The NBER Digest
NATIONAL BUREAU OF ECONOMIC RESEARCH, INC.

July/August 1991

Role Models Matter

A recent NBER study by **Anne Case** and **Lawrence Katz** shows that role models—both good and bad—influence the behavior of inner-city youths in very specific ways. The authors report that youths who had family members in jail when they were growing up are more than twice as likely to have committed crimes as those without family members in jail. Youths whose family members have drug or alcohol problems are almost twice as likely to use drugs themselves as those whose family members have no such problems. And, youths with at least one parent who was a high school dropout are over 40 percent more likely to be high school dropouts than those whose parents graduated from high school. Case and Katz also find that the best predictor of whether a youth has parented a child out of wedlock is whether his or her parents were married.

These findings, reported in **The Company You Keep: The Effects of Family and Neighborhood on Disadvantaged Youths** (*NBER Working Paper No. 3705*), are based on a detailed 1989 NBER survey of 1200 minority and nonminority youths aged 17 to 24 living in low-income, inner-city Boston neighborhoods. Case and Katz point out that, at that time, these youths were in a tight labor market at the end of a sustained economic boom in New England.

The authors recognize that the relationship between parental behavior and the behavior of young people can be more complex than has just been implied. For example, youths born out of wedlock are also more likely to commit crimes than the children of married couples. But even when Case and Katz account for other background factors, they find strong relationships between parental behavior and similar behavior by their children. For example, after correcting for the effect of being born out of wedlock and other background factors on the propensity to commit crime, Case and Katz still find that a family's criminal history is a strong predictor of whether the youth will commit (or at least admit in a questionnaire to having committed) a crime.

"The best predictor of whether a youth has parented a child out of wedlock is whether his or her parents were married."

Case and Katz also find that a youth's neighborhood appears to affect his or her behavior. Living in a neighborhood in which a substantial fraction of young people are involved in crime, for example, makes a young person significantly more likely to commit crime than someone with a similar family background and personal characteristics who lives in a neighborhood where fewer youths commit crimes. Peer influence is particularly strong for illegal drug use and church attendance, but it is not important for childbearing out of wedlock, the authors find.

Case and Katz conclude that there are grounds for both pessimism and optimism based on these findings. On the pessimistic side, youths from disadvantaged backgrounds have trouble even in a tight labor market. On the optimistic side, the presence of a few good influences can have a substantial positive impact on young people.

DRH

Imports and Competition in Domestic Markets

Foremost among the asserted benefits of reducing trade barriers is competition: firms that operate in an economy with relatively weak domestic competition are supposed to be forced by the onslaught of foreign goods to improve their quality and service and to keep costs and prices down. The benefits of trade liberalization are assumed to be particularly great in developing countries, where a relatively few firms may control a given industry. But while the theoretical benefits of freer trade are well understood, do businesses actually respond in that way? After studying the effects of trade liberalization in Turkey, NBER researcher **James Levinsohn** concludes that the answer is "yes."

Until 1984, the Turkish economy was highly protected against imports, with tariffs averaging 49 percent and an array of nontariff barriers including quotas, import licenses, and foreign exchange regulations. In 1984, however, tariffs were reduced to an average of 20 percent and restrictions on many types of imports were eliminated. In **Testing the Imports-as-Market-Discipline Hypothesis** (*NBER Working Paper No. 3657*), Levinsohn investigates the impact of this sweeping liberalization by using detailed data on individual firms from the Turkish manufacturing census. The data span 1983-6, allowing him to pinpoint the impact of the dramatic increase in imports over that period.

"In the three high-margin industries . . . price markups declined as import competition increased."

Prior to the change in trade policy, Levinsohn finds, firms in six of the 11 industries studied were pricing at marginal cost, indicating a high level of competition. In three industries, companies were pricing above marginal cost, indicating the existence of imperfect competition, while in two industries, including the largely government-owned steel industry, firms were losing money on each unit of output. The 1984 trade liberalization reduced the level of protection enjoyed by nine of the 11 industries. In the three high-margin industries, miscellaneous chemicals, pottery, and electrical machinery, price markups declined as import competition increased. For two of the previously competitive industries, transport equipment and scientific equipment, the trade reform resulted in higher levels of import protection, and price markups in those industries increased. Of the six previously competitive industries that had their protection reduced by the trade reform, three had lower markups and one was unchanged; one of the two industries in that category with higher markups was the steel industry.

Levinsohn warns that the price markups reported by companies to census officials may not be completely accurate. Firms with high profits may be inclined to understate their revenues or overstate costs in case tax officials learn of their reports, while firms with losses may exit the industry and not report. Nonetheless, Levinsohn writes, the Turkish data indicate that imports increase competition and restrict the ability of domestic firms to exercise market power.

ML

Do Rising Interest Rates Predict Rising Inflation?

From the end of World War II until October 1979, increases in inflation in the United States were highly correlated with increases in short-term interest rates. This led some observers to conclude that movements in short-term interest rates reflected changes in expected future inflation and could be used to predict future inflation rates with some accuracy.

Since 1979, however, the relationship between interest rates and inflation has been much weaker. NBER Research Associate **Frederick Mishkin** notes that the relationship was also weak prior to World War II and in other countries even in the postwar period. In **Is the Fischer Effect for Real? A Reexamination of the Relationship Between Inflation and Interest Rates** (*NBER Working Paper No. 3632*), Mishkin analyzes monthly data on inflation rates and one- to twelve-month U.S. Treasury bill rates for February 1964 to December 1986.

"Changes in short-term interest rates are not a reliable predictor of future inflation."

He concludes that there is no short-run relationship between interest rates and future inflation, but there is a long-run relationship in which inflation and interest rates share a common trend. This solves the puzzle of why the level of interest rates predicts future inflation rates in some periods but not in others. The existence of a long-run relationship between interest rates and inflation implies that when interest rates and inflation exhibit a rising trend, as over 1950 to 1979, there will be a strong correlation between interest rates and inflation. On the other hand, when interest rates and inflation do not exhibit trends, as occurred after 1979, changes in short-term interest rates are not a reliable predictor of future inflation.

Income Differences and Trade Barriers

As international trade has grown in importance, many observers have voiced the fear that import competition will force the wages of workers in wealthier countries down to the level of those in poorer nations. Concerns about the income effects of greater trade have been especially pronounced in debates over the desirability of free trade agreements, such as the 1988 U.S.-Canada accord and the agreement now under negotiation between the United States and Mexico. According to an NBER study by **Dan Ben-David**, free trade indeed will cause incomes in the nations involved to converge—although that does not mean that real incomes in any nation must decline.

In **Equalizing Exchange: A Study of the Effects of Trade Liberalization** (NBER Working Paper No. 3706), Ben-David examines the dispersion of incomes in the six original member countries of the European Economic Community (EEC) between 1950, seven years before the Community's formation, and 1985. Prior to World War II, he finds, these countries had large and persistent differences in per capita incomes, with no tendency for income levels to converge. Following the onset of trade liberalization, however, the per capita incomes in the EEC countries drew much closer together. After Denmark, the Republic of Ireland, and the United Kingdom joined the EEC in 1973, the income disparities among them began to decline as well. This followed many years of diverging income.

The reduction in income differences is strongly related to the sharp increase in imports experienced by each EEC member state. Elimination of all tariffs and quotas within the EEC caused member nations' overall foreign trade to increase rapidly, Ben-David says, and "the link between the timing of liberalization and the increases in intra-EEC trade is striking." When major barriers within the EEC were eliminated by the late 1970s, the increase in intra-Community trade leveled off, and so did the movement toward income convergence.

> "Following the onset of trade liberalization ... the per capita incomes in the EEC countries drew much closer together."

Where trade is restricted, however, there is no general tendency toward income convergence. Ben-David analyzed income differences among a group of 107 countries that have enjoyed a general reduction in trade barriers but do not have completely free trade with one another. Differences in per capita incomes among that group have tended to grow over time. Among the 25 leading industrial countries, there is no tendency for income differences either to diminish or increase.

Thus, Ben-David asserts, free trade may play an important role in bringing nations' income levels closer together. So long as barriers to trade remain, he concludes, "there is no reason to assume convergence in income levels." ML

Language-Earnings Gap Decreases in Canada but Not in the United States

French-speaking men in Canada and Spanish-speaking men in the United States earn less than English-speaking men in their respective countries. Although the gap in earnings narrowed considerably for speakers of French in Canada in the 1970s and 1980s, it remained high for speakers of Spanish in the United States. In **The Earnings of Linguistic Minorities: French in Canada and Spanish in the United States** (*NBER Working Paper No. 3660*), **David Bloom** and **Gilles Grenier** report that in Quebec the average income of English-speaking males aged 25 to 64 was $24,054 in 1970, but had fallen to an inflation-adjusted $21,908 by 1985. Their French-speaking counterparts had an average income of $17,820 in 1970, which increased to $19,600 by 1985. For men elsewhere in Canada, inflation-adjusted earnings rose slightly more for the speakers of French than for the speakers of English.

Therefore, the language-earnings gap in Canada narrowed substantially in the 1970s and 1980s. Indeed, the authors conclude that all of the remaining gap for Quebec men is accounted for by the fact that speakers of English work more hours per year and have more education than the speakers of French.

Bloom and Grenier attribute the decline of the language-earnings gap in Canada to the fact that the relative supply of speakers of French increased only slightly in the 1970s, while the relative demand increased substantially, especially in Quebec. The authors highlight the fact that government policies that encouraged the use of French served to increase the demand for speakers of French and to raise their relative wage.

For Spanish-speaking men in the United States, the story is entirely different. In regions with high percentages of speakers of Spanish, the real earnings of English-speaking men aged 25 to 64 fell by 2.9 percent between 1969 and 1979, from $16,190 to $15,726. In those same regions, their Spanish-speak-

"Rapid immigration during the 1970s increased the relative supply of speakers of Spanish by more than the increase in relative demand, thus causing the relative wages of speakers of Spanish to decline."

ing counterparts' earnings fell by 4.2 percent, from $9970 to $9548. For men in the rest of the United States, earnings fell by 2.2 percent for speakers of English and by 11.2 percent for speakers of Spanish.

In short, the language–earnings gap in the United States actually has increased slightly over time. Bloom and Grenier note that some of the gap can be accounted for by differences in hours worked and in education. Yet, even after correcting for these differences, they find a sizable wage gap. The reason, they argue, is that rapid immigration during the 1970s increased the relative supply of speakers of Spanish by more than the increase in relative demand, thus causing the relative wages of speakers of Spanish to decline. DRH

NBER