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New Levy Institute Measure of Economic Well-Being Report

WEALTH AND ECONOMIC INEQUALITY: WHO'S AT THE TOP OF THE ECONOMIC LADDER

EDWARD N. WOLFF and AJIT ZACHARIAS
www.levy.org/pubs/limew1206.pdf

The press has recently paid a great deal of attention to compensation packages for top CEOs. In 2005, the average boss in a top corporation earned 145 times as much as the average male full-time worker and 188 times as much as the average female full-time worker. But comparisons of net worth can be even more striking than comparisons of pay. In 2004, the average net worth of the individuals on the Forbes 400 list was 16,000 times the net worth of the average household.

A new Levy Institute Measure of Economic Well-Being (LIMEW) report by Senior Scholar Edward N. Wolff of New York University and Senior Scholar Ajit Zacharias examines how comparisons of economic well-being are affected by the inclusion of an accurate measure of well-being derived from wealth. Standard measures, such as U.S. Census Bureau data, usually count property income (e.g., interest and dividends) as part of income. But net worth confers economic well-being in ways that go beyond the receipt of such payments. For example, homes and retirement assets clearly benefit their owners, but they generate no cash income. Also, in a nation with a badly frayed safety net, ownership of substantial financial wealth is one of the few routes to economic security.

Wolff and Zacharias use a measure of household well-being that combines all forms of income with the benefits of asset ownership. From the Federal Reserve Bank's Survey of Consumer Finances, they obtain detailed information on the assets and debts of U.S. households. They convert nonhome wealth for each household into a lifetime annuity. In doing so, they take into account the fact that life expectancies and typical portfolios differ among demographic groups. Since the primary purpose of a house is for shelter, Wolff and Zacharias measure well-being from homes by the cost of renting an equivalent dwelling.

One of the key findings of the paper is a comparison of the level of the authors' "wealth-augmented" measure of well-being (WI) with a standard measure of money income (MI) at various

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

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percentiles of the population in 1982 and 2000. Between the two years, median WI grew by 18 percent, after adjusting for inflation, while median MI rose only 9 percent. The threshold for almost any given percentile of WI rose much faster than the percentile thresholds for MI, especially at the higher end of the distribution. In particular, the WI threshold for the top 5 percent of all U.S. residents rose by 63 percent between 1982 and 2000. The authors also find that the share of WI held by the richest families is much greater than their share of MI: in 2000, the richest 10 percent of the population received 48.1 percent of WI and 42.9 percent of MI, and the top 1 percent held 20.1 percent of WI and 17.4 percent of MI.

The authors' WI measure of well-being belies the perception that today's rich are increasingly the "working rich"—people who derive most of their large incomes from salaries and bonuses. In their study, 42 percent of WI for the top decile came from wealth, rather than executive compensation or any other standard form of money income, a percentage that did not change between 1982 and 2000. WI also depicts a more racially and ethnically polarized society than MI. The ratio of median WI for African Americans to median WI for non-Hispanic whites fell from .53 in 1982 to .49 in 2000. These bleak numbers reflect the fact that the net worth gap between the races is much larger than the gap in wages.

New Policy Note

The April AMT Shock: Tax Reform Advice for the New Majority

DIMITRI B. PAPADIMITRIOU and L. RANDALL WRAY
Policy Note 2007/1
www.levy.org/pubs/pn_1_07.pdf

Levy Institute President Dimitri B. Papadimitriou and Senior Scholar L. Randall Wray of the University of Kansas City–Missouri and the Center for Full Employment and Price Stability begin this new Policy Note with the observation that U.S. consumers are being squeezed by declining real wages, rising debt-service costs, and higher energy prices. What is less well recognized is that taxes are also taking an increasing bite out of gross household incomes. In fact, tax liabilities have been growing faster than government spending and personal income. The Congressional Budget Office projected last year that federal tax revenues would continue to grow, rising from 17.5 percent of GDP in 2005 to 19.8 percent in 2016. It is clear that if this trend continues, it could undermine the basis for economic growth.

Perhaps the most important source of rising revenues is the Alternative Minimum Tax (AMT). Higher-income taxpayers are required to calculate their tax liabilities under both the regular income tax rules and AMT rules, which employ a different definition of income, a higher tax rate, and fewer deductions and credits. If taxes are higher under the AMT than under the regular rules, the filer is required to pay the AMT. Some of the credits and deductions not allowed under the AMT include those for dependents, medical expenses, and state and local taxes. Unfortunately, the AMT is not indexed for inflation, and more and more people will be affected by this provision over the coming years—26 percent of all taxpayers in 2007. This tax represents a significant proportion of all tax revenues; eliminating the AMT would have an effect on government revenues similar to dropping all estate, gift, and excise taxes for the current year.

Most politicians believe that the AMT should be pared back, at least for the nonwealthy. Many believe that Congress should make this change revenue-neutral by increasing other taxes. But in light of the trend toward higher revenues discussed above, another boost in taxes would be undesirable from the point of view of macroeconomics and household well-being. Congress, Papadimitriou and Wray argue, should consider eliminating the AMT, without raising other taxes.

New Public Policy Briefs

Maastricht 2042 and the Fate of Europe: Toward Convergence and Full Employment

JAMES K. GALBRAITH
Public Policy Brief No. 87
www.levy.org/pubs/ppb_87.pdf

One of the great hopes of the European Union is that living standards of member states will gradually converge and, especially, that incomes in the accession countries will approach those in Germany, France, and Italy. In a new Public Policy Brief, Senior Scholar James K. Galbraith warns that just the reverse may be happening: misguided policies—designed to make labor markets more "flexible"—are undermining the fortunes of the least-skilled European workers, who make up a larger percentage of workers in the poorer countries of Europe than in the wealthier countries.

Proposed labor market reforms include cuts in unemployment benefits, reduced legal protection against termination, and moves to undermine the bargaining power of unions. Numerous experts, including perhaps a majority of economists, support such measures on the grounds that unemployment in Europe is primarily the result of government and union interference with the operation of free labor markets. The implication is that the high levels of inequality endured in the United States are the price that must be paid for relatively low unemployment rates.

But Galbraith disagrees with several factual claims made by proponents of reforms. First, he argues that by most measures, the United States enjoys greater equality than Europe. This can be seen by comparing the dispersion of wages across the 50 states and the District of Columbia with dispersion across the regions of Europe. Moreover, international studies have shown that inequality in individual incomes (*before* taxes and transfers, such as Social Security) is not higher in the United States than in typical European countries.

If the United States is not keeping unemployment relatively low by driving its weakest citizens into bankruptcy, how is it accomplishing this goal? According to Galbraith, a more equal pay structure may actually help reduce unemployment. When there is a high degree of inequality in pay rates, workers are more likely to risk an extended period of unemployment in order to search for a better-paying job. This reality is more important in Europe now than ever before, because economic unification is offering workers in poorer European countries a glimmer of opportunity to greatly increase their earnings.

Galbraith presents a calculation of how rapidly real (inflation-adjusted) wages would have to grow in each European region to achieve U.S. levels of regional wage parity. Wages would have to rise between 5.7 and 7.4 percent per year in much of Eastern Europe, even assuming wages remained stagnant in the wealthiest areas.

Given Galbraith's theory that regional wage disparities are an important driving force in generating unemployment in Europe, it is important to find policies that will help the poorest European countries increase wages fast enough to reach greater cross-regional equality. Galbraith argues that Europe can achieve this much as the U.S. government helped its poorer regions catch up decades ago: by equalizing the levels of government cash benefits across the Continent, increasing funding for institutions of higher learning all over Europe, and so on.

U.S. Household Deficit Spending: A Rendezvous with Reality

ROBERT W. PARENTEAU

Public Policy Brief No. 88

www.levy.org/pubs/ppb_88.pdf

Economists, pundits, and policymakers have long been preoccupied with the sustainability of government budget deficits. In a new Public Policy Brief, Robert W. Parenteau argues that household borrowing may be a more urgent concern.

Using several standard measures of the sustainability of debt, including a comparison of interest rates and the growth of household income, Parenteau shows that the current round of debt-fueled consumption cannot continue much longer at such a rapid pace. The current boom would not have been possible without the recent steep run-up in asset prices, which now may have begun to slow.

If this analysis is right, and consumption growth is due for a significant drop, the implications for the world economy would be serious. U.S. consumption spending amounts to a large fraction of world GDP and has largely underwritten the development of China and other newly industrializing countries that export to the United States.

There are two common counterarguments to the notion that U.S. households save too little. One school of thought holds that certain official statistics understate rates of saving. But if these numbers are inaccurate, so too are a number of other important statistical estimates that are mathematically related to the saving rate. If all of these government statistics are incorrect, our understanding of the entire economy would be flawed. Apparent inaccuracies in the data can be accounted for by the increasing use of debt to fund the acquisition of financial assets.

A more valid, but still optimistic, view would emphasize that while households have been taking on unprecedented amounts of debt, their net worth has increased as a percent of after-tax income. Net worth has risen because of increases in real estate and stock prices. According to this optimistic view, net worth is a better indicator of households' financial health than debt. But Parenteau shows that the saving rate is relatively low by historical standards, even compared to other periods of high net-worth-to-disposable-income ratios.

If and when consumption retreats to more sustainable levels, the transition could be smooth or abrupt. Even a gradual fall in consumption could lead to a recession, Parenteau says. Estimates of consumer borrowing growth have already shown marked declines, and a more serious retrenchment could occur if banks decide to tighten their lending standards, as they often do in the early phases of a contraction.

Parenteau's portrait of an overextended economy is consistent with the work of Wynne Godley and other Levy Institute scholars. If correct, this picture calls for no less than a complete rethinking of economic policy.

The Economics of Outsourcing: How Should Policy Respond?

THOMAS I. PALLEY
Public Policy Brief No. 89
www.levy.org/pubs/ppb_89.pdf

A trend toward outsourcing of production and employment has generated some controversy in the United States in recent years. Some economists believe that, even though the immediate effect of outsourcing may be a loss of jobs in this country, the net benefits, including cheaper goods, are positive. Research Associate Thomas I. Palley, in a new Public Policy Brief, argues that the main effects of outsourcing involve a new regime of economic competition. The way to deal with this new constellation of economic power is by developing new rules and institutions, just as the United States implemented New Deal reforms in response to the socioeconomic developments of the early 20th century.

The effects of outsourcing are the latest in a series of developments in the world economy that began with the rise of multinational corporations in the 1950s and 1960s. In this period, corporations learned how to export state-of-the-art technology and production methods, and, for the first time, were able to subject U.S. labor to foreign competition. Later came the retail revolution: big-box stores began scouring the world for the cheapest prices. Outsourcing is the application of the retail sector's global sourcing model to manufacturing and services. All of these developments have put U.S. workers in competition with two billion workers around the world, putting downward pressure on wages, benefits, and working conditions.

The rise in competition for jobs has important macroeconomic consequences. First, it has generated increasing income inequality in almost all countries; in particular, in the United States, upper-income managerial workers gained at the expense of lower-level workers in the 1980s and 1990s, and since 2000, the profit share has increased. Another impact is that many industries around the world depend on export demand rather than a domestic market, meaning that incentives are strong to keep wages down. This retards the development of strong domestic demand and raises questions about what might happen to companies around the world if U.S. demand declined significantly. So far, the deflationary pressures generated by this situation have been held in check by heavy consumer borrowing and stock market and housing bubbles—phenomena that may prove unstable.

The solution to these problems lies in institutionalist and Keynesian economics. The work of John Maynard Keynes showed the importance of stimulative macroeconomic policies under deflationary conditions. The American institutionalists held that competition could be destructive and wasteful and must be held in check—an important insight now that a "race to the bottom" is under way. Some of the specific suggestions made by Palley include: worldwide labor standards, strong unions, the prevention of competitive devaluation (beggar-thy-neighbor exchange rate policies), investment in education, and job-loss assistance.

New Working Papers

Methodology and Microeconomics in the Early Work of Hyman P. Minsky

JAN TOPOROWSKI
Working Paper No. 480
www.levy.org/pubs/wp_480.pdf

The Levy Institute recently published the Ph.D. dissertation of the late scholar Hyman P. Minsky. Jan Toporowski of the School of Oriental and African Studies, University of London, and the Centre for the History and Methodology of Economics at the University of Amsterdam reviews the contribution of this important but, until now, little-studied work.

Minsky is well known for his studies of macroeconomics and for his thesis of financial fragility. But his dissertation emphasizes somewhat different matters: methodology and the microeconomic foundations of business cycle theory. The insights developed in Minsky's dissertation may be seen as the foundation of his later, better-known work.

In the first two chapters, Minsky critiques several theories of the business cycle. He argues that business cycle theory should be based on analyses of economy-wide variables and firm- and market-level behavior. He finds empirical support for a "stochastic coefficient" model, in part based on the "irregularity" and "nonsymmetry" of economic fluctuations. Models by Richard Goodwin and John Hicks are criticized for their lack of foundations in the theory of individual firms. Minsky also faults models that posit a mechanical relationship between output, or sales, and investment. In his view, this "accelerator" relationship actually varies over time.

Minsky's analysis of the behavior of firms emphasizes their needs for finance and their balance sheets, a key theme in his later macroeconomic work. For Minsky, market structure, including the level of competition in each industry and the pricing power of individual firms, was an important factor in business cycles. In particular, firms in concentrated industries would not rapidly increase their investment in capacity as demand increased. Moreover, the ability to finance investment was an important but neglected variable. Minsky rejected the more conventional analyses of imperfect competition that had been developed by Joan Robinson and Edward Chamberlain, because of what to him was their unjustified assumption of profit maximization. Minsky believed that monopolies and near monopolies would restrain their prices below profit-maximizing levels in order to fend off new market entrants.

Toporowski points out the surprising fact that Minsky makes little reference in his dissertation to one of his most important undergraduate mentors, Henry Simons of the University of Chicago. It was Simons who introduced Minsky to the notion that the financial system in the United States was structurally flawed and that it contributed to the Great Depression. Simons blamed financial problems not on unstable monetary policy, but on overly liberal private banking practices. He argued that the fiscal authorities should control monetary policy and that commercial banks should be required to hold reserves equal to 100 percent of their deposits.

In the final chapter of the dissertation, Minsky argues that the accelerator relationship depends upon the cooperation of the monetary authorities—that investment cannot grow without a concomitant expansion of the money supply.

An Inquiry into the Nature of Money: An Alternative to the Functional Approach

ÉRIC TYMOIGNE
Working Paper No. 481
www.levy.org/pubs/wp_481.pdf

There is a long tradition in economics of defining money by certain functions it performs in society, such as a means of exchange. In a new working paper, Éric Tymoigne of Fresno State University argues that money must be defined not by its functions, but by its inherent characteristics.

Tymoigne begins by discussing the characteristics of a monetary *economy*: 1) the existence of a mechanism to record transactions; 2) a social unit of account, that is, one that is widely recognized as the unit in which debts and credits are kept; 3) tools called financial instruments that record debts and credits; 4) generally accepted financial instruments called monetary instruments; and 5) sometimes a hierarchy of financial instruments, with one issuer (or a small number of issuers) whose debts are usually used to clear accounts.

Money is a specific form of financial instrument, with certain features: its maturity is instantaneous (unlike a bond, which is repaid over time); it is always accepted at par value; and it is impersonal (i.e., it lacks the name of the creditor who created it). Moreover, its payment capacity is infinite, meaning it is always accepted by sellers.

Tymoigne goes on to address a number of specific points raised by his analysis of the nature of money. He shows that the definition of "money" has often been in the eye of the beholder; the history of economics has seen many debates over whether items such as checks or bank notes count as money. Tymoigne believes that while checks are certainly financial instruments, they fail to qualify as money. He notes that debts can be settled using many different forms of payment; for this reason, "means of payment or discharge of debts" is an overly broad definition of money. He discusses several "special-purpose monies," discovered in various societies, that were apparently used for compensating debts incurred, according to one author, "not as a result of an economic transaction, but of events like marriage, killing, coming of age, being challenged to potlatch, joining a secret society, etc." Tymoigne comes to the conclusion that most of these objects were not truly monies, partly because they were not denominated in a unit of account.

Next, the author discusses the difference between "flat" and "pyramidal" monetary systems. In the latter, some forms of money are merely promises to pay an amount of some "higher" form of money at a later date. In "flat" systems, since money takes only one form, it is not a promise to pay something else but to accept the money in payment for a debt, such as taxes. Tymoigne argues that the "acceptance" of a financial instrument (or its ability to be exchanged for money) rests on the creditworthiness of the borrower, which in turn depends on the borrower's potential to obtain cash flows from others in the future. He also addresses situations in which all instruments denominated in a particular unit of account fall in value at once, because the unit of account is too easily obtainable. This may happen for a number of reasons, including lax credit standards.

Net Intergenerational Transfers from an Increase in Social Security Benefits

LI GAN, GUAN GONG, and MICHAEL HURD
Working Paper No. 482
www.levy.org/pubs/wp_482.pdf

An earlier version of this paper was presented at the Levy Institute conference "Government Spending on the Elderly," April 28–29, 2006. It is summarized on p. 6 of the July 2006 *Report.*

Fisher's Theory of Interest Rates and the Notion of "Real": A Critique

ÉRIC TYMOIGNE
Working Paper No. 483
www.levy.org/pubs/wp_483.pdf

The Fisher equation, named after the American economist Irving Fisher, is an important formula in neoclassical economics. It states that the nominal interest rate is equal to the real interest rate plus expected inflation. In this model, the nominal, or money, interest rate automatically rises as expected inflation increases. In a new working paper, Éric Tymoigne of Fresno State University provides a critique of this relationship.

The equation seems to make sense. The idea is that the real interest rate is determined by "real" factors, such as a willingness by savers to defer consumption and the productivity of capital. Investors have the opportunity to invest in goods, with a real rate of return equal to the real interest rate. They are also willing to buy or sell bonds, but if they expect inflation, they demand compensation in the form of a higher nominal interest rate on the securities, since their return is denominated in currency, not goods. When nominal interest rates include an appropriate "inflation premium," people are equally willing to hold real capital goods and bonds, so financial markets are in equilibrium.

Economist John Maynard Keynes criticized this notion on several grounds. First, when asset holders make investment decisions, they principally consider what the returns will be in nominal—not real—terms. Second, people do not hold in their portfolios real capital goods, or any other types of goods, as hedges against inflation. It is very difficult for individual investors to buy and sell real capital goods, as they are not traded in deep, liquid markets. Third, even if inflation is actually foreseen—which certainly does not always happen—the price of real goods will immediately fall to compensate. Hence, the nominal interest rate need not rise at all in response to expected inflation.

Keynes also was critical of extending theories about micro-level tradeoffs to the macro level. This is important, because Fisher and others often linked real interest rates to tradeoffs of current aggregate income for future aggregate income. Aggregate savings is denominated in money, not in terms of "real income." Nor does this sort of financial savings lead to increased output in the future; only investment in capital goods can accomplish this.

Fisher, according to Tymoigne, overemphasized the real value of cash flows. Many contracts, debts, and prices are stated in nominal terms, and people and institutions are therefore concerned with nominal returns when they make investment decisions.

Tymoigne examines the Fisher effect using U.S. data. He finds that interest rates and inflation in consumer goods prices were not correlated until about 1953, but that they have been directly related since then. Tymoigne attributes this fact to the Federal Reserve's responses to inflation. Also, several long-term relationships link the expected federal funds rate with other interest rates; interestingly, no long-run relationship exists between interest rates and expected inflation, and beginning in 1953, the federal funds rate caused the inflation rate, in the sense that lagged values of the former helped predict the latter.

Expensive Living: The Greek Experience under the Euro

THEODORE PELAGIDIS and TAUN N. TOAY
Working Paper No. 484
www.levy.org/pubs/wp_484.pdf

According to Theodore Pelagidis of the University of Piraeus and Taun Toay, a Bard College graduate and former Fulbright scholar, one phrase, seemingly more than any other, is on the lips of Europeans today: "Life is getting too expensive." A sense that the European Economic and Monetary Union (EMU) is at fault for recent increases in the cost of living across Europe has bred dissatisfaction with the euro, which has been especially intense in Greece. This paper investigates the causes of the rise in the cost of living in Greece, calling into question the notion that monetary unification is the culprit.

Problems can theoretically arise in areas that adopt a common currency, owing to the resulting necessity of a "one-size-fits-all" monetary policy. Economic shocks can strike particular countries and regions within a currency union. With monetary policy determined by the European Central Bank, a country such as Greece cannot respond independently to such local shocks. Greece may have been the victim of a number of "asymmetric shocks" in recent years, and the monetary union may have constrained the government's ability to respond.

Another way in which the EMU has affected prices is that the changeover to the new currency offered businesses an opportunity to raise prices, if only to "round up." There is controversy over the degree to which price gouging has occurred. Pelagidis and Toay argue that while one-off price increases may have occurred around the time of Greece's adoption of the euro, price increases would not be so pervasive if the economy were more competitive. "Rigidities" in product markets—such as monopolies and near monopolies, and burdensome regulations that fail to protect consumer interests—represent the biggest impediment to competition.

The adoption of the euro may have also exacerbated what is known as the "Pasha effect," or price hikes during periods of high seasonal demand. An example would be increased consumption of vegetables in the period before Orthodox Easter, which is known as Pasha, due to dietary restrictions. Since Greeks consume relatively few processed foods, the demand for fresh vegetables can easily outrun supply. The authors believe that people may overestimate the overall impact of such seasonal price increases on inflation, but that they are nevertheless important.

The bottom line is that Greeks have not enjoyed a notable rise in living standards since the country's adoption of the euro. At the lower end of the wage distribution especially, wages have not kept up with price increases. Unemployment stands at 9.7 percent, a problem that puts a damper on wage increases.

The authors next deal with the "Balassa-Samuelson effect." Economists Bela Balassa and Paul Samuelson posited that when foreign competition was introduced in tradable goods sectors, productivity would rise in those industries, raising incomes. People with higher incomes would then bid up the prices of goods and services not subject to foreign competition. But inflation has outpaced the Eurozone average even in tradable goods sectors. Moreover, the Greek economy is simply not open enough for the Balassa-Samuelson effect to be significant.

The Balance Sheet Approach to Financial Crises in Emerging Markets

GIOVANNI COZZI and JAN TOPOROWSKI
Working Paper No. 485
www.levy.org/pubs/wp_485.pdf

The financial and currency crises in Southeast Asia in 1997–98 have sparked a revival of interest in economic theories of such events. Hyman P. Minsky, who was a scholar at the Levy Institute for the last years of his life, was a pioneer in the area of financial crises, and his corpus has inspired many theorists of "the Asian crisis." In this new working paper, Giovanni Cozzi and Jan Toporowski of the School of Oriental and African Studies at the University of London assess attempts to extend theories of financial crisis to emerging markets in general, and to the Asian case in particular.

Many of the new theories adopt Minsky's view that an analysis of the balance sheets of financial and nonfinancial firms is crucial to an understanding of financial crises. There are two versions of the so-called balance sheet approach, each of which has several shortcomings. The first branch of balance sheet theory puts financial markets at the center of the picture. Problems develop when investors panic and dump the bonds and stocks of an emerging economy, an event that usually leads to depreciation of the currency. Depreciation presents a problem because the debts of emerging countries are usually denominated in dollars or another reserve currency: a weaker domestic currency means that local borrowers must come up with more domestic money to meet a given obligation in dollars or any other "hard" currency. Other, similar theories lay the blame for financial crises on an increase in the asymmetry of information available to borrowers and lenders, which disrupts financial markets.

An alternative balance sheet approach to financial crisis in emerging markets is grounded in Minsky's classic work. Minsky divided firms into three categories based on the health of their balance sheets, especially the relationship of their assets to their liabilities. "Hedge finance" firms could reasonably expect to service their debt out of their revenues; "speculative finance" meant that a firm could pay its interest costs, but not its principal, out of revenues; and "Ponzi finance" implied that neither interest nor principal could be fully covered by ongoing income. When a firm reaches a condition of speculative or Ponzi finance, it relies on financial markets or banks to stay afloat, because it needs new loans merely to pay creditors. The Minskyan approach differs from the other balance sheet approach because it emphasizes problems that originate on the balance sheets of nonfinancial firms and spread to financial markets.

Cozzi and Toporowski are sympathetic to Minskyan scholars; however, they argue that the Minskyans have concentrated on one or two key issues, neglecting other aspects of financial crises. An important underemphasized issue, which Minsky himself did not always confront, is how the structure of nonfinancial business evolved along with the financial markets. Most Minskyan economists have circumvented this issue by imagining for the sake of analysis that the business sector is a single firm or as a group of identical firms, which could be understood collectively by analyzing a single, "representative" company. But developing economies are made up of both small- and medium-size firms, which are dependent upon finance from banks, *and* larger firms, which issue securities. It is only recently that small, emerging markets have had a significant "Minskyan sector" of position-taking firms that could undertake "balance sheet operations," such as issuing liabilities denominated in foreign currency.

The authors turn to empirical evidence on the financial condition of firms in the crisis economies of Indonesia, Malaysia, and Thailand in 1996–2004. They examine a number of financial indicators, including the ratio of debt to capital, of debt to assets, and of current assets to debt. The evidence confirms a financial weakening immediately before the crisis relative to Singapore and Hong Kong, two of the Asian economies that remained stable. It also shows that conditions varied significantly among the crisis countries, pointing to the danger of telling an all-encompassing story. Also, in Indonesia and Thailand, both assets and liabilities of nonfinancial firms increased prior to the crisis, implicating a loss of business revenue from exports and casting doubts on some theories that focus exclusively on liabilities.

Global Imbalances, Bretton Woods II, and Euroland's Role in All This

JÖRG BIBOW

Working Paper No. 486

www.levy.org/pubs/wp_486.pdf

A group of scholars has recently advanced the view that the enormous U.S. current account deficit reflects a renewal of the Bretton Woods system, which lasted from the period immediately following World War II until the early 1970s. In that system, the dollar was recognized as the world's reserve currency, and dollars tended to flow out of the United States, in return for goods from the "periphery" of the world economy—Western Europe and Japan. The United States benefited because it was able to consume more goods than it produced, while the periphery used the U.S. market to build its manufacturing base. Exponents of the "revived Bretton Woods hypothesis" argue that the current constellation of economic powers parallels the old Bretton Woods, with the United States again assuming the role of economic core, and Asian countries—especially China—now acting as the periphery. Seen in this way, the overvalued U.S. dollar and massive current account deficits serve an important function in fostering development abroad, and therefore may be more stable than some economists believe.

Research Associate Jörg Bibow of Skidmore College argues against the notion that a sharp devaluation of the dollar, especially vis-à-vis Asian currencies, should be the number one remedy for the U.S. deficit. Rather than an undervalued currency, steep reductions in unit production costs have been the primary fuel for China's export growth. A better solution would be to reduce the high saving rate of the Chinese private sector, which would increase imports and help Chinese firms find a domestic market for their products. It is important to realize that China's current account balance with the rest of the world was small until at least 2002, becoming a major imbalance relative to the size of the world economy only recently. Turning to the other Asian economic powers, Bibow points out that their current account balances with the United States have risen relatively little; moreover, their accumulations of foreign reserves have been primarily a precautionary measure against a replay of the currency crises of 1998–99 rather than part of a strategy of export-led growth. All in all, the sources of the world's imbalances are far more diverse than a Bretton Woods II thesis would have us believe.

Bibow contends that the external macroeconomic policies of the United States—a strong dollar and benign neglect of current account imbalances—are closely related to the pragmatic U.S. internal policies of stimulating domestic demand. The United States has used relatively expansionary monetary policy compared to the Eurozone (which has been obsessed with "sound money" polices), with the inevitable result of strong U.S. import growth and weak export markets. Hence, the Eurozone's economic growth will be highly dependent on foreign markets, unless and until domestic European demand is shored up. (Recent data show that the European economy may finally be reviving.) European Central Bank officials have denied their complicity in international imbalances and have in fact blamed many of their problems on the recent depreciation of the dollar against the euro. Contractionary European economic policies have their roots in Germany's former central bank, the Bundesbank, and will be difficult to reverse; this could cause problems if the United States were to stop acting as the world's "buyer of last resort."

Class Structure and Economic Inequality

EDWARD N. WOLFF and AJIT ZACHARIAS
Working Paper No. 487
www.levy.org/pubs/wp_487.pdf

Evidence exists that economic inequality among U.S. residents has increased over the past 25 years. Several explanations for this could potentially be offered. In a new working paper, Senior Scholars Edward N. Wolff of New York University and Ajit Zacharias investigate the extent to which class position was a cause of inequality in 1989 and 2000.

There are numerous definitions of class. While some describe the capitalist class as the owners and top management of large corporations or those among the self-employed who supervise at least a certain number of employees, Wolff and Zacharias contend that it is important to include in the capitalist class anyone with large amounts of financial wealth. Capitalists, in their definition, have at least $4 million in nonhome wealth or $2 million in business equity (2.0 percent of the civilian workforce in 2000). Households who do not meet these wealth thresholds are classified by occupational category: managers (13.0 percent); supervisors (5.8 percent); professionals (13.7 percent); white-collar skilled workers (6.1 percent); blue-collar skilled workers (8.7 percent); nonskilled workers (40.2 percent); and the self-employed (10.6 percent).

The authors use a comprehensive measure of economic well-being that the Levy Institute has developed in recent years. Notably, their yardstick includes income from wealth and in-kind government benefits and services, and subtracts taxes.

Perhaps because of the rise in the stock market in the years leading up to 2000, the capitalist class grew rapidly. Between 1989 and 2000, this group's economic well-being increased from $425,245 to $511,715. By comparison, those with less wealth were much worse off than the capitalists: managerial households had a median well-being of $69,021 in 2000, and the least well-off class, the nonskilled workers, had a median well-being of $42,749. How did people in the capitalist class obtain most of their income? Almost 85 percent of their total well-being came from the annuitized value of nonhome wealth.

The authors go on to discuss how class contributes to the extent of inequality in the distribution of well-being. In particular, they use an index to divide inequality into interclass and intraclass components. The interclass component will be relatively large if the classes are stratified—if their members are concentrated in separate ranges of the income distribution. This sort of separation does indeed divide the capitalists from most other households. The authors find that the entire increase in well-being inequality that took place from 1989 to 2000 was a rise in interclass inequality. In fact, the capitalists' share of aggregate well-being roughly doubled in that period.

Demand Constraints and Big Government

L. RANDALL WRAY

Working Paper No. 488
www.levy.org/pubs/wp_488.pdf

Many economists and business journalists are convinced that today's government budget deficits will eventually lead to economic ruin for the United States. In a new working paper, Senior Scholar L. Randall Wray of the University of Missouri–Kansas City and the Center for Full Employment and Price Stability argues that government's share of economic output must continually rise if economic stagnation is to be averted. The paper summarizes and provides support for work by Harold Vatter and John Walker, then examines the leading dangers to the U.S. economy today.

Mainstream economists believe that robust private investment in capital goods must be the basis for long-term growth. But they fail to recognize an important point raised by the Keynesian Evsey Domar over 50 years ago: high investment adds to productive capacity. Hence, following a period of high investment, more consumer and government demand is required simply to keep the economy running at or near capacity. If the government relies on private investment, it will experience chronic excess capacity and underemployment. This is what has sometimes happened in the United States since the 1970s, when the growth of the federal government was curtailed.

If government deficits are beneficial, rather than detrimental, to the economy's health, what are the key threats to prosperity in the United States? Wray cites five. First, government spending has stagnated since the 1970s, with the federal government scaling back financial help to states and localities, "reforming" Social Security, and ending welfare as we knew it. Politicians are unduly alarmed about the fiscal burden of providing for the baby boom generation in its old age. Second, tax revenues are growing rapidly—15 percent per year as of fall 2006. Third, in the absence of strongly stimulative fiscal policy and with the burden of large current account deficits, the economy has depended upon high consumer spending since the late 1990s; in fact, the private sector has spent more than its income in every year except one since 1996. It is doubtful that the U.S. consumer can maintain this pace of spending much longer. Fourth, while globalization offers benefits in the form of inexpensive goods, it may also undermine wages and employment in the United States. This would not be a problem if the government responded by filling the gap in aggregate demand, but instead policymakers remain vexed by the notion that the country is living "beyond its means." Fifth, a neoconservative economic ideology has gained currency in the United States, blocking needed public sector action.

During the Great Depression, the country learned the important economic lesson that "Big Government" is essential to a modern economy. Wray urges his readers not to forget this fact.

Fixed and Flexible Exchange Rates and Currency Sovereignty

CLAUDIO SARDONI and L. RANDALL WRAY

Working Paper No. 489
www.levy.org/pubs/wp_489.pdf

In this new working paper, Claudio Sardoni of the University of Rome "La Sapienza" and Senior Scholar L. Randall Wray of the University of Missouri–Kansas City and the Center for Full Employment and Price Stability examine various proposals for systems of fixed exchange rates, and argue that flexible rates are superior.

It is not surprising that many Post-Keynesians argue for a system of fixed exchange rates governed by an international central bank of some kind, since John Maynard Keynes was himself known for such a proposal. In the wake of World War II, Keynes proposed an international body that would help deal with current account imbalances and maintain fixed (but adjustable) exchange rates, partly on the grounds that this would be the only way to combat "beggar-thy-neighbor" devaluations. As a modern-day example, proponents of this type of system say that more should be done to combat undervalued exchange rates in the export-oriented economies of Asia. Instead of allowing individual nations to spur exports by cutting costs of production and undervaluing currencies, an "international Keynesian" system with a world central bank would, according to its proponents, encourage governments all over the world to support domestic demand, even as markets remained largely open.

Sardoni and Wray argue that such a system is not feasible or desirable in today's economic environment. A fixed exchange rate regime can ensure a nearly balanced current account only when capital is immobile—that is, people cannot invest across international borders. This condition has not been met for a number of decades in most of the world. Today's prevailing laissez-faire economic philosophy makes it unlikely that restrictions on capital flows could be reintroduced; too, technological change has eased financial transactions and rendered them more difficult to monitor. Moreover, even if it were feasible, a fixed-rate system would handcuff national economic policies, a constraint that would be disastrous in the absence of a "pie-in-the-sky" world economic agency or bank.

Sardoni and Wray's own analysis rests on the chartalist theory of money, to which Keynes himself subscribed. The theory says that the state has sovereign power to designate a "unit of account," and the physical objects or accounting entries that count as money, by choosing how tax liabilities can be paid. Hence, it can spend without first obtaining tax revenues or borrowing. Moreover, through a central bank, it can set the interest rate for creditworthy borrowers. From the perspective of the chartalist theory, setting fixed exchange rates is bad policy, because by doing so, the state forfeits the ability to set fiscal and monetary policy at the appropriate levels to ensure domestic full employment and moderate inflation. Sardoni and Wray illustrate these problems with examples from Argentina and the Eurozone.

Productivity, Technical Efficiency, and Farm Size in Paraguayan Agriculture

THOMAS MASTERSON

Working Paper No. 490

www.levy.org/pubs/wp_490.pdf

In a new working paper, Research Scholar Thomas Masterson examines the relationship between farm size and farm productivity and efficiency in Paraguay. This relationship has important policy implications: for example, what would be the effects on productivity of a redistribution of land from wealthy landholders to the poor?

Masterson uses the 2000–01 MECOVI dataset, which includes 8,131 households, as well as data on soil quality from the agriculture ministry of Paraguay. He employs several different methods to measure productivity and efficiency. First, he uses net farm income divided by farm size to determine "land productivity." Second, he finds a frontier, showing combinations of inputs and outputs for the farms that produce the most with the fewest inputs, and measures each of the other farms' distance from that frontier. Masterson's next method is to find an equation linking outputs to inputs, such as family labor, hired labor, and depreciation of capital stock. He then uses the unexplained residual in this equation for each farm as an efficiency measure.

Masterson finds interesting relationships between a farm's size and its productivity and efficiency of operation. Land productivity consistently falls as farm size increases. The author attributes this result in part to the need to get as much output as possible from each acre when the cultivated area is small. Using his frontier model, he finds that the relationship between farm size and efficiency is downward sloping at first, then rises for the largest farms. However, few farms in Paraguay are large enough to be on the upward-sloping segment of this curve. Masterson's third measure depicts falling efficiency as farm size rises. Masterson argues that these slightly differing results suggest that researchers cannot rely exclusively on any single measure of efficiency. Nevertheless, his central finding—the relatively high productivity of small farms—is consistent when the measurement is made in different ways, and confirms the findings of other social scientists.

Some of Masterson's other important findings show which factors other than farm size affect land productivity and efficiency. Security of land tenure seems to have an adverse effect on both, a finding that conflicts with both previous research and the strongly held beliefs of some economists. Also, high shares of household labor lower productivity and efficiency. In theory, household labor should require less supervision than hired hands. Masterson suggests that one explanation for this seeming anomaly is that a household's best workers tend to work for wages on farms owned by others. He concludes by noting that female land rights have no significant effect on land productivity or efficiency, and that households headed by single people are less efficient and productive overall.

Land Rental and Sales Markets in Paraguay

THOMAS MASTERSON

Working Paper No. 491

www.levy.org/pubs/wp_491.pdf

The redistribution of access to land from the rich to the poor remains an important issue in many countries. First, numerous studies have found that smaller farms are the most efficient. Second, access to land can lift households out of poverty. Third, conflicts, unrest, and violence over land would likely be reduced if land were distributed more widely and fairly.

How can the poor gain access to more land? The World Bank has worked to make land sales markets function "properly" by granting title to land, providing grants to buy land, and offering credit assistance. But the results of reforms urged by this and other international financial institutions have been mixed. In this new working paper, Research Scholar Thomas Masterson focuses on how rental markets affect the distribution of access to land in Paraguay.

In theory, rental markets that work well could remove some of the barriers to land access for less-well-off farmers. Land rental can be a stepping-stone to ownership, since renters may acquire savings in addition to farming experience. Masterson, however, argues that land rental cannot and has not improved distribution. He bases his arguments on an analysis of government data from the MECOVI survey of urban and rural households, which contains a great deal of information about land tenure, farm management, and production. The author's sample includes about 3,000 farms.

Masterson first looks at how rental markets affect land distribution, by comparing ownership and operational landholdings. The latter indicate who actually runs the farm, including those who rent. The data show that land is extremely unequally divided in terms of ownership. Renting has had a slight redistributive effect, but that effect waned between 1991 and 2001.

Examining the factors that determine participation in land markets, Masterson finds that one barrier faced by poor people who want to rent land is a lack of access to the credit needed to buy production inputs other than the land itself. He then asks how participation in land markets affects farm income. In Paraguay, land renters have higher net income on average than landowners, those who work loaned land, and the landless. Using a statistical technique to control for other variables, Masterson finds that the mere fact of participation in land or rental markets has no significant effect on net income.

The author's findings indicate that credit must be distributed widely and democratically in order for land rental to achieve equitable redistribution. However, the political barriers to gaining access to credit for small farmers may be just as intractable as those facing the redistribution of land ownership.

Levy Institute News

New Senior Scholars

The Levy Institute welcomes **Jan Kregel** as senior scholar and director of its Monetary Policy and Financial Structure program. Kregel is distinguished visiting research professor at the Center for Full Employment and Price Stability of the University of Missouri–Kansas City. He was formerly chief of the Policy Analysis and Development Branch of the United Nations Financing for Development Office and deputy secretary of the U.N. Committee of Experts on International Cooperation in Tax Matters. Before joining the U.N., he was professor of economics at the Università degli Studi di Bologna and professor of international economics at Johns Hopkins University's Paul H. Nitze School of Advanced International Studies (SAIS); he also served as associate director of the SAIS Bologna Center from 1987 to 1990.

Kregel is the author of more than 160 papers and articles, which have been published in international academic journals including the *Economic Journal, American Economic Review, Journal of Economic Literature, Journal of Post Keynesian Economics, Economie Appliquée,* and *Giornale degli Economisti*, among other academic journals. His books include *Rate of Profit, Distribution and Growth: Two Views*, 1971; *The Theory of Economic Growth*, 1972; *The Reconstruction of Political Economy*, 1973 and 1975 (2nd ed.); *Theory of Capital*, 1976; *Origini e Sviluppo dei Mercati Finanziari*, 1996; and most recently, *International Finance and Development* (with J. A. Ocampo and S. Griffith-Jones), 2006.

Kregel studied primarily at the University of Cambridge, and received his Ph.D. from Rutgers University. He is a life fellow of the Royal Economic Society (U.K.), an elected member of the Società Italiana degli Economisti, and a distinguished member of the Asociacion Nacional de Economistas de Cuba.

Nilüfer Çağatay, formerly a research associate with the Gender Equality and the Economy program, has become a senior scholar, and will be working with Rania Antonopoulos toward the creation of a Center on Gender, Macroeconomics, and Globalization within the Institute.

Çağatay is associate professor of economics at the University of Utah, Salt Lake City. Her recent work has focused on gender and development; international trade theories; and on engendering macroeconomics and international trade theories and policies. In 1994, she cofounded the International Working Group on Gender, Macroeconomics, and International Economics (GEM-IWG). Between 1997 and 2000, she was economic advisor at the Social Development and Poverty Elimination Division of the United Nations Development Programme in New York.

Çağatay holds a B.A. in economics and political science from Yale University and an M.A. and a Ph.D. in economics from Stanford.

New Research Scholar

Thomas Masterson has joined the Levy Institute as a research scholar working chiefly on the Levy Institute Measure of Economic Well-Being within the Distribution of Income and Wealth program. Masterson has in the past worked as a consultant on rural economic development for the United Nations Development Programme and the World Bank, and was formerly assistant professor of economics at Westfield State College in Massachusetts. His specific research interests include the distribution of land, income, and wealth.

Masterson received a Ph.D. in economics from the University of Massachusetts, Amherst.

New Editor

Barbara Ross has joined the Levy Institute as an editor. She will review all Institute public documents and develop an overall style for published Institute research. Ross has served as an editor at *Forbes* magazine, as well as *Artforum*. At The Museum of Modern Art in New York, she was editor of the annual journal *Studies in Modern Art* and also oversaw editing of the museum's pilot website. She has been an educational researcher, archivist, and rare books cataloguer. Ross was educated at Rhodes College in Memphis, Tennessee, and at Columbia University.

Publications and Presentations

Publications and Presentations by Levy Institute Scholars

PHILIP ARESTIS *Senior Scholar*

Publications: "The New Attitudes about Inflation" (with J. McCombie and W. Mosler), *Challenge: The Magazine of Economic Affairs*, Vol. 49, No. 5, September/October 2006; "Fiscal Policy Matters" (with M. Sawyer), *Public Finance*, Vol. 54, Nos. 3–4, October 2006; "The Role and Nature of Monetary Policy When Money Is Endogenous" (with M. Sawyer), *Cambridge Journal of Economics*, Vol. 30, No. 6, November 2006; "Monetary Policy When Money Is Endogenous" (with M. Sawyer) in *Complexity, Endogenous Money, and Macroeconomic Theory: Essays in Honour of Basil J. Moore*, M. Setterfield, ed., Cheltenham, U.K.: Edward Elgar, 2006; *Growth and Economic Development: Essays in Honour of A. P. Thirlwall* (with J. McCombie and R. Vickerman, eds.), Cheltenham, U.K.: Edward Elgar, 2006; *A Handbook of Alternative Monetary Economics* (with M. Sawyer, ed.), Cheltenham, U.K.: Edward Elgar, 2006.

Presentations: "Monetary Policy in the U.K." (with A. Angeriz) and "EMU Economic Policy Perspectives," 10th international conference of the research network Alternative Macroeconomic Policies, titled "European Integration in Crisis," Berlin, October 27, 2006; "The Channels through which Financial Liberalization Influences Poverty" (with A. Caner), meeting of the Association for Evolutionary Economics, annual Allied Social Science Associations conference, Chicago, January 5; "New Consensus Macroeconomics and the ECB Macromodel," 33rd Annual Conference of the Eastern Economic Association, New York, February 24.

WYNNE GODLEY *Distinguished Scholar*

Publications: *Monetary Economics: An Integrated Approach to Credit, Money, Income, Production, and Wealth* (with M. Lavoie), New York: Palgrave Macmillan, 2007; "A Simple Model of Three Economies with Two Currencies: The Eurozone and the USA" (with M. Lavoie), *Cambridge Journal of Economics,* Vol. 31, No. 1, January.

CAREN GROWN *Senior Scholar*

Publication: "Non-Governmental Organizations" in *The New Palgrave Dictionary of Economics,* Second Edition, L. Blume and S. Durlauf, eds., London: Palgrave Macmillan, 2007.

Presentations: "Putting Women at the Center of Development," Earth Institute Sustainable Development Seminar, New York, December 8, 2006; "The Financial Requirements of Achieving Gender Equality and Women's Empowerment," paper presented at IAFFE-URPE panel, meeting of the American Economic Association, annual Allied Social Science Associations conference, Chicago, January 5; "Gender and Development: Some Reflections on 30 Years of Research," Young Women in International Development Group, New York, January 23; "Poverty from a Gender Perspective," keynote speaker, International Planned Parenthood Association annual donor meeting, London, January 26; "Taking Stock of MDG 3: Progress and Way Forward" and "Achieving Gender Equality: How to Accelerate Progress and How Much Does It Cost?" African Development Bank Seminar on Gender and the MDGs, Tunis, February 8; "Gender Equality, Poverty, and the Millennium Development Goals," School of Development Studies, University of KwaZulu-Natal, Durban, South Africa, February 28.

GREG HANNSGEN *Research Scholar*

Publications: "The Transmission Mechanism of Monetary Policy: A Critical Review" in *A Handbook of Alternative Monetary Economics*, P. Arestis and M. Sawyer, eds., Cheltenham, U.K.: Edward Elgar, 2006; "A Random Walk Down Maple Lane: A Critique of Neoclassical Consumption Theory with Reference to Housing Wealth," *Review of Political Economy*, Vol. 19, No. 1, January.

DIMITRI B. PAPADIMITRIOU *President*

Presentations: Interview regarding the Federal Reserve year in review with Greg Robb, MarketWatch.com, November 27, 2006; interview regarding Greek banks' expanding their operation in Turkey with Özer Turan, *Turkishtime*, December 12, 2006; interview regarding dollar reserve holdings of central banks in China and other Asian economies with Steven Johnson, Reuters, January 10; interview regarding the impact of growing debt on the economy with Michael E. Kanell, *Atlanta Journal-Constitution*, February 27.

L. RANDALL WRAY *Senior Scholar*

Publications: "Money: An Alternative Story" (with E. Tymoigne) in *Handbook of Alternative Monetary Economics*, P. Arestis and M. Sawyer, eds., Cheltenham, U.K.: Edward Elgar, 2006; introduction and new chapter for the Spanish-language edition of his book *Understanding Modern Money* (2003), *El Papel Dinero Hoy: La Clave del Pleno Empleo y la Estabilidad de Precios*, trans. G. Feher, Mexico, D.F.: Universidad Nacional Autonoma de Mexico, 2006; "What a Long, Strange Trip It's Been: Can We Muddle Through without Fiscal Policy?" (with S. Kelton) in *Post-Keynesian Principles of Economics Policy*, C. Gnos and L.-R. Rochon, eds., Cheltenham, U.K.: Edward Elgar, 2006.

Presentations: "Demand Constraints, Secular Stagnation, and Big Government: The Contributions of Harold G. Vatter," Harold Goodhue Vatter Memorial Lecture in Economics, Portland State University, Oregon, October 25, 2006; "Veblen's Theory of Business Enterprise and Keynes's Monetary Theory of Production," meeting of the American Economic Association, annual Allied Social Science Associations conference, Chicago, January 7; interview regarding the twin deficits with Peter Coy, *BusinessWeek*, February 21; "Credit Money, State Money, and Endogenous Money Approaches" (with P. Tcherneva, presenter), Eastern Economic Association annual conference, New York, February 23.

EDWARD N. WOLFF *Senior Scholar*

Publications: Review of *Means-tested Transfer Programs in the United States*, edited by Robert A. Moffitt, in *Eastern Economic Journal*, Vol. 32, No. 2, Spring 2006; "The Global Distribution of Household Wealth" (with J. Davies, S. Sandström, and A. Shorrocks), *Wider Angle*, No. 2006/2.

Presentations: Press briefing on the study "The World Distribution of Household Wealth," United Nations University, New York, December 5, 2006; interview regarding the status of U.S. wages with Liz Claman, *Morning Call*, CNBC, December 27, 2006.

AJIT ZACHARIAS *Senior Scholar*

Presentation: "Class Structure and Economic Inequality," Department of Economics, University of Utah, Salt Lake City, December 14, 2006.

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