist economy. They did not recognize that ours is an economy that has more intricacy in its layers of government, the kinds of regulation to which we all submit quite happily, than almost any other society you can think of.

When I was first dating my wife, who arrived in 1986 from China, she was rooming with a young woman who had just come from China. The roommate wanted a driver's license, took the driver's license exam, and failed it. My wife told her that it might be prudent for her to study the rules of the road a bit before she retook the exam because Americans tend to take this sort of thing quite seriously, which is not the case in China. The roommate totally rejected this astonishing idea, saying, "Oh no, I'll just go back and maybe on the next exam they'll be a bit more sympathetic." Rule of law is something that exists in an intricate, capitalist, mixed society in a way that it doesn't exist at all in the so-called totalitarian societies. I think we simply have failed to be honest with ourselves about the nature of the society we live in and about some of its most attractive features, including that we all basically do respect the same very complex rules.

Papadimitriou: The federal budget had a surplus last year and surpluses are projected for some years into the future. Economists are clearly divided over what should be done with the surpluses. What do you think?

Galbraith: The idea of squirreling away surpluses is really an invitation to disaster. We are enjoying surpluses now because monetary policy has supported the growing economy and because after a long period of growth tax revenues catch up with expenditure levels.

However, it's not obvious that this situation will go on forever and it's not obvious that you get the same impetus from monetary policy when you cut interest rates from 3 percent to 2 percent as you can get when you cut them from 6 percent to 3 or 4 percent. The assumption underlying this surplus talk is that the Federal Reserve alone can keep economic growth strong and unemployment low; that is, people are basing their ideas about the surpluses on the assumption that the Federal Reserve can maintain full employment. As an old Humphrey-Hawkins man, it warms my heart, but I caution people not to go overboard and overstate what the actual capabilities of the central bank are. The rest of the government has a role. These surpluses, as they pile up, will have a diminishing effect and will impose a drag on the economy.

There also is a completely unfounded assumption that as the surpluses pile up, they will be smoothly channeled by efficient capital markets into long-term investments. There is absolutely no reason on earth to believe that this will be the case. If the surpluses were somehow dumped into the financial markets, they would look for the highest return. They would become part of vast speculative pools that would go overseas into so-called emerging markets, into real estate, and into domestic asset speculation. And the more liberal the world capital markets areÑwe are the apostles of liberal and free capital marketsÑthe more pronounced this tendency would be.

To assume that the rate of investment will simply rise on its own and maintain full employment is a leap of faith (although I hate to characterize the views of some distinguished members of my profession in such a manner) that serious economists should not make. An assumption like that dates back to the ideas of Jean-Baptiste Say in 1802, and his ideas have been contradicted by every financial and macroeconomic crisis that has occurred in the last 200 years. I can't imagine why people are going along with this idea, except, of course, in the context of the lesser evil or the greater danger. One could argue that Republican proposals to make massive cuts in capital gains taxes and otherwise funnel the surpluses back to their own clientele, which is essentially the platform on which they stand, would be even more dangerous than the notion of saving the surpluses. I'm sympathetic to the idea that Clinton's original motive in proposing that the surpluses should be saved may have been to prevent the Republicans from passing a tax bill; I can understand that as a motivation.

Papadimitriou: But there are ways of investing the surpluses to assure the economic growth of the United States.

Galbraith: Yes. We have gone through a long period in which government functions have been eroded. Public services, urban services, the housing stock available to the poor have all been run down. It seems to me we should be thinking about ingenious ways to use our resources, both public and private, to build up the kind of institutions and services that make people's lives better. That's what we should be doing with the resources that we now have, resources that have not been generated by the government budget but by full employment and the economy.

Papadimitriou: There is another issue I want to bring up, even though we have heard so much about it, namely, globalization. What should we be doing to enable the U.S. economy to withstand the impact of global crises?

Galbraith: The Asian crisis, like that in Brazil, has its origins in the international financial instability that we promoted, in the pressure we put on countries to accept short-term capital flows and to make themselves vulnerable to outflow. In March of 1997 the Federal Reserve nudged up the interest rate by a quarter of a point and a great many people concluded that we were at the beginning of a new wave of higher interest rates. Money started flowing back into the United States to take advantage of the situation and an expected appreciation of the dollar. Although the flows came from around the world, it just happened that certain Asian economies felt the tail end of the whip.

We have to recognize that these crises are not alien things; they are intimately connected with the way in which the global economy is being run. It seems to me they illustrate a fatal weakness in the doctrine of free capital flows; they make it clear that free capital flows and the slightest fluctuation in our national monetary policy can have enormous ramifications overseas. A lesson I would draw from this is that it is a fundamental right of small countries, particularly those on the periphery of the industrial world, to regulate their banking sector and inflows and outflows of capital because, from the standpoint of those countries, the supposed efficiency of allocation is not what is important.

Papadimitriou: But most of those countries don't appear interested in regulating outflows; they are interested in inflows.

Galbraith: As the Chileans discovered, if you tax the inflow, you don't have to worry as much about the outflow, first, because the hot money, the really hot money, will steer clear and, second, because your own domestic capitalists will be reluctant to move money out because it will be taxed when they bring it back in. So you can tax either channel and get some of the desired effect.

The fundamental point is that those policies are sensible policies. China is the great example so far; it has not entirely bucked the crisis but it has done better than most other countries. What is really disastrous for a poor country is that during a crisis and in its aftermath people don't eat. When people don't eat, that's a catastropheÑsomething that is at risk in Indonesia and is not entirely out of the question in Russia. We should recognize that every government has an overriding interest in being able to control capital. It is a sovereign right and we should contribute to it. We don't need to control them because as a capital-rich country we are not nearly as subject to the consequences of the kind of instabilities to which smaller countries are subject. But we should recognize their right and we should help them out. Establishing a Tobin tax [on foreign exchange transactions] would be a nice first step and trying to help with related types of policies. But the real virtue of a Tobin tax is that it would represent an acknowledgment to the world community that every country has a right to control capital flows.

Papadimitriou: A question related in some ways to the issues of inequality and joblessness: Do private sector firms have some responsibility as corporate citizens? When a company downsizes or right-sizes, do the individuals who have been downsized or right-sized have the right to expect some sort of assistance from the company to deal with the situation? Does, or should, the corporate sector feel responsible for what happens to those individuals? Could some sort of public-private arrangement create a structure of institutions that would ensure that these individuals continue to be active members of the labor force?

Galbraith: This is not an issue I've studied as deeply as I have some of the others, but let me just offer a few thoughts. Corporations are inherently profit-pursuing entities and relying on them to pursue a larger purpose brings conflicts of interest into play. That said, the right balance needs to be struck; companies need to be asked to do the things that they can most usefully do and that are the most effective in achieving a goal. A parallel that comes to mind would be in the area of environmental policy. It is clear that one cannot have an effective pollution policy without engaging the corporation because the corporation is the pollution producer. The issue then becomes how to formulate the policy. Do you do it by regulating emissions or by pushing corporations to adopt nonpolluting technologies? The answer is a mixed bag.

I think there should be some rules that encourage a measure of stability in the way a corporation treats people. Right now, for example, it is apparently attractive to corporations to goose their stock prices by announcing layoffsÑsometimes, in the best Christian spirit, right before Christmas. Such announcements might be made then because some executive stock options settled at the end of the year are based on stock prices at Christmastime; corporations therefore announce layoffs they don't intend to make or announce larger layoffs than they are planning in order to jack up their stock prices to help the executives out at ChristmastimeÑwhatever heartbreak the announcements cause among employees, even if they are ultimately not laid off.

Now I could, given a couple of good graduate students, design a pretty effective policy that would help prevent this type of thing from happening, a policy that would put a real cost on it. I think you could have sensible social policies that require a corporation that feels it must get rid of employees who have made a real investment in the corporation (in a human capital sense) to compensate those employees for their investment with some of the capital wealth of the corporation. If you did that, corporations would look for ways to keep people rather than downsizing.

Papadimitriou: To sum up, what do you think our task should be as economists?

Galbraith: I think economists should be social reformers and acerbic critics of the prevailing received view. (I'm trying to avoid saying "conventional wisdom"; that's my father's coinage.) They should be particularly hard on the tendency within the economics profession to bend before the prevailing winds, before convenient ideas like the natural rate of unemployment.

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New Working Papers

Theories of Value and the Monetary Theory of Production

L. Randall Wray
Working Paper No. 261

Theories of value seek to explain the relative prices of commodities. One such theory, the neoclassical utility theory, was considered appropriate for analysis of a barter or real wage economy. Senior Scholar L. Randall Wray argues that analysis of a monetary production economy requires the use of two theories of value: the labor theory and the liquidity preference theory.

Both Marx and Keynes tried to develop a monetary theory of production. Marx adopted a labor theory of value in his analysis, while Keynes adopted a liquidity preference theory. According to Wray, Keynes seems to have recognized that a monetary theory of production should include both. Keynes adopted labor hours as the measure of value and agreed that labor produces all value. Wray does not claim that Keynes accepted both theories, but he does argue that Keynes should have adopted both and that this would have been consistent with the purposes of the *General Theory.*

The 1966 Financial Crisis: A Case of Minskian Instability?

L. Randall Wray
Working Paper No. 262

The credit crunch of 1966 has long been recognized as the first significant postwar financial crisis that required intervention by the Federal Reserve Bank. Senior Scholar L. Randall Wray interprets the crisis as the first verification of the financial instability hypothesis that Hyman P. Minsky had been developing since the 1950s. The events of that year also stimulated the further development of his analysis of the early postwar transition from a "robust" financial system to a "fragile" financial system.

As liquidity became stretched during the robust postwar expansion in the 1960s, the Federal Reserve reacted to inflation fears by tightening monetary policy to the point that the profitability of some financial institutions was threatened. As Minsky argued, "by the end of August [1966] disorganization in the municipals market, rumors about the solvency and liquidity of savings institutions, and the frantic position-making efforts by money-market banks generated what can be characterized as a controlled panic." The Federal Reserve was forced to step in as lender of last resort to save the municipal bond market. Its action in effect validated practices that were stretching liquidity. However, in exchange it required that borrowing banks attempt to reduce loans to private businesses. The result was a drop in investment and a decline in the growth of bank credit.

According to Wray, recession was avoided because government spending compensated for the fall in investment. Thus, government took on what Minsky said were its two most important roles; as the "big bank" it acted as lender of last resort and as "big government" it used its spending powers to provide a floor for aggregate demand. The economy continued to expand, new financial practices emerged and were validated, leverage ratios increased, memories of the Great Depression faded, and markets came to expect that the government and the Federal Reserve would always come to the rescue.

From Common Market to EMU: A Historical Perspective of European Economic and Monetary Integration

Philip Arestis, Kevin McCauley, and Malcolm Sawyer
Working Paper No. 263

After the establishment of the European Economic Community in the late 1950s, monetary integration, and ultimately monetary union, tended to be pursued as an important goal during a financial crisis, but returned to being a vague objective after the crisis receded. Only in recent years has monetary integration assumed greater urgency. Economic integration, on the other hand, has followed a smoother path. In this working paper, Visiting Senior Scholar Philip Arestis and Kevin McCauley, both of the University of East London, and Visiting Senior Scholar Malcolm Sawyer, of the University of Leeds, trace the history and institutional background of European integration.

The initial stages of economic integration occurred soon after World War II with the aim of anchoring West Germany to the western European alliance. During these early stages European currencies were not convertible and domestic trade was highly protected. Intra-European trade was based on bilateral clearing arrangements institutionalized by the European Payments Union. Today economic integration has developed into a system in which currencies are fully convertible, capital controls and intra-European tariffs and quotas have been eliminated, and the single market is complete.

Monetary union developed with more difficulty. The Werner Plan of the early 1970s set the goal of monetary union by the end of that decade, but it was only partially implemented. The authors attribute its failure to unfavorable international economic conditions and poor institutional structures. The European Monetary System plan, launched in the early 1980s, was followed by the more successful Maastricht Treaty in 1991, which laid out the precise path and timetable for economic and monetary union that culminated in the establishment of the EMU in 1999.

Further Evidence on the Distributional Effects of Disinflationary Monetary Policy

Willem Thorbecke
Working Paper No. 264

In an earlier work (Levy Institute Working Paper No. 185), Research Associate Willem Thorbecke examined the distributional effects of disinflationary monetary policy and found that the burden of such policy falls on low-income individuals. In this working paper, he presents further evidence to support this position and the conclusion that Federal Reserve action to slow economic activity in order to stabilize asset prices, as some have called for, would have adverse distributional effects.

Thorbecke examines two disinflationary periodsÑ1974 to 1975 and 1979 to 1982Ñusing various methods of studying the effects of monetary policy on economic activity: vector autoregression (VAR), a compilation of qualitative evidence to construct a narrative history, the Romer and Romer examination of minutes of the Federal Open Market Committee meetings, and a social accounting matrix. The housing industry was decimated following the rise in interest rates in the first period; housing and durable goodsÑtwo interest-rate-sensitive sectorsÑshowed large declines following the tightening of monetary policy in 1979. Thorbecke shows that in both of the sectors hit hard by recession following the disinflations, blue-collar workers and urban households suffered more loss of income than other workers and rural households and that minorities bear the brunt of disinflationary policy. He argues that the Federal Reserve should keep in mind that individuals most likely to be hurt by deflating asset prices are also the ones least likely to gain from asset price stabilization.

Real Exchange Rates and the International Mobility of Capital

Anwar Shaikh
Working Paper No. 265

Comparative advantage theory holds that free trade among capitalist nations will eventually make all nations equally competitive. The theory admits that differences in level of development may initially produce trade patterns in which the strong dominate the weak. However, if market forces are given free rein, they will drive the real exchange rate to a level that will create trade balances among all countries. Anwar Shaikh, of New School University, challenges this view and argues that it is absolute advantage that regulates international competition, just as it does competition within a nation. He demonstrates that the terms of trade are determined by the equalization of profit rates across international regulating capitals for socially determined national real wages.

Shaikh's analysis implies that international trade will generally give rise to persistent structural trade imbalances covered by endogenously generated capital flows that will fill any existing gaps in the overall balance of payments. It also implies that devaluations will not have a lasting effect on trade balances, unless they are also attended by fundamental changes in national real wages or productivities. Finally, it implies that neither the absolute nor the relative version of the purchasing power parity hypothesis will generally hold, with the exception that the relative version will appear to hold when a country experiences a relatively high inflation rate.

Minsky's Analysis, the European Single Currency, and the Global Financial System

Malcolm Sawyer
Working Paper No. 266

Hyman P. Minsky argued that requirements for a stable capitalist economy are a central bank as lender of last resort, "big government" spending to provide a floor for aggregate demand, and the expansion of base money derived from a budget deficit. In his analysis of a stable global financial system, Minsky stated that such a system requires stable exchange rates, an accommodative mono-reserve setup, and an international lender of last resort. Visiting Senior Scholar Malcolm Sawyer, of the University of Leeds, examines Minsky's ideas in the context of the European Union and the global economy.

Sawyer asserts that Minsky's analysis suggests that in the European Union the current institutional arrangement and drift of economic policy are deflationary and do not pay sufficient regard to building economic stability. The system created under the EU does not fulfill the three requirements for financial stability. The European central bank is not required to act as lender of last resort. The budgetary constraints placed on the EU and national governments prevent the EU from taking on the "big" government role that Minsky felt was needed. The relatively closed nature of the EU in terms of trade outside the union will mute exchange rate effects on prices within the union, thereby reducing the effects of monetary policy.

The Minimum Wage and Regional Wage Structure: Implications for Income Distribution

Oren M. Levin-Waldman
Working Paper No. 267

When the minimum wage was first enacted in 1938, the fiercest opposition came from the South, where wages were considerably lower than in the industrialized North. Today wage structure, and, as a result, the position taken with regard to minimum wage increases seem to be determined more by union density than by geographic location itself.

Using census data from the Integrated Public Use Microdata Series for the years 1940 to 1990, Resident Scholar Oren M. Levin-Waldman examined workers earning around the minimum wage by region and industry. He finds that, controlling for education and industry type, wages tended to be depressed more in states with right-to-work legislation than in states with high union density, and it is in the right-to-work states that opposition to increases in the minimum wage has been greatest. Right-to-work states tend to have lower wages and, according to Levin-Waldman, are therefore more affected by increases in the minimum wage. States with high union density, on the other hand, support minimum wage increases because those increases tend to equalize wages across states and thus make it harder for low-wage states to use their lower labor costs to attract capital from high-wage states.

Risk Reduction in the New Financial Architecture: Realities, Fallacies, and Proposals

Martin Mayer
Working Paper No. 268

Five times in a decade not yet completed, financial markets have floated to the edge of a whirlpool. In October 1998 they were about to drown when Alan Greenspan threw them a piece of string that, surprisingly, turned out to be a lifeline. In this working paper Martin Mayer, of the Brookings Institution, argues that the causes for this financial instability lie deepÑin the economic theory that urges easy and efficient substitution of one piece of paper for another, always and everywhere; in the technology-driven tight articulation of receipts and payments that Hyman Minsky warned against a generation ago; and in the growth of leverage that diminishes the creditworthiness of major institutions when an interruption in their receipts requires them to seek funds. Meanwhile, as decision making in finance moves from banks to markets and the creators of derivative instruments find ways to present uncertainties as risks that can be modeled, time horizons fall and spurious interrelations promote "dynamic hedging" that communicates financial disturbance anywhere to price volatility everywhere.

Mayer argues that prevention should be sought in rules to control the creation of leverage in the repo and derivatives markets and in limits on banks' freedom to back away from borrowers' cross-border liabilities in currencies other than their own. Crisis management when prevention fails will require "standstill" agreements to encourage the continuation of something like normal economic life while the losses from merely financial failure are sorted out.

Demand Constraints and Economic Growth

Marc-André Pigeon and L. Randall Wray
Working Paper No. 269

While many developed nations are experiencing high unemployment and slow economic growth, the United States continues to experience robust economic growth, low unemployment, and low inflation. Many economists attribute this American success to a reduction in supply-side constraints resulting from fewer regulations, a freer labor market, and a reduced safety net, which has encouraged more private initiative. Research Assistant Marc-André Pigeon and Senior Scholar L. Randall Wray show that although it is true that the United States has experienced a higher employment rate than its major competitors, it lags behind them in per capita GDP growth since 1970. When one breaks down per capita GDP growth into its componentsÑgrowth of employment rates and growth of output per employeeÑthe U.S. experience is different from that of other countries.

According to Pigeon and Wray, countries "choose" high or low employment paths, but regardless of their choice, economic growth does not appear to be affected. This is because countries have not faced significant supply constraints. Instead, per capita GDP growth has been largely demand constrained. For this reason policies to remove supply constraints do not lead to rapid economic growth. It would be better for nations to pursue demand-side policies in order to increase growth rates.

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New Policy Notes

How Negative Can U.S. Saving Get?

Wynne Godley and Bill Martin
1999/1

The force driving the American economy's robust expansion has been consumer spending. But Distinguished Scholar Wynne Godley and Bill Martin, of Phillips and Drew, argue that such spending cannot continue indefinitely. A large and growing gap now exists between private expenditures and income, and that gap has been financed primarily by an increasing level of borrowing. Given fiscal policy directed at budget surpluses and a worsening trade performance, in order to keep the U.S. economy growing at a rate of about 2 percent, private expenditures and therefore private borrowing must continue to increase to unprecedented levels. Such a high level of borrowing, they argue, is unsustainable but without it the economy will cease to grow, unemployment will soar, and overseas activity will be curbed, thus inflicting severe damage on the economies of many other nations. Godley and Martin argue that monetary policy will be unable to offset the deflation and the only plausible solution is coordinated fiscal pump priming in Europe and the United States.

The Emperor Has No Clothes: President Clinton's Proposed Social Security Reform

L. Randall Wray
1999/2

President Clinton has proposed using a large portion of projected government budget surpluses to build up a large Social Security Trust Fund to ensure that retirees of the future will be provided for. Senior Scholar L. Randall Wray argues against Clinton's proposal on the grounds that the federal government has never run surpluses for periods of 15 to 25 years as President Clinton has claimed, the projected budget surplus will be achieved mainly thanks to Social Security surpluses, and setting aside any surplus or increasing payroll taxes now to accumulate the Trust Fund will do nothing to ease the burden of paying for the retirement of baby boomers in the future.

Surplus Mania: A Reality Check

L. Randall Wray
1999/3

The federal government is projecting budget surpluses for the next 15 to 25 years. President Clinton has proposed setting aside most of those surpluses for the future and paying off the public debt. Senior Scholar L. Randall Wray argues against the president's plan. The federal government has been in debt every year but one since 1776. Wray argues that the historical record indicates that debt, rather than being a horror to be avoided, has been beneficial. Every time the federal government significantly reduced the outstanding public debt, a depression soon followed. History also shows that there is a positive correlation between government deficits and economic growth. Deficits increase the stock of private disposable income and wealth, and surpluses decrease that stock. Finally, surpluses, even if realized, cannot be locked away for future use.

Can Goldilocks Survive?

Wynne Godley and L. Randall Wray
Policy Note 1999/4

The current economic boom is the longest peacetime expansion in U.S. history, and the Congressional Budget Office is projecting a rise in the federal budget surplus through the next 10 years from 1.2 percent of GDP for 1999 to 2.8 percent for 2009, contingent on continued growth and unchanged budget policies. Distinguished Scholar Wynne Godley and Senior Scholar L. Randall Wray consider what this CBO projection means for the private sector. By accounting identity, the government budget balance, the current balance of trade, and the private financial balance (between income and expenditure) must sum to zero. Thus, if the public sector runs a surplus (as projected) and the trade account is negative (as it is), the private balance must be in deficit. Given a restrictive fiscal stance and worsening trade performance in light of world recession, the Goldilocks economy can survive only if the private sector increases its already unprecedented debt and deficit to implausible and unsustainable levels. Godley and Wray argue that in order for the U.S. economic expansion to continue, policymakers may need to adopt targeted tax cuts and federal spending increases while the private balance sheets improve. For the longer term, fiscal policy must take into account changes in the trade balance and become more or less stimulative in response.

How Can We Provide for the Baby Boomers in Their Old Age?

Dimitri B. Papadimitriou and L. Randall Wray
Policy Note 1999/5

Many policymakers have recently argued that the Social Security system will face a financial crisis in the early part of the next century as the retirement population increases and the working-age population decreases. Many have suggested that the accumulation of a large financial balance in the Trust Fund, which can be drawn on in the future, would ensure that future retirees gain a sufficient share of society's output of goods and services. President Dimitri B. Papadimitriou and Senior Scholar L. Randall Wray argue that there is no way to guarantee that such an accumulation will shift the distribution of goods and services toward future retirees, and it is not clear that a larger Trust Fund will result in a more desirable distribution. The authors do have some recommendations for the program: return to a pay-as-you-go system, expand the payroll tax base, and cap the Trust Fund. However, they emphasize that changes to the program today cannot ameliorate any problems that may be encountered in the future. The search for a solution to Social Security problems should focus not on how to amend the program but on how to achieve faster long-term economic growth. Achieving such growth lies within the realm of monetary and fiscal policy, not Social Security policy.

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Institute News

Lectures

Michael Handel: Computers and the Wage Structure

Wage inequality has increased dramatically in the past two decades, and many researchers and policymakers have concluded that technology, specifically the increased use of computers, has played a large role in widening the wage gap. They say that computerization increases the skills needed for employment and those who have the skills are rewarded.

Michael Handel, of Harvard University, has examined much of the research on the effects of technology on wages. In a lecture on February 18 at the Levy Institute, he asserted that there is no credible evidence that computerization has been the driving force behind the growing gap in wages. He finds that studies have exaggerated the returns to computer use; other office tasks, such as writing memos and using mathematics, had a similar, if not greater, effect on employee wages. Also, the widespread use of computers did not begin until after 1984, but the greatest growth in inequality came in 1981 and 1982. Handel suggested that researchers must search for other causes of the wage gap.

Dean Baker: Social Security: Is There a Real Problem?

Recent concerns about the future financial health of the Social Security program have led a number of policymakers, including President Clinton, to offer proposals for saving the system. Clinton has suggested using part of the current budget surplus and those projected for the next few years to build the Social Security Trust Fund. In a lecture on March 16 at the Levy Institute, Dean Baker, senior research associate at the Preamble Center, argued that the program is not in need of saving. Social Security already has enough funds to last until about 2032, which puts it in far better financial shape than other government programs.

Baker said Social Security can be viewed as a separate program or as one of many government programs. If it is treated as a separate program and it needs additional funding in the future, Social Security payroll taxes can simply be raised, just as they have been in the past. Because workers' wages are likely to grow in the future, the increase will not be a great burden. If Social Security is viewed as one of many government programs, the government can simply allocate more money to it in the future, if it is needed. There have been periods in the past during which particular programs, such as military spending and education, have taken a large share of the budget, but the nation was always able to deal with this burden. Baby boomers were a burden as children, yet the U.S. economy prospered. According to Baker, the nation will be able to deal with the Social Security burden, if there is one. The number of retirees will increase for a time in the future, but this increase will be offset by a decrease in the number of children, which might actually reduce the number of dependents each worker must support.

John T. Harvey: The Psychology and Institutional Determinants of Foreign Exchange Rates

Neoclassical theory has been unable to provide an adequate explanation for foreign currency prices. In a lecture on April 15 at the Levy Institute, John T. Harvey, professor of economics at Texas Christian University, ascribed this failure in large part to the theory's assumption that economic behavior is independent of social and cultural influences. The theory assumes that decision making is based on rational expectations and expected utility. When faced with a decision, such as whether to buy or sell on a market, people start by forecasting all possible outcomes and their likelihood (rational expectations theory). They then choose the outcome that will maximize their return (expected utility theory). According to this view then, expectations translate the underlying determinants of exchange rates into reality.

Harvey presented a different model of decision making, heuristic judgment theory (HJT), which draws on psychology. According to this theory, the decision-making process itself affects the realized pattern of exchange rates. The decision-making process is broken down into six stages: eventuality analysis, choice and consequence definition, decision weight assignment, choice, and post-event assessment. The first two stages involve probability assessment and this involves three main tendencies in decision making: availability (the more available an event is in memory, the more likely people feel that event will reoccur), representativeness (the tendency to presume causation when only chance may be at work), and anchoring (the tendency to anchor any subsequent revisions of an initial estimate to that estimate, no matter how it was arrived at). Harvey argued that the approach of heuristic judgment theory helps explain the actions of participants in the exchange rate market.

Ingrid H. Rima: Sectoral Changes in Employment: An Eclectic Perspective on "Good" Jobs and "Poor" Jobs

According to Ingrid H. Rima, of Temple University, traditional Keynesian analysis does not include a breakdown of the labor market that can account for sectoral differences in the way workers are treated or employment levels are determined. In a lecture at the Levy Institute on May 3, Rima noted that although the Keynesian model can explain such differences within the consumption and investment segments of the economy, itÑand contemporary labor market and macroeconomic models in generalÑcannot say why, for example, there has been a decline in the number of "good" jobs (in which workers receive training and higher pay) and a rise in the number of "poor" jobs (in which workers receive little or no training and are paid low wages) despite increases in productivity. The problem in analysis arises from applying a price-taking model (in which firms cannot set prices or wages) to the labor market. By applying a model in which firms in some sectors can set prices and wages (such as in manufacturing) and others cannot (such as in services), Rima is able not only to explain differences in jobs and wage rates across sectors, but to link these differences to price and output decisions of firms and to effective demand and aggregate employment.

New Appointments for Papadimitriou

Levy Institute president **Dimitri B. Papadimitriou** has been named a member of the Trade Deficit Review Commission, a bipartisan congressional panel. The commission will consist of six members appointed by congressional Democrats and six appointed by congressional Republicans. It will be charged with studying ways to narrow the U.S. trade deficit. In addition to Papadimitriou, the appointments are Wayne Angell, former Federal Reserve governor; George Becker, president, United Steelworkers of America; Richard D'Amato, Maryland state representative; Carla Hills, former U.S. trade representative; Kenneth Lewis, former shipping company president; Anne Krueger, professor of economics, Stanford University; Donald Rumsfeld, former defense secretary; Lester Thurow, economist, Massachusetts Institute of Technology; Murray Weidenbaum, economist, Washington University in St. Louis, and former chair, Council of Economic Advisers; Michael Wessel, former counsel to U.S. Representative Richard Gephardt; and Robert Zoellick, president, Center for Strategic and International Studies.

Papadimitriou has also been appointed a visiting professor at Smolny College in St. Petersburg, Russia. He will be lecturing on topics in macro- and microeconomics.

President's Commission to Study Capital Budgeting Submits Findings

On February 1, 1999, the President's Commission to Study Capital Budgeting submitted its report to the White House. Established on March 3, 1997, by President Clinton, the commission held hearings at which experts from the public and private sectors presented their views on the process by which the federal government budgets capital expenditures. Vice Chairman and Director of Forecasting **David A. Levy** served on the commission.

The commission concluded that capital spending by all levels of government, as well as the private sector, provides the nation with important long-term benefits. However, the commission's research shows that the current federal budget process does not permit decision makers in the executive branch and Congress to pay sufficient attention to long-run implications of their decisions. This results in inefficient allocation of resources among capital expenditures and failure to maintain existing assets. The commission made a series of recommendations to improve budget process components such as setting current and long-run priorities, making budget decisions in the current year, and reporting on and evaluating those decisions in order to make improvements in subsequent years. The full report is available at http://www.whitehouse.gov/pcscb.

Wray's Congressional Testimony on Expansion's Employment Effects

On March 11, 1999, Senior Scholar **L. Randall Wray** testified before the Immigration and Claims Subcommittee of the House Judiciary Committee. His prepared statement, written with Research Assistant **Marc-André Pigeon,** is an examination of the impact the current expansion has had on job opportunities. Wray and Pigeon find that, despite falling unemployment rates and a putatively tight labor market, the expansion has not created a significant number of jobs for workers who do not have at least some college education (who constitute about half the nation's labor force) and that well-targeted, active labor market policies will be required to help these workers who have not shared in the employment gains. The complete text of the testimony can be found at http://www.house.gov/judiciary/6.htm.

Congressional Briefing by Scholars

During a policy briefing held in Washington, D.C., on April 27, Levy Institute scholars presented findings from their research on the global financial system and Social Security reform. Distinguished Scholar **Wynne Godley** reviewed his work using the Levy Institute macroeconomic models of the U.S. and world economies. His analysis indicates that current growth cannot be sustained without ever increasing consumer spending, which, because of current income growth, means ever increasing indebtedness of the household sector. Senior Scholar **L. Randall Wray** presented his research with President **Dimitri B. Papadimitriou** on the Social Security System in which they examined various proposals, including President Clinton's plan to build up the Social Security Trust Fund with the budget surpluses that are projected to accrue over the next several years. Wray and Papadimitriou conclude that "saving" any surplus will not preclude having to raise tax rates (or cut benefits) in the future unless those "savings" are used to stimulate economic growth today.

Vice Chairman and Director of Forecasting **David A. Levy** updated the Forecasting Center's outlook for the U.S. economy, noting that the growth rate of corporate profits was actually much lower than the rate reported after adjustments are made for one-time occurrences, such as the GM strike and the effects of El Ni–. He predicted that growth would slow markedly during the second half of the year. Visiting Senior Scholar **Jan A. Kregel** and President Papadimitriou also participated in the briefing.

Participants in *Debates-Debates*

Vice Chairman and Director of Forecasting **David A. Levy** participated in a recent segment of the national television program *Debates-Debates.* To the question "Are we headed toward recession in 1999?" Levy answered yes, along with Jeffrey Madrick, editor of *Challenge,* and Larry Chimerine, senior economist at the Economic Strategy Institute. Answering no were Adam Smith, chairman of Adam Smith Global Television; Lawrence Kudlow, chief economist at American Skandia Life Assurance, Inc.; and Jagdish Bhagwati, professor of economics and political science at Columbia University.

Upcoming Events

Workshop on Earnings Inequality, Technology and Institutions
June 8--10, by invitation only

Association for Evolutionary Economics/Levy Institute Summer School on Institutional Economics
June 20--23, by invitation only

Symposium on Behavioral Economics and Policy
July 8--9, by invitation only

Publications and Presentations by Levy Institute Scholars

Distinguished Scholar Wynne Godley
Publications: "Determining Balance between Receipts and Outlay" (with L. Randall Wray), *Financial Times,* January 26; "U.S. Economy: An Impossible Balancing Act," *Financial Times,* February 19; "Growth Fueled by Heavy Borrowing Hard to Sustain," *USA Today,* March 17; "Nation of Savers, or Just Spenders," Letter to the Editor, *New York Times,* May 10.

Senior Scholar Walter M. Cadette
Publications: "A Novel Approach to Healing the U.S. Health Care System," Bridge News, March 19; "Providing New Hope for Medically Uninsured," *Daily Record,* March 28; "With Reform, HMOs Can Deliver Both Savings and Care," Bridge News, April 12.

Senior Scholar James K. Galbraith

Publication: "The Dangers of Debt Reduction" (with Paul Davidson), *The Wall Street Journal,* March 3.

President Dimitri B. Papadimitriou
Publication: "Problem of Distribution," Letter to the Editor, *New York Times,* February 5.
Presentations: "(Full) Employment Policy: Theory and Practice," "Can Social Security Be Saved?" (with L. Randall Wray), Eastern Economic Association, Boston, March 12--14.

Senior Scholar L. Randall Wray
Publications: "Public Service EmploymentÑAssured Jobs Program: Further Considerations," *Journal of Economic Issues,* June; "Government as Employer of Last Resort: Full Employment without Inflation," *Economic and Labour Relations Review,* April; "Did the Clinton Rising Tide Raise All Boats?" (with Marc-André Pigeon), *Challenge,* March-April; "Determining Balance between Receipts and Outlays" (with Wynne Godley), *Financial Times,* January 26.
Presentations: "Modern Money," "Goldilocks and the Three Bears: A Parable about the Asian Financial Crisis," "Did the Clinton Rising Tide Raise All Boats?" (with Marc-André Pigeon), "Can Social Security Be Saved?" (with Dimitri B. Papadimitriou), Eastern Economic Association, Boston, March 12--14; "Full Employment as an Alternative to Austerity," Conference, The Economics of Public Spending: Debt, Deficits and Economic Performance, Laurentian University, Sudbury, Canada, March 26--27; "Modern Money," New School for Social Research, February 25, and University of East London, March 5; "Did the Clinton Tide Raise All Boats?" Testimony before the House Committee on the Judiciary, Subcommittee on Immigration and Claims, March 11.

Visiting Scholar Mathew Forstater
Presentations: "Functional Finance," "Money and Budgetary Policy," Eastern Economic Association, Boston, March 12--14; "Functional Finance and Full Employment," Post Keynesian Study Group, London, March 5.

Resident Scholar Oren M. Levin-Waldman
Presentations: "Revisiting the Minimum Wage as a Tool for Assisting the Poor," "The Minimum Wage and Regional Wage Structure: Implications for Income Distribution," Eastern Economic Association, Boston, March 12--14.

Resident Scholar Jamee K. Moudud
Presentations: "Government Spending and Growth Cycles: Fiscal Policy in a Dynamic Context," "Finance and the Macroeconomic Process in a Classical Growth and Cycles Model," Eastern Economic Association, Boston, March 12--14.

Cambridge University Visiting Scholar Malcolm I. Barr
Presentation: "Keynes on Convention and Animal Spirits: Toward a Post Keynesian Theory of Financial Markets," Eastern Economic Association, Boston, March 12--14.

Cambridge University Visiting Scholar James N. Miller
Presentations: "Constructing the GATT: The Political Origins of American Multilateralism," International Studies Association, Washington, D.C., February 16--20; "The Pursuit of a Talking Shop: Political Origins of American Multilateralism, 1934--1945," Eastern Economic Association, Boston, March 12--14.

Resident Research Associate Karl Widerquist
Presentations: "Public Choice Problems among Altruists," Public Choice Society, New Orleans, March 12--14; "A Voting Paradox and Legislative Gridlock," Midwest Economics Association, Nashville, March 26--28.

Resident Research Associate Ajit Zacharias
Presentation: "Competition and Profitability: A Critique of Robert Brenner," Eastern Economic Association, Boston, March 12--14.

Research Assistant Marc-André Pigeon
Publication: "Did the Clinton Rising Tide Raise All Boats?" (with L. Randall Wray), *Challenge,* March-April.
Presentation: "Did the Clinton Rising Tide Raise All Boats?" (with L. Randall Wray), Eastern Economic Association, Boston, March 12--14.

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