The Levy Economics Institute of Bard College

# Summary

**Spring 2006** **Vol. 15, No. 2**

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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 issues that profoundly affect the quality of life in the United States and abroad.

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## Contents (continued)

## LETTER FROM THE PRESIDENT

### To our readers:

This issue begins with a strategic analysis by Research Scholars Edward Chilcote and Gennaro Zezza, and me under the state of the U.S. and world economies program. If house price appreciation and private sector borrowing subside, government spending and foreign deficits must increase in order to maintain current growth and employment levels. Such fiscal policy implies a government deficit that may not be politically feasible, so the remaining alternative is policy aimed at addressing the U.S. trade imbalance. Distinguished Scholar Wynne Godley and Marc Lavoie develop a formal model of a complete economic system that is rooted in a realistic accounting framework and post-Keynesian theory. They conclude that the fiscal stance must grow at the same rate as the economy or there will be devastating consequences for aggregate demand and the financial system.

Under the distribution of income and wealth program, Research Associate Stephanie Seguino observes that gender and ethnic inequalities can stimulate economic growth by producing positive demand-side effects. She concludes that countries can choose to pursue various macro policies and mechanisms, so that equity and growth are compatible. In another working paper, Daniel S. Hamermesh finds that in 2003 the average U.S. household devoted much less time to the commodity "eating" than it did in 1985. Research Associate Indira Hirway reviews the National Employment Guarantee Act in India. While the act should be used as a tool to promote pro-poor growth of the Indian economy, the scheme will fail without a government strategy to assist the poor against vested interests, she says. Lyn Craig reviews the Australian time-use survey and finds that the time spent in activities with children does not decline when mothers enter the labor force. Using the American and U.K. time-use surveys, Charlene M. Kalenkoski, David C. Ribar, and Leslie S. Stratton find no evidence that married, cohabiting, and single mothers allocate different amounts of time to child care. In a new working paper, I review the distributional effects of government policies in the United States and other countries and find that state-sponsored retirement programs are the most important mechanisms for achieving redistributive outcomes and reducing income inequality.

Under the gender equality and the economy program, Ebru Kongar analyzes the wage and employment effects from increased import competition in manufacturing during the pre-NAFTA period. She finds that any apparent gains regarding discrimination and gender equality during the 1980s were illusory. The reduction of the wage bill was achieved through disproportionate layoffs of low-wage women and outsourcing.

The program on economic policy for the 21st century begins with a working paper by Giuseppe Fontana and Alfonso Palacio-Vera. The authors recommend a "flexible opportunistic" approach to monetary policy that minimizes the possibility of policy-induced economic recessions and does not have permanent effects on output and employment. C. Sardoni and Senior Scholar L. Randall Wray find that fiscal policy constraints in euroland have led to low growth and high unemployment, and that monetary and inflation targeting are neither compatible nor achievable. These constraints carry the possibility of a catastrophic financial crisis and pose problems for sustaining the unification of Europe, they say. In a policy note, Chilcote addresses the potential for a major credit-derivatives debacle of the type that was averted in 1998 with the Long-Term Capital Management crisis. In another policy note, Senior Scholar James K. Galbraith maintains that the true threat to the weak U.S. economic expansion is a financial reversal of the private sector should interest rates rise much higher or real estate prices fall dramatically. A working paper by Bruce Fallick, Charles A. Fleischman, and Research Associate James B. Rebitzer identifies the presence of hypermobility in Silicon Valley's information technology clusters as a result of the ban on noncompete agreements under California state law.

Under explorations in theory and empirical analysis, Research Associate Korkut A. Ertürk focuses on Keynes's insights about asset price speculation and its link to monetary circulation in Keynes's *Treatise* (1930), and finds continuity and complementarity of thought with Keynes's *General Theory* (1936). In another working paper, Wray examines Keynes's approach to money and concludes that, in lieu of Keynes's bancor plan, sovereign currencies and floating exchange rates are the best ways to achieve fiscal and monetary domestic policy independence and full employment. Kaye K. W. Lee examines how behavioral and personality traits affect employer responses in the workplace. He finds that memes are very influential and limit the scope of normal optimization within economic theory.

As always, I welcome your comments and suggestions.

Dimitri B. Papadimitriou, *President*

# Program: The State of the U.S. and World Economies, and Strategic Analysis

## Are Housing Prices, Household Debt, and Growth Sustainable?

DIMITRI B. PAPADIMITRIOU, EDWARD CHILCOTE, and GENNARO ZEZZA

Strategic Analysis, January 2006

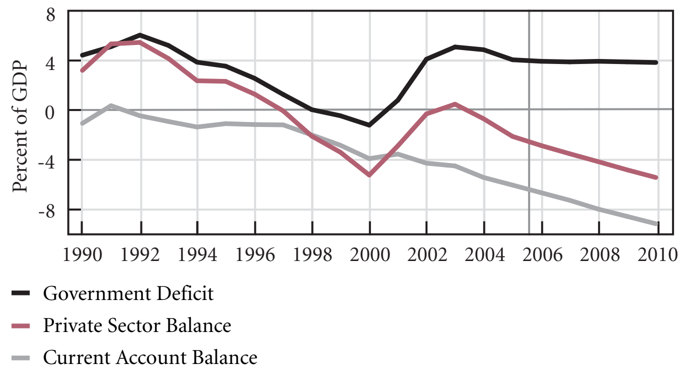
www.levy.org/pubs/sa_jan_06.pdf

Previous strategic analyses have pointed out that net lending to the personal sector and the ability of consumers to spend at high rates relative to their income cannot be sustained. In this analysis, President Dimitri B. Papadimitriou and Research Scholars Edward Chilcote and Gennaro Zezza focus on the residential real estate market and its effect on household spending, economic growth, and sectoral balances. Their analysis suggests that much of the recent growth in GDP can be attributed to house price appreciation and private sector borrowing. However, rising house prices have not improved the equity position of households. The authors conclude that a decline in house prices and a reduction in borrowing will slow GDP growth. Increased government spending to maintain existing growth and employment levels means that government and foreign deficits must increase.

The authors note that contrary to warnings by some economists and central bankers, [former] Federal Reserve chairman Alan Greenspan maintained that high real estate prices do not pose a significant risk to growth. They also note that many economic indicators suggest that houses are overpriced (e.g., the price-to-annualized rent ratio, the financial obligations ratio for renters, and the rental vacancy rates are all high). Combined with low affordability, these indicators suggest that it is unlikely house prices will continue to appreciate at recent rates.

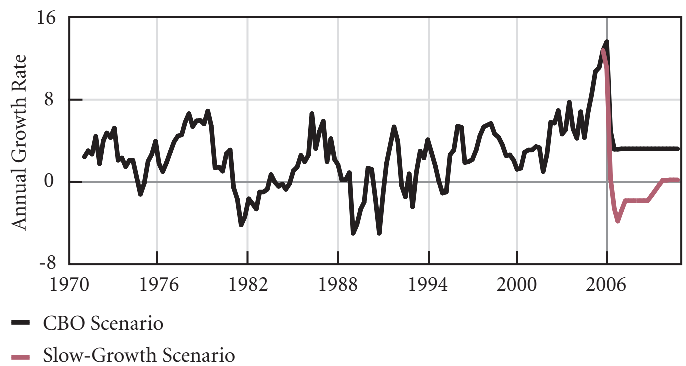
The debt burdens of U.S. households continue to rise despite low interest rates and have reached unprecedented levels (13.5 percent of personal disposable income in the third quarter of

**Figure 1** CBO Scenario: Main Sector Balances



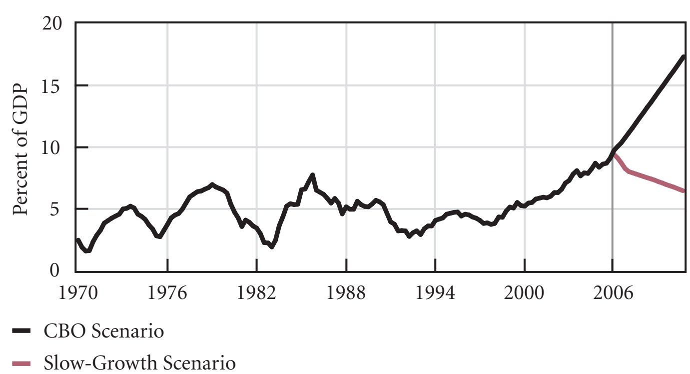

*Sources:* BEA and authors' calculations

**Figure 2** Real Median Price of Existing Family Homes



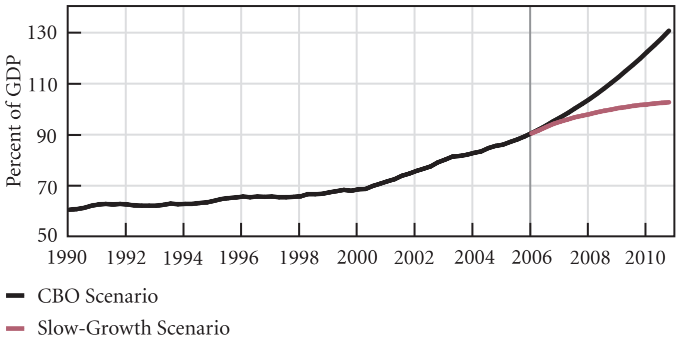

*Sources:* National Association of Realtors, BEA, and authors' calculations

**Figure 3** Household Borrowing



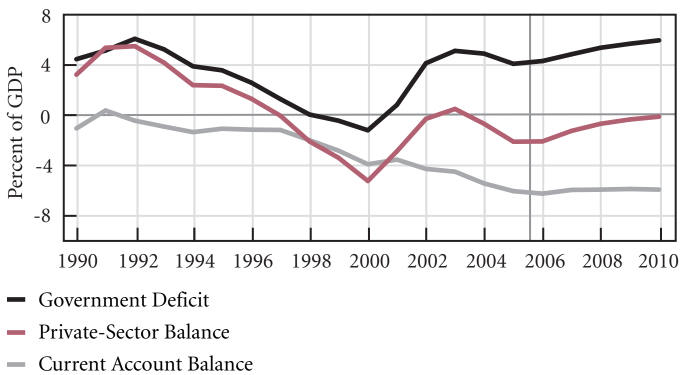

*Sources:* Federal Reserve, BEA, and authors' calculations

**Figure 4** **Household Debt Outstanding**



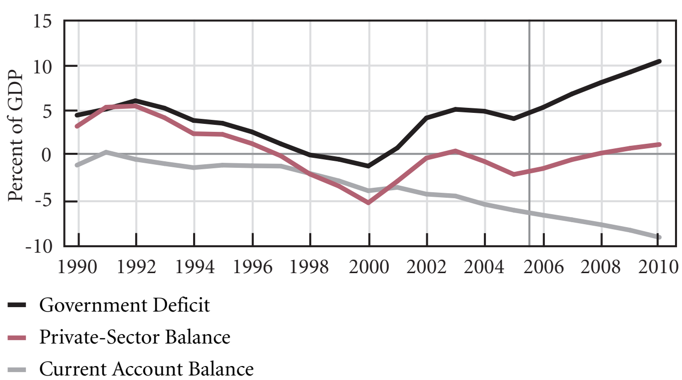

*Sources:* Federal Reserve, BEA, and authors' calculations

**Figure 5** **Slow-Growth Scenario: Main Sector Balances**




*Sources:* BEA and authors' calculations

**Figure 6** **Fiscal-Policy Scenario: Main Sector Balances**




*Sources:* BEA and authors' calculations

2005). Evidence from the Flow of Funds data suggests that household liabilities have risen more rapidly than household financial assets (the household sector's financial asset-to-liability ratio hit an historic low in the third quarter of 2005). Given the highly leveraged position of households, the authors find that even a modest drop in housing prices (e.g., 20 percent) would reduce household equity (wealth) considerably (i.e., by 35 percent). Rising house prices and low interest rates have stimulated many homeowners to use cash-out refinancing for consumption spending. However, since households are now financially stretched, falling or flat housing prices will reduce their capacity to borrow and spend.

The authors outline a series of missteps that may have contributed to the excessive growth in housing prices, household borrowing, and household spending: adjustable rate mortgages in place of traditional mortgages (in response to Greenspan's counsel); falling credit standards; and continued low interest rates in spite of higher risk. Nontraditional mortgages such as interest-only adjustable rate mortgages can lead to an unexpected rise in debt-service requirements, say the authors. They observe a positive correlation between household borrowing and the growth in real home prices, and note that housing markets in other countries (e.g., the Netherlands, Great Britain) have declined when output growth has slowed.

The authors explore the implications of plausible changes in housing prices on the projected growth path of the internal- and external-sector balances of the U.S. economy over the next five years using the August 2005 Congressional Budget Office (CBO) projection as its base case scenario (Figure 1). The base case assumptions mean that the public and external sectors will not provide additional stimulus to growth, so only increased private spending relative to income will stimulate GDP. However, the growth path projected by the CBO (the private sector deficit grows to more than 4 percent of GDP and the government deficit stabilizes below 4 percent of GDP) requires an unprecedented household debt-to-income ratio.

The authors estimate the impact of an 8-percent drop in house prices relative to the general price index over a period of three years (a pattern similar to the downturn during the early 1980s). Figure 2 compares the projected path of real housing price growth rates for a slow-growth scenario with the base case, under the assumptions that household borrowing declines slowly and household debt as a share of GDP stabilizes by the end of the simulation period (Figures 3 and 4). Using these assumptions, the cumulative drop in GDP is more than 5 percent. The authors believe that the private sector will move back to balance (Figure 5), a trend that slows growth in output and increases unemployment. This trend can only be countered by fiscal policy unless action is taken to stop the decline in demand for domestically produced goods and services.

Another scenario is an increase in general government spending to counterbalance the reduced demand stemming from a fall in private expenditure (Figure 6). The private sector balance returns to surplus, the current account balance continues to deteriorate, and the government deficit must reach 10 percent of GDP if unemployment is to stay at the same level as the CBO's base case. Fiscal policy aimed at sustaining growth and employment implies a government deficit that may not be politically feasible, observe the authors. The remaining alternative, as suggested in previous strategic analyses, is policy aimed at addressing the U.S. trade imbalance.

## Prolegomena to Realistic Monetary Macroeconomics: A Theory of Intelligible Sequences

WYNNE GODLEY and MARC LAVOIE
Working Paper No. 441, February 2006
www.levy.org/pubs/wp_441.pdf

Post-Keynesian methodologies are not grounded in rigorous and formal models of a complete economic system and are not capable of expression in well-articulated mathematical models. Based on the social accounting matrices of Richard Stone, Distinguished Scholar Wynne Godley and Marc Lavoie, University of Ottawa, outline a system of accounts that represents all major components of national income and flow of funds in combination with a system of behavioral relations. They contend that there are no equilibria (disequilibria) outside the financial markets and that the role of prices is to distribute the national income among wages, profits, and creditors, with inflation sometimes playing a key role in determining outcomes. The authors find that their model requires active management of fiscal and monetary policy in order to achieve full employment without inflation, as a result of complex interactions between real stocks and flows, inflation, and the evolution of financial variables.

Economies evolve in accordance with the diverse motivations, constraints, and resources of five sectors: firms, governments, households, banks, and a central bank. The authors' matrix describes the net transactions among the sectors (measured at current prices) and includes the national income identity, which comprises the major expenditure categories (government expenditure, personal consumption, and fixed investment) and the flows of factor income (wages and profits). The flow of funds shows how the balances among sectors have counterparts in terms of transactions in stocks of assets and liabilities (cash, money, government bills and bonds, loans, and equities). Godley and Lavoie note that decisions of firms regarding output, investment, prices, employment, and finance are either totally ignored or based on inaccurate assumptions in mainstream macroeconomic textbooks. Therefore, it is impossible to understand the essential role of money and credit in a modern industrial economy.

An alternative way of thinking about quantities and prices postulates that all decisions relating to consumption, fixed investment, inventory accumulation, and production are made in terms of physical quantities, and that prices and costs are denominated as dollars per unit. Equivalence is achieved by using relative prices in a base year, so that changes in aggregated quantities are the same as conventional measures. Aggregate supply and demand are brought into equivalence via a quantity adjustment process rather than the price adjustment process common to mainstream macroeconomic theory.

Credit money is a flexible component in the wealth allocation process that gives signals in much the same way as inventories give signals to firms. The authors outline an arithmetical example of how the monetary interrelationships work. If households change asset preferences, they posit, seven simultaneous changes must occur in the balance sheets of commercial banks, the central bank, and government. The equality between the supply and demand of bills from and to banks is the identity that validates the authors' structure. In the model, banks can choose rates of interest on money and loans (relative to the exogenous bill rate of interest) in order to generate profits while simultaneously respecting the interest rate hierarchy, namely, that the loan rate exceeds the bill rate, which exceeds the money rate.

The baseline solution to the model extends over 50 years, during which period all stocks and flows rise at a rate of 3 percent per annum, and nominal wage rates, normal productivity, and prices rise at 4 percent, 3 percent, and 1 percent, respectively. A major conclusion relates to the conduct of fiscal policy, where the fiscal stance must grow at the same rate as the economy (except in the very short term). Otherwise, the budget balance explodes or collapses, and there are devastating consequences for aggregate demand and the financial system. A steady state budget deficit is determined by private net saving (rather than the other way around), and the budget must be (normally) in deficit. This conclusion is inconsistent with the assumption of some politicians that the budget balance should be zero.

The model shows that increasing the nominal bill of interest will initially have a negative effect on output, but that will more than reverse itself as a result of an increase in the flow of interest payments by government. An increase in the bill rate causes banks to raise the money rate of interest and the loan rate in order to preserve profits. A rise in government expenditures results in a smaller rise in real output, as inventory accumulation turns negative in response to the (unexpected) shock. Total output then rises to twice the rate of government expenditures as inventory accumulation recovers in combination with the multiplier effects on investment. As interest payments by government rise, the real fiscal stance of government also rises and generates a recovery that more than compensates for the initial downturn. The inventory adjustment process readily reconciles actual with expected sales, and the money creation (destruction) process does the same thing for misleading expectations about personal income.

The model defies the ridiculous assumption in mainstream macroeconomic textbooks that the quantity of credit money is determined by the money multiplier, say the authors. A rise in the fractional reserve ratio has no immediate effect on the money stock, as banks raise their cash reserves by buying bills, which initially reduces the liquidity ratio. Banks then raise the money and loan rates of interest to restore the liquidity ratio, which raises the stock of credit money. In terms of capacity utilization, a rise in the fiscal stance generates a net addition to aggregate demand and the whole system eventually achieves a new (growth) steady state.

The authors note that their model includes some major simplifications, such as no foreign trade or lending to households. They also note that the model is rooted in a solid, comprehensive, and realistic accounting framework, and accords with facts backed by theory that is grounded in the post-Keynesian tradition.

# Program: Distribution of Income and Wealth, and the LIMEW

## All Types of Inequality Are *Not* Created Equal: Divergent Impacts of Inequality on Economic Growth

STEPHANIE SEGUINO

Working Paper No. 433, December 2005

www.levy.org/pubs/wp_433.pdf

Economic inequality within and between countries has widened over the past decades but research is inconclusive about its effect on growth and development. Research Associate Stephanie Seguino, University of Vermont, finds that growth can be enhanced or reduced depending upon the kind of inequality, the social and institutional environment, and the economic structure. She explores the different conceptual approaches to measuring inequality and finds that gender and ethnic inequalities can stimulate economic growth in the short to medium term by producing positive demand-side effects. Seguino concludes that countries can choose to pursue various macropolicies and mechanisms, so that equity and growth are compatible.

The literature hypothesizes three transmission mechanisms from household inequality to growth: (1) the effects on education and fertility (labor quality); (2) the impact of social conflict on macroeconomic policy; and (3) the incentive effects on wealth holders and business owners, including aggregate saving. Income inequality is linked to underinvestment in education and health care, land distribution, social discontent and political conflict, and poor macroeconomic policies. While most of the literature emphasizes the negative incentive effects of equality, empirical studies are not universal in claiming that inequality has a negative effect on growth.

Seguino notes that the mainstream literature pays little attention to the functional distribution of income (i.e., wages versus profits) as it affects output and growth, although this topic is a vibrant area of research among post-Keynesian and neo-Kaleckian scholars. She also notes that short-run, demand-side macroeconomic disturbances (e.g., prolonged unemployment) can produce long-run growth effects. Her review finds that the conditions under which an economy is wage- or profit-led are influenced by the structure of the economy, the stage of development, external relations with the rest of the world, and class-based differences in saving and consumption. The author expects, therefore, that the relationship between inequality and growth is not universal, but influenced by a country's history and economic structure.

The household and functional distribution of income are the dominant conceptual categories that are used to measure the effects of inequality on growth. Racial/ethnic and gender inequalities, however, do not fall neatly into either category. Unequal resource and income distribution between ethnic groups can place downward pressure on growth rates in the long run.

With regard to growth theory, gender divisions in accessing resources, labor segregation, human capital investments, and differential bargaining power in the labor markets and at home imply that short- and long-term effects of gender inequality on the macroeconomy depend on the structure of the economy. Seguino suggests that realistic growth models should incorporate the evidence that the labor supply is not determined exogenously but rather is a function of the gender distribution of earnings, resources, and power.

Seguino points out that total household income measures obscure gender inequality within the household (e.g., East Asian countries have the most equitable distribution of household income but a wide gender wage gap) and miss an important component of inequality that stimulates investment, exports, and growth in the short run. She notes that the interaction of race and gender can result in different types of macroeconomic effects, so growth is not limited to the household distribution of income.

Using a global data set and a subset of semi-industrialized countries, Seguino compares and correlates several measures of inequality. She finds that the gender wage gap is not strongly correlated with other measures of inequality or measures of gender gaps in capabilities, and that the correlation between educational and wage gaps is very weak. An interesting result is that both the gender wage gap and ethnic wage gap show a pronounced negative correlation. While cautious about the nature of the data, Seguino observes that gender and ethnicity play similar roles in the macroeconomy, depending on the ethnic makeup of society. In terms of cross-country regressions for the periods 1975–99 and 1990–99, income inequality has a negative effect on growth, as hypothesized in the literature, and the wage gap variable is significant and positive, indicating that an increase in gender wage inequality stimulates growth.

## Time to Eat: Household Production under Increasing Income Inequality

DANIEL S. HAMERMESH

Working Paper No. 434, January 2006
www.levy.org/pubs/wp_434.pdf

A summary of this working paper appears in session 1 of the write-up for the conference on time use and economic well-being in the Winter 2006 *Summary*, Volume 15, No. 1, pages 6–7.

## Enhancing Livelihood Security through the National Employment Guarantee Act: Toward Effective Implementation of the Act

INDIRA HIRWAY

Working Paper No. 437, January 2006
www.levy.org/pubs/wp_437.pdf

The National Rural Employment Guarantee Act passed by the Indian Parliament in 2005 was designed to enhance the livelihood of households in rural areas. According to Research Associate Indira Hirway, Centre for Development Alternatives, Ahmedabad, India, effective implementation of the employment guarantee scheme (EGS) requires a strong planning component and a well-designed implementation strategy. The EGS should be used as a tool to eradicate the worst kinds of poverty, empower the poor, and promote pro-poor growth of the Indian economy.

Hirway reviews the history of wage employment programs in India since its independence in 1961. She observes that the major objectives of past programs have been to generate employment for the poor and to create durable assets. She finds that the programs were somewhat unsuccessful, as the planning and implementation components were unsatisfactory in the short and long run (e.g., ad hoc decision making combined with an unproductive use of assets). The need for similar programs remains, however, due to the low growth rate of agriculture, greater environmental depletion and degradation, and a lagging rural economy. She further observes that the works associated with wage employment programs need to be labor intensive with a shift in focus toward natural resources.

Planning under the 2005 act will depend on how the EGS is designed at the national level (broad guidelines) and at the state level within existing guidelines set by the Rural National

Food for Work Programme (2004). The act proposes an elaborate multilevel planning component—from the national to the village level—in order to carry out its tasks. The panchayat, or local governing bodies, at the district, intermediate (block), and village levels are the principal authorities for planning and implementing works related to natural resource management and infrastructure (e.g., roads and water projects). Hirway notes that the act and the programme have instituted guidelines that the national and state-level EGS are expected to follow.

Construction of infrastructure requires a systematic and multilevel approach in order to identify and locate services at the optimal level and distance for all people, says Hirway. A service center plan involves the selection of minimum services at different levels of service centers, the selection of potential settlements as service centers, and the necessary linkages and involvement of people. The primary service center is expected to provide basic physical infrastructure and social services to ensure a minimum quality of life. The construction of facilities will generate considerable employment for the poor. The secondary and tertiary services (e.g., secondary schools and public health centers) at the block level will also have to be planned optimally by determining the hierarchy of service centers. An important aspect of ensuring livelihood to the poor through the EGS is to coordinate and integrate schemes with the local/regional economic development process.

Planning for natural resource management is also a multilevel task (e.g., water conservation at the village level needs to be compatible with macro watersheds). Hirway notes that the experiences of nongovernmental organizations have resulted in the Bhopal Declaration, which presents eight nonnegotiable principles of development and management of natural resources in a sustainable manner and which has important implications for the proposed EGS.

Labor is another important aspect of planning. Employment should align with the specific demands of the poor so that the poor seek the work offered and are protected from obstacles created by the rich. Hirway cautions that the political consequences of the EGS could be radical, as the EGS empowers the powerless and disturbs existing power structures. There is no government strategy, however, to assist the poor against vested interests, so it is urgent to address this situation or the EGA will fail along with previous measures.

It is important to realize that expectations about the act are very high, says Hirway. To ensure adequate government efficiency, she proposes local involvement in planning and implementing the EGS, concurrent monitoring and learning from the field, capacity building of all agencies, monitoring and evaluating the act and EGS, and a strong commitment and clear vision at the state level.

## Where Do They Find the Time? An Analysis of How Parents Shift and Squeeze Their Time around Work and Child Care

LYN CRAIG

Working Paper No. 439, February 2006

www.levy.org/pubs/wp_439.pdf

A summary of this working paper appears in session 2 of the write-up for the conference on time use and economic well-being in the Winter 2006 *Summary*, Volume 15, No. 1, page 7.

## Parental Child Care in Single Parent, Cohabiting, and Married Couple Families: Time Diary Evidence from the United States and the United Kingdom

CHARLENE M. KALENKOSKI, DAVID C. RIBAR, and LESLIE S. STRATTON

Working Paper No. 440, February 2006

www.levy.org/pubs/wp_440.pdf

A summary of this working paper appears in session 2 of the write-up for the conference on time use and economic well-being in the Winter 2006 *Summary*, Volume 15, No. 1, pages 7–8.

## Government Effects on the Distribution of Income: An Overview

DIMITRI B. PAPADIMITRIOU

Working Paper No. 442, February 2006

www.levy.org/pubs/wp_442.pdf

The costs and benefits associated with public goods and services are not distributed equally among citizens, and there is no consensus about the role of government to support social protection systems. President Dimitri B. Papadimitriou reviews a range of theories, findings, and applied policies that focus on issues of income distribution and well-being in his book *The Distributional*

*Effects of Government Spending and Taxation* (Palgrave Macmillan 2006). He finds that research on the distributional effects of government policy shows that government has a role to play in reducing inequalities and enhancing well-being.

The author notes that the provisioning of public goods and services can be classified into two broad categories: collective and private consumption goods that affect the entire population (e.g., defense and the judicial system) and individuals (e.g., education and health care), respectively. He also notes that it is difficult to quantify parameters relating to public finance projects, education, health care, basic needs, and externalities. He further notes that income distribution has always been a dominant concern of the public sector and that governments are empowered to achieve a more equitable distribution of income. Disparities among constituencies, however, result in differences in welfare state programs, unemployment and disability insurance, retirement benefits, special purpose subsidies and transfers, and public spending across countries and over time.

Redistribution became an important government function in the latter part of the 19th century (e.g., the first old-age pension system was instituted in Germany in the late 1880s). Following the Great Depression of the 1930s, the New Deal boosted expansionary government expenditures in the United States, including work-related and income-assisted programs. In the 1970s, public sector expenditure efficiency became a major topic in policy discussions and in economic research, which ultimately led to the development of performance and efficiency indicators, the assessment of institutions and rules, and the suggestion of optimal levels of government. Societies today play a crucial economic role in seeking to improve well-being and alleviate poverty, observes Papadimitriou. However, rising incomes, which have been associated with faster economic growth, have occurred in association with a marked increase in inequality as a result of reduced public expenditures in concert with legislative mandates for deficit reduction and "fiscal responsibility."

Papadimitriou outlines the results of various studies that shed light on the distributional effects of government policies in the United States and other countries. During the 1990s, Americans were taxed more than they received in benefits from either transfers or public consumption. The tax benefits of new or employer contributions to defined contribution retirement plans are skewed in favor of high-income households. State-sponsored retirement programs (e.g., Social Security) are the most important mechanisms for achieving redistributive outcomes. Baby boomers will likely have higher incomes and lower poverty rates than current retirees, but their replacement income rates will be lower than those suggested by financial planning advocates and many subgroups will be economically vulnerable (e.g., elderly divorced women). These results are an endorsement of activist government redistributive policies as effective instruments in reducing income inequality, says the author.

International comparisons of the effectiveness of key social programs are vital when assessing redistributive policies. Research shows extensive variations of results among European Union countries. For example, pensions can play a major or minor role in reducing inequality and, while nonmeans-tested benefits are important for the redistributive process, the reduction in inequality from these benefits varies significantly among countries. Finally, the effect of income taxes on reducing inequality is high in countries with the most equal distributions of disposable income.

Studies of Poland and Australia show that government intervention through the collection of taxes and distribution of benefits narrows the gap between rich and poor, while Korea's tax system shows some undesirable redistributive effects. Papadimitriou observes similar attitudes among the wealthy in all countries, as well as some controversial results, such as contributory pension plans that benefit the poor and economic integration that is not significantly linked with redistribution.

## Program: Gender Equality and the Economy

### Importing Equality or Exporting Jobs? Competition and Gender Wage and Employment Differentials in U.S. Manufacturing

EBRU KONGAR

Working Paper No. 436, January 2006

www.levy.org/pubs/wp_436.pdf

Studies of the impact of trade expansion on U.S. manufacturing show contradictory findings in terms of women's employment and the gender wage gap. Ebru Kongar, Dickinson College, Pennsylvania, examines the finding that discrimination against women in manufacturing declined during the 1980s. She pursues a gender- and class-differentiated analysis of wage and employment effects from increased import competition in manufacturing during the pre-NAFTA period (1976–1993). Kongar finds that the decline in gender wage inequality is most likely the outcome of job losses and wage adjustments in response to increasing imports in concentrated industries (e.g., computer/electronic products, motor vehicles, and primary metal manufacturing). There was an increase in women's wages without a concomitant increase in the relative demand for female labor. Any apparent gains regarding discrimination and gender equality were illusory.

Kongar notes that there is evidence suggesting that trade expansion has led to a decline in the relative demand for less educated and less experienced workers in the U.S. economy. There is also evidence that the relative demand for production workers compared to nonproduction workers has declined, but that the relative demand for women compared to men is uncertain. She also notes that U.S. trade studies have focused on skill rather than gender-wage differentials, that the 1976–1993 period had historically high unemployment rates in manufacturing (averaging 7.4 percent), and that there was a relative increase in the demand for skilled and nonproduction workers.

In regard to declines in low-wage occupations and employment in low-wage nonproduction occupations, women were more affected than men. Their share of manufacturing employment remained constant, but the occupational composition of the female workforce changed significantly as women moved out of low-wage production occupations into high-wage nonproduction occupations that were traditionally the domain of men.

Using the methodologies of Borjas and Ramey (*The Changing Distribution of Income in an Open U.S. Economy* 1994) and Black and Brainerd (*Industrial and Labor Relations Review* 2004), earnings and employment data from the Current Population Survey (March Annual Demographic Files), and trade data from the National Bureau of Economic Research (NBER), Kongar analyzes the underlying mechanisms that explain trade-related changes in gender wage differentials and searches for an alternative interpretation that is consistent across both concentrated and competitive industries. Her objective is to test the hypotheses that an increase in import competition causes a decline in the share of low-wage production workers among women and that it causes a rise in the average wages of women remaining in the labor force, thus narrowing the gender wage gap.

The results indicate that the increase in import competition reduced the gender wage gap in concentrated industries relative to competitive industries and closed the gap due to an increase in women's wages. The reduction in the wage bill was achieved through disproportionate layoffs of low-wage women and through outsourcing, which may have preserved some jobs for men, says Kongar. This result is consistent with the prediction that the increase in women's wages reflects changes in the occupational composition of the female workforce rather than an increase in relative demand for women due to declining gender discrimination. In competitive industries, the gender wage gap widened as a result of a decline in female wages. Overall, the results suggest that employers in concentrated and competitive industries reacted differently to increased import competition.

As expected, technological change widened the gender wage gap. The decline in unionization rates during the period also widened the gap. Contrary to Gary Becker's theory of discrimination (*The Economics of Discrimination* 1971), the findings show that the exposure of concentrated industries to increased import competition leads to defeminization of low-wage production occupations. Rather than indicating a reduction of discrimination against women, the closing of the gender wage gap may actually be associated with an increase in discrimination, observes Kongar. It is better to interpret increased international competition as a factor that increases job competition among, and decreases the relative demand for, low-wage production workers rather than as a factor that forces employers to reduce discrimination.

Kongar concludes that deindustrialization is unlikely to reduce the gender earnings gap in the U.S. economy. The differential impact of increased import competition on gender inequalities seems to arise from heavy outsourcing rather than the competitive structure of industry. She suggests that future research should focus on outsourcing activities rather than market structure in order to shed more light on the gendered outcomes of international competition. The empirical framework for manufacturing should account for both employment and earnings differentials by gender. Kongar also suggests that extending her analysis to include the post-NAFTA period might change the results.

# Program: Economic Policy for the 21st Century

## Financial Markets and Monetary Policy

### Are Long-run Price Stability and Short-run Output Stabilization All That Monetary Policy Can Aim For?

GIUSEPPE FONTANA and ALFONSO PALACIO-VERA

Working Paper No. 430, November 2005
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A central tenet of the new consensus view in macroeconomics is that inflation-targeting strategies do not affect unemployment, output, or other real variables in the long run. The policy implications of this view rely on the assumption that the trend movement in real output is independent from the level and time path of aggregate demand. Based on their review of theoretical and empirical research, Giuseppe Fontana, University of Leeds, United Kingdom, and Alfonso Palacio-Vera, Universidad Complutense de Madrid, Spain, find contrary evidence to this view. They therefore recommend a "flexible opportunistic" approach to monetary policy decisions that not only seeks to stabilize output in the short run and achieve price stability in the long run, but actively contributes to the growth rate of output and employment.

The stance of monetary policy is a function of the gap between current and target inflation rates and it seeks to minimize fluctuations of current output relative to potential output. Long-run price stability and short-run output stabilization are the ultimate goals, and the real interest rate is the operating target variable that is used to achieve the goals. By adjusting the nominal interest rate to changes in the inflation rate, the central banks attempt to bring current output in line with potential output. The authors point out that the consensus in policy circles is that monetary policy will adopt a conservative monetary stance biased toward economic contraction and loss of output. On the basis of Fed records, as many as six of eight postwar recessions in the United States appear to have been preceded by decisions to cause an economic downturn in order to reduce inflation.

The authors review three types of models that suggest that the long-run time path of real output and employment is determined, at least in part, by monetary policy: demand-led growth models, hysteresis models, and multiple equilibria models. Demand-led growth models identify several economic forces that lead to cumulative processes, including increasing returns to scale, learning and technical progress, and aggregate demand. Hysteresis is a property of nonlinear models with heterogeneous microelements and is best modeled in terms of an input-output framework. A system is hysteretic when the value of outputs is permanently affected by a temporary change in the value of inputs, and this property draws attention to the possibility that the application of exogenous forces to an economic system can take the form of deliberate policy decisions. Multiple equilibria models show that fluctuations in production appear to persist indefinitely, a result that can be explained by permanent changes in production technology. Fluctuations in aggregate demand are most likely to make the economy move between different equilibria, so macroeconomic outcomes are path dependent and policies can be used to select particular levels of employment (e.g., macroeconomic policies that improve welfare by moving the economy to an equilibrium position with low inflation and high employment).

The authors outline two potential problems with the conventional inflation-targeting approach: policy-induced recessions and permanent effects on output and employment. They propose an inflation-targeting regime to deal with these problems. A feature of the model is that the current level of output can wander freely between the upper and lower limits of output without significantly affecting the current rate of inflation. The output gap that keeps inflation constant is a plateau rather than a single point. This opportunistic approach calls for a more cautious deflationary strategy and it minimizes the possibility that economic recessions are policy induced. When current and expected inflation is moderate, though above the long-run target, the central bank should keep the economy producing at its potential level.

The authors' flexible opportunistic approach starts from the same principle as the conventional and opportunistic approaches—price stability is the long-run goal of monetary policy (i.e., the approach will tolerate some output loss in order to reduce inflation). However, as opposed to the standard opportunistic approach, the flexible approach maintains that when current inflation is at the long-run inflation target or below it, the central bank should actually lower the real interest rate. The decision of the central bank to stimulate aggregate demand increases the current level of output and employment and also changes the underlying economic relationships that allow the economy to produce at high levels of output and employment without engendering inflationary pressures. In other words, the central bank lowers the nonaccelerating inflation rate of unemployment (NAIRU).

## Monetary Policy Strategies of the European Central Bank and the Federal Reserve Bank of the United States

C. SARDONI and L. RANDALL WRAY
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According to C. Sardoni, University of Rome "La Sapienza," and Senior Scholar L. Randall Wray, University of Missouri–Kansas City and director of research, the Center for Full Employment and Price Stability, the European Central Bank (ECB) and the U.S. Federal Reserve (Fed) have adapted the new monetary consensus to develop their approaches to policy formation. The authors find that official interest rate differences between the banks are too small to explain the differences in economic performance between the European Union (EU) and the United States. Rather, fiscal policy constraints in euroland have led to lower growth and higher unemployment. In fact, these constraints carry the possibility of a catastrophic financial crisis and pose problems for sustaining the unification of Europe.

The authors observe that the Fed began implementing a procedure that is loosely based on the new monetary consensus in the early 1990s. The formulation of Fed policy is based on five key principles: transparency, gradualism, activism, inflation as the only official goal, and a neutral interest rate as the policy instrument. The authors note that the combination of openness and gradualism can force the Fed to make policy moves at the wrong time in order to fulfill market expectations that the Fed has itself created. For example, the Fed raised interest rates as the U.S. economy headed into recession at the end of the 1990s.

Because the neutral interest rate cannot be temporally or spatially fixed, the Fed's policy instrument conflicts with its adoption of increased transparency, so the instrument cannot provide useful guidance. Sardoni and Wray challenge the Fed's claim that its only concern is inflation. The Fed targets asset prices and income shares, they say, and it shows a strong bias against labor in favor of entrepreneurs (by accepting profits-driven inflation while guarding against wage-driven inflation). For example, transcripts show that the Fed tried to "prick" what it perceived to be an equity price bubble as early as 1994. Furthermore, rate hikes since 2004 are believed to be an unsuccessful attempt to cool the real estate bubble, in spite of Fed claims that bubbles are impossible to identify.

The authors conjecture that the Fed cannot help but notice that interest rate changes have distributional impacts or that the anticipation of changes can impact the financial markets and affect the "real" economy through different interest rate elasticities and spending propensities. Therefore, if interest rates matter, they work largely through distributional channels, which are complex and not often studied. Because rate hikes are fully incorporated within expectations, however, the hikes have almost no discernible impact on market behavior. New monetary consensus policy formation in the United States shuns large rate changes; because there is no role for direct credit controls, monetary policy is impotent, the authors say.

The ECB's basic conviction is that money is neutral in the long run, which is a key component of the new monetary consensus. The bank's fundamental task then is to guarantee price stability. Rather than taking any direct responsibility for eliminating the output gap, the ECB purportedly provides an environment in which the economy can "naturally" close the gap. It defines a precise inflation target—i.e., by maintaining annual inflation close to 2 percent over the medium term—and makes the target public in order to generate consistent expectations.

The ECB bases its price stability on "two pillars:" (1) assessing the short- to medium-term determinants of price developments with a focus on real activity and financial conditions in the economy; and (2) focusing on a longer-term horizon and exploiting the link between money and prices. The authors observe that ECB policy measures are preoccupied with inflation and that the bank's crucial problem is grounding policy on the two pillars. Monetary and inflation targeting are neither compatible nor achievable, and such measures have led to slow economic growth and high unemployment.

The authors conclude that fiscal policy constraints in euroland play a significant role in explaining the differences between the economic performances of the United States and euroland. U.S. federal government spending averages close to

20 percent of GDP versus about 1 percent for the European parliament (most government spending is decentralized to member states). Unlike the United States, the EU relies on foreign demand as an engine of economic growth, and this reliance results in competition among member states that leads to lower wages and prices, fiscal austerity, slow growth, and high unemployment. The authors observe that interest rates among EU members have diverged since monetary union because the markets recognize that members have relinquished some sovereignty and that the ECB is practically prohibited from bailing out member states. There is no central fiscal authority like the U.S. Treasury.

The authors believe that the new monetary consensus has erred in its rejection of the efficacy of fiscal policy. They suggest ECB reforms that include the creation of a mechanism for establishing a lender of last resort and perhaps automatic countercyclical fiscal transfers from a central fiscal authority to member states.

### Credit Derivatives and Financial Fragility

EDWARD CHILCOTE
Policy Note 2006/1
www.levy.org/pubs/pn_1_06.pdf

On September 15, 2005, the Federal Reserve held a meeting involving 14 large credit derivatives–dealer banks. The last time such a meeting took place was on September 16, 1998—in the midst of the Long-Term Capital Management crisis. Does the recent meeting portend a new crisis?

Research Scholar Edward Chilcote outlines the potential for a major credit-derivatives debacle of the type that was averted in 1998. Credit derivatives are bilateral contracts that transfer credit risk between parties, for example, contracts that represent one part (tranche) of the risk of a pool of bonds. By acquiring derivatives contracts, banks or other institutions can reduce their exposure to credit risk. These contracts grew at an annual rate of 128 percent in the first six months of 2005, with hedge funds among those heavily involved. This occurred while banks and other institutions seemed to be relaxing their other protection against adverse "credit events" by lowering their provisions for credit losses.

The growth of credit derivatives contracts increases the links between various financial players: if there are a few defaults, the sellers of derivatives could fail to hold up their end of the bargain to insure against risk. Banks and other lenders could rush to cover the risks that were exposed by the default of some derivatives buyers. If the banks found no willing purchasers (perhaps due to a climate of many defaults), then a "run" could occur and the derivatives markets could lose liquidity, meaning that it would be impossible to obtain cash in return for the contracts. With so many institutions exposed to risk without the protection of credit derivatives, a chain reaction of defaults could occur.

All of this is much more likely in light of the recent massive growth of the derivatives market, which, unfortunately, has made difficult the orchestration of an orderly bailout of the type engineered in the 1998 crisis. In order to prevent a crisis, Chilcote recommends standardizing trading documentation, imposing time limits for clearing transactions, mandating strict margin requirements, and several other reforms.

## Federal Budget Policy

### The Fiscal Facts: Public and Private Debts and the Future of the American Economy

JAMES K. GALBRAITH
Policy Note 2006/2
www.levy.org/pubs/pn_2_06.pdf

Senior Scholar James K. Galbraith of the University of Texas at Austin argues that "bankruptcy" is an inaccurate metaphor for the financial condition of the U.S. government. Bankruptcy may become a reality for all too many individual households, however, posing a serious problem for the economy as a whole.

Some observers, Galbraith notes, have implied that the government can literally go bankrupt. But U.S. debts are denominated in dollars, which can be created by the Federal Reserve in unlimited quantities. Other economists argue that a metaphorical bankruptcy could occur. In this scenario, investors and central banks would rapidly sell off large quantities of U.S. assets, raising the government's cost of borrowing and sending the currency into a tailspin. Since the United States has relied on the international purchase of a large share of U.S. securities in recent years, such a debacle is not impossible.

Some facts make a sell-off of U.S. securities rather unlikely, however, at least in the near term. First, Japan and China, two nations that together hold a large portion of U.S. securities, are dependent on exports to the United States, just as the United States is dependent upon foreign capital. Japan, a nation of savers, suffers from weak domestic consumer demand, while China must keep its factories running in order to support its rapidly expanding urban population.

Eventually, the sell-off may well occur, jeopardizing the dollar's status as the world's main reserve currency. But there is little that economists, governments, or anyone else can do to prevent this outcome, Galbraith argues. The sheer size of the current account deficit does not pose the greatest threat to the dollar; rather, a major foreign policy crisis, such as a war over Taiwan, would be most likely to precipitate a currency collapse.

Moreover, government deficit reductions would not ensure a return to current account balance, since the private sector's borrowing must also be taken into account. The private sector, already deeply in hock, may suffer a financial reversal, should interest rates rise much higher or real estate prices fall dramatically. Therein lies the true threat to the weak U.S. economic expansion.

Tax policy and expenditure decisions do not affect the budget deficit, notes Galbraith. (They affect the *projected* deficit, but not the *realized* deficit.) He also notes that if the private sector spends ahead of its income, the budget deficit can be made to disappear without changes in tax and spending policy (e.g., the boom of the late 1990s). However, booms of this nature are infrequent and cannot be sustained, and the budget deficit will revert to equal the current account (e.g., the first four years of the present decade).

The fiscal condition of the government does not require a radical assault on or any reduction of Social Security benefits, says Galbraith, since Social Security is actually in the best financial condition in its history. Furthermore, there is no convincing evidence that there are penalties to pay, either in higher interest rates or in lost investment, for today's large deficits. Galbraith speculates that if Fed Chairman Ben Bernanke continues the policy of raising short-term interest rates and long-term interest rates do not rise, then the economy is likely to fall into recession within a year.

## The Labor Market

### Job-Hopping in Silicon Valley: Some Evidence Concerning the Micro-Foundations of a High Technology Cluster

BRUCE FALLICK, CHARLES A. FLEISCHMAN, and JAMES B. REBITZER

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Noncompete agreements are legal mechanisms designed to reduce costly human capital externalities that result from job-hopping. Bruce Fallick and Charles A. Fleischman, Board of Governors, Federal Reserve System, and Research Associate James B. Rebitzer, Case Western Reserve University and the National Bureau of Economic Research, investigate the mobility of skilled employees among firms in the agglomeration economy of Silicon Valley, California. Their findings support the results of other studies that show hypermobility in Silicon Valley's computer cluster (frequent job-hopping facilitates the rapid reallocation of resources toward the most innovative firms), that the omission of noncompete agreements in California state law enhances mobility and agglomeration economies related to information technology (IT) clusters, and that heightened mobility is a feature of California's computer industry but not of other state industries.

The analysis is based on a relatively new feature of the Current Population Survey. The authors can collect mobility data for computer industry agglomeration economies by linking the employment transition data with demographic and employment data by individual. The authors restrict their sample to men with at least four years of college living in metropolitan areas with IT clusters in the 1994–2001 period (44,202 individuals). Individuals changing employers at least once during the period represented 7.84 percent of the sample, and the monthly rate of employer-to-employer job change was 2.41 percent.

The authors' approach differs from other empirical studies of agglomeration economies and human capital externalities in two ways: (1) it focuses on employee mobility within a labor market rather than on the returns to education; and (2) it examines a specific industry within geographically specified labor markets. The authors seek to establish that rapid employee mobility within a cluster will lead to underinvestment in human capital, that job-hopping can be a source of agglomeration economies, and that conditions in the computer industry make it especially likely that hypermobility will produce agglomeration economies. Their analysis relies heavily on the model used by Daron Acemoglu (1997) in "Training and Innovation in an Imperfect Labour Market," *The Review of Economic Studies.* Employees in the computer industry are identified using both a broad and narrow definition of the industry.

As expected, interfirm mobility of employees in the computer industry is higher in Silicon Valley than in other IT clusters in states with enforceable noncompete agreements. There is a "California" effect on the rate of interfirm mobility for employees in the computer industry, and the mobility patterns of other employees in the same location are not the same as computer industry employees. Employer-to-employer mobility rates in Silicon Valley and California's IT industries are much higher than the sample average (by 40 and 56 percent, respectively) and intraindustry computer industry mobility is higher in Silicon Valley than in other locations.

The authors note that there is reason to believe that the boundaries of IT clusters bleed into other industries, and that this effect varies by city. They therefore interpret the absence of a California effect in some of their intraindustry computer mobility results with caution. They also caution that their interpretations must be qualified by data limitations and that they have not observed employment contracts. They cannot rule out the hypothesis that rapid employee mobility may be the result of some unobserved features of computer firms in California rather than their posited agglomeration economy or the role that other factors (e.g., the local culture) may play in sustaining high rates of employee turnover.

# Explorations in Theory and Empirical Analysis

## Speculation, Liquidity Preference, and Monetary Circulation

KORKUT A. ERTÜRK

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The dynamic interaction of industrial and financial circulation has been explored in the works of economists such as Wicksell, Hicks, Keynes, Kaldor, Minsky, Leijonhufvud, and Friedman. According to Research Associate Korkut A. Ertürk, University of Utah, the controversies arising from the publication of Keynes's *The General Theory of Employment, Interest, and Money* (1936) (GT) overshadowed Keynes's observations about the macroeconomic effects of asset market speculation in his earlier work, *A Treatise on Money* (1930). Ertürk focuses on Keynes's insights about asset price speculation and its link to monetary circulation in the *Treatise* and finds continuity and complementarity of thought with the GT.

Ertürk notes that Keynes's insights in the *Treatise* contributed to the basic Wicksellian theme: a fall in the money rate of interest below the return on new capital (the natural rate of interest) gives rise to a cumulative process of inflation (assuming full employment and fixed output). Keynes linked expected changes in securities prices over the credit cycle to changes in net hoarding through variations in the stock demand for financial assets, a framework that allows direct discussion of the effects of market speculation and asset price bubbles on monetary circulation. The idea is that monetary injection has a direct and immediate impact on the prices of financial assets, but the injection affects consumer goods prices indirectly and slowly, as the investment sector expands. An essential feature of Keynes's argument in the *Treatise* is the contention that the prices of investment goods are subject to different forces than those that affect consumer goods prices.

Some economists, such as D. H. Robertson, objected to Keynes using two separate principles to determine investment and consumer goods prices. According to Ertürk, Robertson's disagreement with Keynes after the publication of the GT was about two separate issues: consistency in macro accounting and economic behavior. The author suggests that the former issue and the accounting debate generated by the GT drew attention away from the more important debate concerning economic behavior and Keynes's "two-price" theory, whereby asset prices are determined independently of investment and saving flows (the elastic money supply and the stock demand for financial assets keep the interest rate in check). The focus on the accounting problem emphasized financial demand as a separate motivation to hold money, which obscured the essential aspect of Keynes's "two-price" theory. The way that self-sustained biases in asset price expectations in the financial markets exert their influence over the business cycle was mainly forgotten, says Ertürk, so asset price speculation was no longer part of Keynesian macroeconomic theory. Later on, Minsky reemphasized that aspect, noting that Keynes's position was about an investment theory of fluctuations in real demand and a financial theory of fluctuations in real investment (the essential features of the "two-price" theory).

Keynes's approach in the *Treatise* is consistent with the modern behavioral approach (i.e., opinion or noise moves prices). A rising bear position when security prices rise is important in explaining the turning point of a business cycle expansion (i.e., financial sentiment falters). Similarly, a declining bear position during a business upswing prevents the interest rate from rising with increasing levels of activity. Stock decisions, therefore, dominate flow decisions.

Ertürk maintains that deviations of current asset prices from true values create a riskless arbitrage opportunity, a view that is mirrored in Keynes's beauty contest analogy in which noise is at least as important as information in determining true values and causing asset price changes that render uncertain resale prices. The author notes that Keynes's discussion in the *Treatise* on how asset prices behave over the business cycle presupposes that speculation can be stabilizing or destabilizing, depending on the phase of the cycle (if investment is still in excess of savings and output expands, the total money supply must increase more than net hoarding). Translating the *Treatise* to the terminology of the GT amounts to the simple proposition that the liquidity preference schedule shifts down (up) when the marginal efficiency of capital shifts up (down) on account of more optimistic (pessimistic) expectations, observes Ertürk.

## Keynes's Approach to Money: An Assessment after 70 Years

L. RANDALL WRAY

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Senior Scholar L. Randall Wray, University of Missouri–Kansas City and director of research, the Center for Full Employment and Price Stability, examines Keynes's approach to money, particularly as conveyed in *The General Theory of Employment, Interest, and Money* (1936) (GT). He finds that the liquidity preference approach presented in Chapter 17 of the GT provides a better treatment of asset price determination than the supply and demand equilibrium approach presented in Chapter 13. He concludes that, in lieu of Keynes's bancor plan, sovereign currencies and floating exchange rates are the best ways to promote fiscal and monetary domestic policy independence and to pursue full employment.

In his attempt to determine the rate of interest, Keynes concludes that the interest rate is the price at which the desire (liquidity preference) to hold wealth in the form of cash equals the available quantity of cash. Liquidity preference is divided into three motives: transaction, precautionary, and speculative. The relationship between the current rate of interest and the state of expectation became the standard approach to money demand.

Keynes is less clear about money supply, says Wray. Common GT interpretations assume that the quantity of money is given when determining the interest rate (i.e., the money supply is determined exogenously by policy or by the government printing money, or endogenously by banks). Keynes, however, seems to reject the textbook presentation of a vertical money supply and a downward-sloping money demand curve, leaving the determination of the interest rate uncertain. Central bank policy is seen to operate through the impact on expectations of future interest rates and the willingness of banks to acquire debts rather than through control over the money supply.

Wray notes that expectations play a large role in determining the own rate of assets (anything that can be held through time) in Chapter 17 of the GT. The own rate is determined as a function of expected yields, carrying costs, subjective returns to liquidity, and expected price appreciation. Asset price equilibrium occurs when marginal efficiencies are equalized and not simply when money supply equals money demand.

Keynes argues that the existence of money causes unemployment because of the role played by liquidity preference. To analyze the impact of monetary policy on employment, Keynes moves beyond the static equilibrium model and considers how monetary policy affects short- and long-period expectations. He concludes that the effects of monetary policy are unpredictable, and perhaps counterproductive, so he emphasizes the efficacy of fiscal policy.

According to Wray, Keynes's fourth reason to hold money—the finance motive—is mostly a diversion for post-Keynesians, who use this motive to resolve Keynes's (apparently) contradictory exposition of the determinants of the quantity of money. Wray suggests that the finance motive should be kept separate from the original three motives to hoard. He believes that it is important to extend Keynes's theory to incorporate endogenous money and that Keynes's liquidity preference should not be discarded in determining asset prices.

Keynes takes the existence of money for granted and distinguishes between money and money of account: the state determines the unit of money and enforces the unit by accepting it in tax payments (all civilized money is chartalist). Wray notes that there is a hierarchy of monies: bank liabilities used by the nongovernment sector and government liabilities used for net clearing among banks and government. The central bank must accommodate the demand for reserves in order to hit its interest rate target.

According to Keynes, state money may take one of three forms: commodity, fiat, or managed money. Wray notes that both the gold standard and the Bretton Woods system of fixed but adjustable exchange rates were managed-money systems. Keynes put forward an alternative to the Bretton Woods system that combined fixed (but adjustable) exchange rates with a mechanism for penalizing both trade-deficit and trade-surplus nations (his bancor plan). His proposal would have reduced the "beggar thy neighbor" tendency to accumulate hoards of international reserves that put a downward bias on global effective demand. Current political realities, however, make international monetary system reform along the lines of Keynes's bancor plan unlikely, says Wray.

Most developed countries today have fiat money systems, but the euro nations are operating toward the commodity money end of the managed-money spectrum. Wray observes that after Bretton Woods, there was a lack of political support for fixed exchange rate systems, trade became more imbalanced, and international exchange rate crises proliferated. He also observes that abandoning national currencies (e.g., the creation of the euro) severely constrained both fiscal and monetary policy, as governments tried to build international reserves (by seeking trade surpluses and balancing treasury accounts) to protect exchange rates and to "finance" government spending. As a result, chronic unemployment is necessary to constrain aggregate demand in a hopeless competitive struggle for export markets.

## Personality and Earnings

KAYE K. W. LEE
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Standard economic analysis uses representative firms and workers, and therefore ignores insights relevant to more specific determinants of worker wages. Kaye K. W. Lee, former Junior Fellow in association with the Cambridge University Visiting Scholar Program, examines how behavioral and personality traits affect employer responses in the workplace. He finds that memes (patterns of thought that affect an individual's awareness and decision-making process) have a great deal of influence in the marketplace and thus limit the scope of normal optimization within economic theory. For example, an individual who is able to conform to an organization will be able to absorb the dominant company memes more easily than others and will place himself in a favorable position for a higher wage.

A theory of wage differentials depends on four interrelated interactions: rationality, the industry, the firm, and workers. Lee notes that players in the labor market do not necessarily behave rationally because they are "programmed" to follow certain behaviors (memes), and that memetic structures exist at a cognitive level (e.g., habits that preserve the status quo). Industry conventions affect firms, which are profit-maximizing entities affected by culture (the habits and thought patterns encoded in memes), the firm's specific culture, and the memetic structure and thought patterns of the employer and workers.

Lee outlines a simple labor market model that shows the relationship between effort and real wages, including an employer's optimal wage rate relative to a miscalculation of the labor extraction function. Although an employer attempts to maximize profits, his memetic notion of fairness or the labor market culture may prevent him from exploiting a higher effort level per dollar. It is clear that memes can influence the results of economic games, says Lee.

Lee also considers the effects of personality (e.g., incentive-enhancing preferences, such as honesty and a low disutility of effort) that enhance the response function of workers. A problem with analyzing personality is that preferences are likely to be heterogeneous and rewarded differently in various workplace situations. If firms are considered to be culture bearing as well as production entities, then memes that do not contribute to production may be rewarded.

Previous studies of memes and the inheritance of socioeconomic status have found substantial intergenerational correlations of economic status. It is therefore important to study memetic transmission further, including the evolution of individual memetic makeup, noncognitive personality traits, and intergenerational transmission of economic status. In light of the effect of personality, memes (as units of culture) are a useful conceptual tool in formulating explanations for wage dispersion.

Lee describes three process functions that affect the evolution of memes: selection (a member internalizes a meme because of firm pressures associated with function, fit, and form), variation (processes of migration, mutation, and recombination), and retention (which is affected by longevity, fidelity, and fecundity). Lee observes that a group consists of heterogeneous individuals who react to situations in a preset manner. There is a problem modeling this feature because memetic patterns are constantly changing. Although there is evidence that personality may be stable enough to include it within wage theory, there is also evidence that absolute stability of personality may have been overestimated. The author notes that previous studies have not included young wage earners and that changes in personality may be gradual over time.

Lee suggests that it may be useful to use systems theories to improve our understanding of memes within a firm and their effect on wage distribution. "Syslogic"—a theory of the logic of system behavior—is uniquely suited to model both groups and individuals, so it is an ideal platform for further research into the author's propositions.

**INSTITUTE NEWS**

## Upcoming Events

### Conference: Government Spending on the Elderly

April 28–29, 2006
Blithewood
Annandale-on-Hudson, New York

Demographic changes in the United States imply a significant growth in the number of beneficiaries in major federal entitlement programs. Existing program rules and rapidly escalating health care costs are expected to lead to fiscal pressures and pose challenges for economic growth.

"Government Spending on the Elderly," presented by The Levy Economics Institute of Bard College with support from the Smith Richardson Foundation, will provide an assessment of forces that drive government spending on retirees. Papers will examine how the retirement and health care of older citizens might be financed and will measure the potential impact of different reform proposals.

The current conference program is outlined below. Further information will be posted as it becomes available on the Levy Institute website.

**Preliminary Program**

**Friday, April 28**

**8:30–9:00 a.m.**
**Breakfast and Registration**

**9:00–9:15 a.m.**
**Welcome and Introduction**
DIMITRI B. PAPADIMITRIOU, President, Levy Institute

**9:15–10:55 a.m.**
**Session 1**
***Welfare State and the Incentives to Retire***
"European Welfare State Regimes and Their Implications for the Elderly." AXEL BOERSCH-SUPAN, Mannheim Research Institute for the Economics of Aging (MEA), University of Mannheim.

"Global Demographic Trends and Provisioning for the Future." L. RANDALL WRAY, Levy Institute and University of Missouri–Kansas City.

*Discussants*: SERGIO NISTICÒ, University of Cassino
RICHARD STARTZ, University of Washington

**10:55–11:25 a.m.**
**Break**

**11:25 a.m. – 1:05 p.m.**
**Session 2**
***Aspects of Economic Well-Being and Gender Disparities among the Elderly***
"Government Expenditures and the Economic Well-Being of the Elderly in the United States, 1989–2002." EDWARD N. WOLFF, Levy Institute and New York University, and AJIT ZACHARIAS and HYUNSUB KUM, Levy Institute.
"Differing Prospects of Women and Men: Young Old-Age and Old Old-Age." LOIS B. SHAW, Institute for Women's Policy Research.

*Discussants*: ROBERT HAVEMAN, University of Wisconsin–Madison
MADONNA HARRINGTON MEYER, Syracuse University

**1:05–2:30 p.m.**
**Lunch**

**2:30–4:10 p.m.**
**Session 3**
***Changing Patterns of Retirement Behavior***
"Working for a Good Retirement." KAREN E. SMITH, BARBARA A. BUTRICA, and C. EUGENE STEUERLE, Urban Institute.
"Net Intergenerational Transfers from an Increase in Social Security Benefits." MICHAEL HURD, RAND Corporation.

*Discussants*: LUCIE G. SCHMIDT, Williams College
DANIEL L. THORNTON, Federal Reserve Bank of St. Louis

**4:10–4:40 p.m.**
**Break**

**4:40–6:10 p.m.**
**Session 4**
***Interaction between Private and Public Provisioning***
"The Changing Role of Employee Benefits and Federal Government Spending on the Elderly." TERESA GHILARDUCCI, University of Notre Dame.
"Trends and Issues in Retiree Health Coverage." STEPHEN WOODBURY, Michigan State University, and JAMES MARTON, University of Kentucky.

*Discussants*: ZVI BODIE, Boston University
BARBARA WOLFE, University of Wisconsin–Madison

**6:10–9:00 p.m.**
**Reception and Dinner**

**Saturday, April 29**

**8:30–9:15 a.m.**
**Breakfast**

**9:15–10:55 a.m.**
**Session 5**
***Budgetary and Macroeconomic Implications of Aging***
"Population Forecasts, Fiscal Policy, and Risk." SHRIPAD TULJAPURKAR, Stanford University.
"Wage Growth and the Measurement of Social Security's Financial Shortfall." JAGADEESH GOKHALE, Cato Institute, and ANDREW BIGGS, Social Security Administration.

*Discussants*: CLARK BURDICK, Social Security Administration
STEPHANIE A. KELTON, University of Missouri–Kansas City

**10:55–11:25 a.m.**
**Break**

**11:25 a.m. – 1:05 p.m.**
**Session 6**
***Retirement Security: Problems and Prospects***
"The Adequacy of Retirement Resources among the Soon-to-Retire." EDWARD N. WOLFF, Levy Institute and New York University.
"Minimum Benefits in Social Security." MELISSA M. FAVREAULT, GORDON B. T. MERMIN, and C. EUGENE STEUERLE, Urban Institute.

*Discussants*: BROOKE HARRINGTON, Brown University
ROBERT K. TRIEST, Federal Reserve Bank of Boston

**1:05–2:30 p.m.**
**Lunch and Closing Remarks**

### Symposium: Gender Equality, Tax Policies, and Tax Reform in Comparative Perspective

May 17–18, 2006
Blithewood
Annandale-on-Hudson, New York

The symposium will focus on the gender dimensions of tax policy and tax reforms in countries at different levels of development. Participants will present papers based on their research about South Africa, India, Kenya, New Zealand, the United Kingdom, Spain, the European Union, Canada, and the United States.

The papers will cover the following topics:

- gender biases in direct taxation, including biases in individual and joint filing, and the structure of exemptions, deductions, and allowances;
- gender biases in indirect taxation, including VAT and excise or sales taxes;
- the impact of personal income taxation on labor supply, household production, and time use;
- gender issues in tax reform and fiscal decentralization; and
- theoretical and methodological issues in tax burden and tax incidence analysis from a gender perspective.

The symposium is part of the Gender Equality and the Economy Program. This new program considers how economic processes and policies affect gender equality, and how existing gender inequalities influence economic outcomes. It hopes to stimulate a reexamination of key economic concepts, models, and indicators—with a particular view to reformulating policy—and offer a broader view of what an economy is and how it functions. The purpose of the program is to contribute knowledge that improves women's status and helps them realize their rights in the United States and other countries.

## Russell Sage Foundation Grant

Senior Scholar Joel Perlmann has received a grant from the Russell Sage Foundation to write a book about ethnic and racial intermarriage in America since 1880. A major focus of his research will be the descendants of the last great wave of immigrants (ca. 1890–1914), particularly Italian immigrants. Another focus will be contemporary issues that relate to Mexican Americans and blacks.

By studying the effects of both past and present immigration, Perlmann intends to place intermarriage rates in the context of history; i.e., to deal with the historical *origins* and *outcomes* of intermarriage rates. He observes that each immigration wave is unique, intermarriage is affected by the complex nature of the "second generation," and high proportions of mixed-origin "third generation" members emerge from relatively modest levels of second-generation intermarriage.

An objective of Perlmann's research is to link the two great themes of American assimilation—intermarriage and upward economic mobility. He also intends to investigate two main issues of black intermarriage (rates of black outmarriage in areas with relatively few black residents and the effect of out-of-wedlock births on intermarriage rates), as well as current rates of Jewish intermarriage.

This research follows Perlmann's 2005 book, *Italians Then, Mexicans Now: Immigrant Origins and Second-Generation Progress, 1890–2000*, which was published by the Russell Sage Foundation and The Levy Economics Institute.

## PUBLICATIONS AND PRESENTATIONS

### Publications and Presentations by Levy Institute Scholars

**RANIA ANTONOPOULOS** *Research Scholar*

**Presentations:** "Unpaid Work, Gender, and Poverty," VI World Social Forum, Caracas, Venezuela, January 27; "Employment Creation Strategies and Time Use Survey Data," International Development Research Centre (IDRC), Montevideo, Uruguay, February 2.

**PHILIP ARESTIS** *Senior Scholar*

**Publications:** *Financial Liberalization: Beyond Orthodox Concerns* (with M. Sawyer), London: Palgrave Macmillan, 2005; *The New Monetary Policy: Implications and Relevance* (with M. Baddeley and J. McCombie, eds.), Cheltenham, U.K.: Edward Elgar Publishing Limited, 2005; "New Consensus Monetary Policy: An Appraisal" and "On the U.S. Post–'New

Economy' Bubble: Should Asset Prices Be Controlled?" in *The New Monetary Policy: Implications and Relevance*, P. Arestis, M. Baddeley, and J. McCombie, eds., Cheltenham, U.K.: Edward Elgar Publishing Limited, 2005; "An Institutional Perspective to Finance and Development as an Alternative to Financial Liberalisation" (with H. Stein), *International Review of Applied Economics*, Vol. 19, No. 4, 2005; "Aggregate Demand, Conflict, and Capacity in the Inflationary Process" (with M. Sawyer), *Cambridge Journal of Economics*, Vol. 29, No. 6, 2005; "Financial Liberalization and the Finance-Growth Nexus: What Have We Learned?" and "Financial Liberalization and Poverty: Channels of Influence," *International Papers in Political Economy* (New Series), 2005; "How Exposed Is the Euro Area Economic Performance to External Factors?" (with E. Karakitsos), *Newropeans Magazine*, November 18, 2005; "Financial Market Puzzles May Affect World Growth," *Challenge: The Magazine of Economic Affairs*, Vol. 48, No. 6, November–December 2005; "Makroökonomische Politik im Euroraum: Eine kritische Betrachtung," *WSI Mitteilungen, Monatszeitschrift des Wirtschafts — und Sozialwissenschaftlichen Instituts in der Hans Böckler Stiftung*, Bund-Verlag, Vol. 58, No. 12, December 2005; "Exposição da Zona do Euro a Fatores Externos," *Revista Autor*, Vol. V, No. 54, December 1, 2005; *Financial Developments in National and International Markets* (with J. Ferreiro and F. Serrano), London: Palgrave Macmillan, 2006; "The Case for Fiscal Policy" in *Financial Developments in National and International Markets*, P. Arestis, J. Ferreiro and F. Serrano, eds., London: Palgrave Macmillan, 2006; "Das Erwartungsparadox" (with W. Mosler), *Financial Times Deutschland*, January 27, 2006; "Is Capital Stock a Determinant of Unemployment?" (with M. Baddeley and M. Sawyer), in *Wages, Employment, Distribution and Growth: International Perspectives*, E. Hein, A. Heise, and A. Truger, eds., London: Palgrave Macmillan, 2006; "What Type of European Monetary Union?" in *Implications of the Euro: A Critical Perspective from the Left*, P. Whyman, M. Baimbridge, and B. Birkitt, eds., Oxford: Routledge, Taylor & Francis Group, 2006.

**Presentations:** "New Monetary Policy and Keynes," Hans Böckler Stiftung conference on Macroeconomics and Macroeconomic Policies—Alternatives to Orthodoxy, Berlin, October 28–29, 2005; "Can the EMU Play a Stabilizing Role in Balancing the Global Imbalances? (Where Does Cyprus Fit in All This?)" Institute of Employment conference, Nicosia, Cyprus, November 18, 2005; "What Is the New Consensus in Macroeconomics?" HM Treasury/GES conference, "Is There a New Consensus in Macroeconomics?" London, November 30, 2005, and "The Political Economy of Governance" conference, University of Bourgogne, Dijon, France, November 2–3, 2005; "The Consensus View on Interest Rates and Inflation: Reality or Innocent Fraud?" International Monetary Policy Conference: The Role of Asset Prices in Central Banking, St. Croix, U.S. Virgin Islands, January 12–14; "Economic Policy in the U.K. under New Labour: The End of Boom and Bust?" (with M. Sawyer), workshop on Growth and Employment in Europe, Oxford Brookes University Business School, January 27; "Can the Euro Area Play a Stabilizing Role in Balancing the Global Imbalances?" at "Euroland: Global Player or Global Drag?" conference, Franklin College Switzerland, Lugano, March 2–4.

**DIANE ELSON** *Senior Scholar*

**Publications:** "Women's Rights and Engendering Development" in E. Kuiper and D. K. Barker, eds., *Feminist Economics and the World Bank: History, Theory and Policy,* Oxford: Routledge, 2006; "The Financial Requirements of Achieving Gender Equality and Women's Empowerment" (with C. Bahadur, C. Grown, and J. Handbury), World Bank Working Paper, Washington, D.C., February 2006.

**Presentations:** "Unpaid Work: Creating Social Wealth or Subsidizing Patriarchy and Private Profit?" Forum for Social Wealth, Political Economy Research Institute, University of Massachusetts Amherst, December 1, 2005; "Gender Budgeting as an Instrument to Promote Emancipatory Policies" at a networking event for European Gender Budgeting Initiatives, Watch Group, Gender and Public Finance, Vienna, February 6.

**JAMES K. GALBRAITH** *Senior Scholar*

**Publications:** "Some Notes on Entrepreneurship and Welfare State," *Industrial and Corporate Change*, Vol. 15, No. 1; "Pay Inequality in Europe 1995–2000; Convergence between Countries and Stability Inside" (with E. Garcilazo) in *European Journal of Comparative Economics*, Vol. 2, No. 2, December 2005; "Galbraith: un éloge partisan," *L'Économie Politique*, No. 28, Octobre–Novembre 2005; "Preface" and "Galbraith: A Partisan Appraisal," in *John Kenneth Galbraith and the Future of Economics*, Blandine Laperche and Dimitri Uzinidis, eds., London: Palgrave Macmillan, 2005; "The Continental Divide," *Mother Jones*, November–December 2005; "Smith vs. Darwin," *Mother Jones*, Special Issue, December 2005; "Ego Inflation," *Mother Jones*, January–February 2006; "State Income Inequality and Presidential Election Turnout and Outcomes" (with T. Hale), University of Texas Inequality Project (UTIP) Working Paper 33, January 13, 2006.

**CAREN A. GROWN** *Senior Scholar*

**Publications:** "The Financial Requirements of Achieving Gender Equality and Women's Empowerment" (with C. Bahadur, J. Handbury, and D. Elson), World Bank Working Paper, Washington, D.C., February 2006; "Quick Impact Initiatives for Gender Equality: A Menu of Options," World Bank Working Paper, Washington, D.C., February 2006.

**Presentations:** "Gender, Growth, and Inequality," panel discussant, Allied Social Science Associations meetings, Boston, January 6–8; "The Global Climate and Women's Economic Empowerment," keynote speaker, SEEDS 25th Anniversary Conference on Promoting Decent Work for Low-Income Women, New York, February 9–10; "Achieving Gender Equality: How to Hasten Progress and How Much Does It Cost?", consultant, Promoting the Gender Equality MDG: The Implementation Challenge, World Bank, Washington, D.C., February 15–16; "Gender Equity and Globalization: Macroeconomic Policy for Developing Countries," Eastern Economic Association annual meetings, Philadelphia, February 24–26.

**GREG HANNSGEN** *Resident Research Scholar*

**Publication:** "The Disutility of International Debt: Analytical Results and Methodological Implications" in *Financial Developments in National and International Markets,* Philip Arestis, Jesus Ferreiro, and Felipe Serrano, eds., Palgrave Macmillan, 2006.

**Presentation:** "A Random Walk Down Maple Lane? A Critique of Consumption Theory with Reference to Housing Wealth," Eastern Economic Association annual meetings, Philadelphia, February 24–26.

**DIMITRI B. PAPADIMITRIOU** *President*

**Presentations:** "The United States and Her Creditors," keynote speaker at the Centre of Full Employment and Equity, University of Newcastle, Australia, December 8, 2005; interview regarding the trade deficit with Michael E. Kanell, *Atlanta Journal-Constitution*, December 14, 2005; interview regarding the economy and the Senate budget bill of December 22, 2005, with Peter Donalds, *The Ben Merens Show*, Wisconsin Public Radio, December 28, 2005; "The Outlook for the U.S. Economy" (with L. R. Wray), International Monetary Policy Conference: "The Role of Asset Prices in Central Banking," St. Croix, U.S. Virgin Islands, January 12–14; "Economic Panel: A Check on Corporate and Consumer Health," guest speaker, British-American Business Council, New York, February 9.

**JOEL PERLMANN** *Senior Scholar*

**Presentation:** "Italians Then, Mexicans Now," immigration seminar, CUNY Graduate Center, New York, February 27.

**EDWARD N. WOLFF** *Senior Scholar*

**Publication:** "Pensions, Social Security, and Inequality," *The Economic Outlook for 2006*, Ann Arbor, Michigan: University of Michigan Press, 2006.

**Presentations:** "Pensions, Social Security, and Inequality," Annual Conference on the Economic Outlook, Ann Arbor, Michigan, November 17–18, 2005; "Is the Well-Being of the U.S. Population on an Upward or Downward Trajectory?" Alfred P. Sloan Foundation seminar, January 26; discussant, Conference on the Economics of the Transition to Adulthood, MDRC, New York, January 27–28.

**L. RANDALL WRAY** *Senior Scholar*

**Publications:** "International Aspects of Current Monetary Policy" in *The New Monetary Policy: Implications and Relevance*, P. Arestis, M. Baddeley, and J. McCombie, eds., Cheltenham, U.K.: Edward Elgar Publishing Limited, 2005; "To Fix or To Float: Theoretical and Pragmatic Considerations" in *Monetary and Exchange Rate Systems: A Global View of Financial Crises*," Louis-Philippe Rochon and Sergio Rossi, eds., Cheltenham, U.K.: Edward Elgar Publishing Limited, 2006; "Neocons and the Ownership Society," *Challenge*, 49(1) January–February 2006; "Money and Taxes: The Chartalist Approach" in *Concepts of Money: Interdisciplinary Perspectives from Economics, Sociology and Political Science*, Geoffrey K. Ingham, ed., Cheltenham, U.K.: Edward Elgar Publishing Limited, January 2006; "The Balance of Trade, Not Payments, Is True Measure of Deficit's Effects" and "Obscure Argument Not Easy to Follow" (coauthored with W. Godley), letters to the editor, *Financial Times*, February 15, 17.

**Presentations:** "Monetary Policy Strategies of the ECB and the Fed" (coauthored with C. Sardoni), Hans Böckler Stiftung conference on "Macroeconomics and Macroeconomic Policies—Alternatives to Orthodoxy," Berlin, October 28–29, 2005; "Employer-of-Last-Resort Programs and Argentina's Jefes de Hogar Plan: A Critical Appraisal," University of Massachusetts, November 29, 2005; "Gender and the Job Guarantee: The Impact of Argentina's Jefes Program on Female Heads of Poor Households," keynote presentation, Centre of Full Employment and Equity conference and the 2005 Society of Heterodox Economists conference, University of Newcastle, Australia, December 8 and 13, 2005; radio interview with Mike Norman, BizRadio Network KXYZ-AM, December 28, 2005; "The Demographics of Social Security," URPE panel presentation, and "Keynes's Approach to Money: An Assessment after 70 Years," HES panel presentation at the Allied Social Science Associations annual meeting, Boston, January 6–8; "The Outlook for the U.S. Economy" (with D. Papadimitriou), International Monetary Policy Conference: "The Role of Asset Prices in Central Banking," St. Croix, U.S. Virgin Islands, January 12–14; interview with Michael E. Kanell, *Atlanta Journal-Constitution*, January 18; interview with Jennifer Bjorhus, *St. Paul Pioneer Press*, February 2; "Extending Minsky's Classifications of Fragility to Government and the Open Economy" and "Monetary Policy Strategies of the ECB and the Fed" (coauthored with C. Sardoni), Eastern Economic Association annual meetings, Philadelphia, February 24–26.

**AJIT ZACHARIAS** *Research Scholar*

**Publication:** "Household Wealth, Public Consumption, and Economic Well-Being in the United States" (with E. N. Wolff and A. Caner), *Cambridge Journal of Economics*, Vol. 29, 2005.

**Presentations:** "Class and Household Economic Well-Being," Allied Social Science Associations meetings, Boston, January 6–8; "Household Production and the Distribution of Economic Well-Being in the United States," Eastern Economic Association annual meetings, Philadelphia, February 24–26.

## Recent Levy Institute Publications

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KAYE K. W. LEE
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