The Levy Economics Institute of Bard College

Summary

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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.

The *Summary* is published three times a year (Winter, Spring, and Fall) and is intended to keep the academic community informed about the Institute’s research. To accomplish this goal, it contains summaries of recent research publications and reports on other activities.

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LETTER FROM THE PRESIDENT

To our readers:

This issue begins with a strategic analysis by Research Scholars Greg Hannsgen and Gennaro Zezza and me under the State of the U.S. and World Economies program. It is clear that the Obama administration's fiscal stimulus package has led to a "growth recession." We determine that real GDP growth will remain well below the rate required to push U.S. unemployment back to a more acceptable level. Moreover, any policy that sustains growth in order to reduce unemployment is likely to reignite the U.S. current account imbalance problem. However, a modest dollar devaluation could be very effective in promoting employment, while addressing the threat posed by large imbalances. In a public policy brief, policy note, and working paper, we show that the success of New Deal programs strengthens the case for fiscal policies and a permanent employer-of-last-resort program as proposed by Hyman P. Minsky.

Four public policy briefs are included under the Monetary Policy and Financial Structure program. Senior Scholar Jan Kregel finds that Brazil's financial system has been relatively untouched by the crisis, and that the country is much better placed than the other BRIC countries to transition from export-led to domestic demand–led growth. Senior Scholar James K. Galbraith reports on a recent meeting where a group of experts warned that the world economy will not grow its way out of depression and widespread unemployment without major public initiatives. Research Associate Éric Tymoigne and Senior Scholar L. Randall Wray point to excessive leveraging as the underlying cause of the crisis and note that the financial bailout has crowded out more sensible spending policies such as federal employment programs. Research Associate Stephanie A. Kelton and Wray find that nations that have adopted the euro have limited fiscal policy space, so they will be unable to prevent a depression that could threaten the existence of the European Union. In a policy note, Marshall Auerback and Wray observe that securitizing life insurance policy "settlements" is financial engineering run amok.

Seven working papers are also included under this program. In the first two, Tymoigne argues that unsupervised financial innovations and lenient government regulation are at the root of the crisis. Further, meaningful regulatory changes should analyze cash flows rather than capital equity, and prevent Ponzi processes in order to manage excessive risk taking and fraud.

Paolo Casadio and Antonio Paradiso find that the financing gap is a leading indicator of business cycles, and that it plays a crucial role in accordance with Minsky's theory of financial fragility. Two papers by Wray blame "money manager capitalism" for the economic crisis and recommend enhanced oversight of financial institutions, a large fiscal stimulus package, and a permanent employer-of-last-resort program.

Two working papers by Alessandro Vercelli suggest that Minsky's narrow classification has hindered the development of analytical models of the financial instability hypothesis and that a unit's financial conditions should be based on measures of liquidity and solvency.

Under the Distribution of Income and Wealth program, a LIMEW report by Research Scholar Thomas Masterson and Senior Scholars Ajit Zacharias and Edward N. Wolff finds that changes in household wealth and net government expenditures are the key elements behind a significant deterioration in the well-being of blacks and Hispanics relative to whites. Government policy that combines elements of both asset building and job creation could be instrumental in diminishing racial inequality. In a working paper, Hugo Benítez-Silva, Research Scholar Selcuk Eren, Frank Heiland, and Sergi Jiménez-Martín find that there is a strong correlation between the accuracy of homeowner property valuations and the business cycle.

Two working papers are included under the Gender Equality and the Economy program. Burca Kizilirmak and Research Associate Emel Memis recommend that gender inequalities in time-use patterns should be considered when designing antipoverty policies and promoting gender equality in South Africa. Research Associate Tamar Khitarishvili finds that government steps aimed at advancing gender equality in Georgia have not led to the inclusion of gender in the decision-making process for political, social, or economic policy.

Under the Economic Policy for the 21st Century program, a working paper by Fatma Gül Ünal finds that the rural factor markets in Turkey enhance rural unemployment as well as income and asset inequality.

As always, I welcome your comments and suggestions.

Dimitri B. Papadimitriou, *President*

Program: The State of the U.S. and World Economies

Strategic Analysis

The Current Recession and Beyond: Medium-term Prospects for the U.S. Economy

DIMITRI B. PAPADIMITRIOU, GREG HANNSGEN, and GENNARO ZEZZA

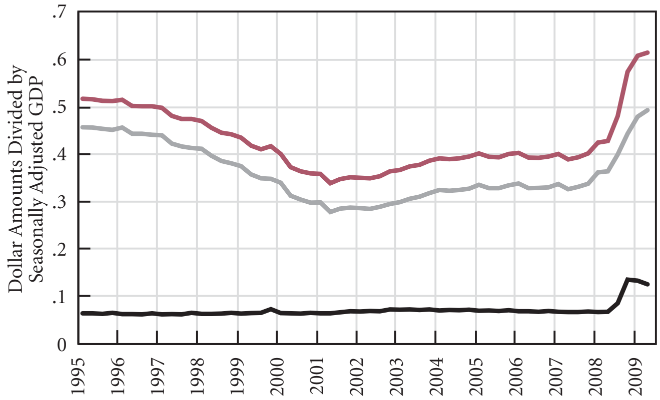
December 2009

A year ago, the U.S. economy was in severe crisis. Now, after unprecedented efforts by the Federal Reserve (Fed) and Congress, and the adoption of "big government" policies, the financial system is more stable but the official unemployment level is 10.2 percent—and rising. According to President Dimitri B. Papadimitriou and Research Scholars Greg Hannsgen and Gennaro Zezza, the nascent recovery is still very fragile, so a good policymaking strategy will require a clear assessment of U.S. economic prospects over the medium term (i.e., six years).

Using the Levy Institute's macro model, the authors review the three key financial balances of the U.S. economy: the private sector, government, and current account. They focus on the current account balance according to (1) a baseline scenario predicated on average projections of fiscal policy and future exchange rates; (2) scenario 1, which assumes a stimulative fiscal policy; and (3) scenario 2, which assumes an 11.9 percent devaluation of the dollar combined with a modestly stimulative fiscal policy.

The authors note that government financial liabilities have risen more than 53 percent relative to GDP since the last quarter of 2007, when the recession officially began (Figure 1). The Fed has reduced its liabilities, but this reduction has been more than offset by the rising federal debt. Nevertheless, public liabilities (61 percent of GDP) are lower than the levels reached in the aftermath of World War II, when interest rates remained low, households built stronger balance sheets, and the financial

Figure 1 Liabilities on the Consolidated Federal Government and Federal Reserve (Fed) Balance Sheet, 1995Q1–2009Q2



Total Liabilities of Federal Government and Fed, Excluding Funds Owed to One Another, Divided by GDP

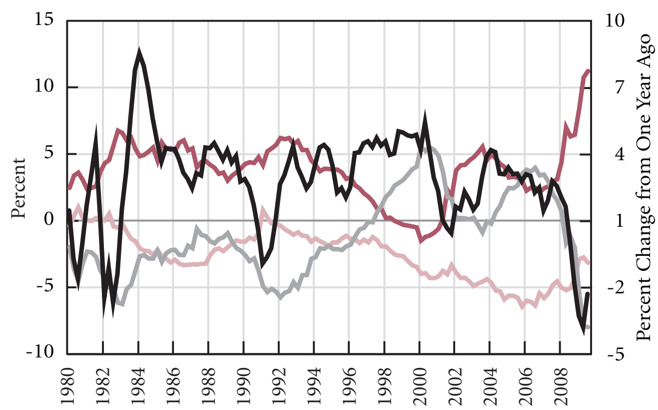
Federal Government Liabilities, Excluding Liabilities to Federal Reserve, Divided by GDP

Federal Reserve Liabilities, Excluding Liabilities to Federal Government, Divided by GDP

Note: Series shown in black equals total Fed liabilities minus checkable deposits due to federal government; Series shown in gray includes total federal government liabilities minus Treasury securities held by the Fed minus nonmarketable securities held by pension funds minus Treasury currency held by the Fed. Assets and liabilities data not seasonally adjusted.

Sources: GDP, St. Louis Federal Reserve FRED database; liabilities series, Federal Reserve Board Flow-of-Funds dataset

Figure 2 U.S. Main Sector Balances and Real GDP Growth



Government Deficit, Divided by GDP (left scale)

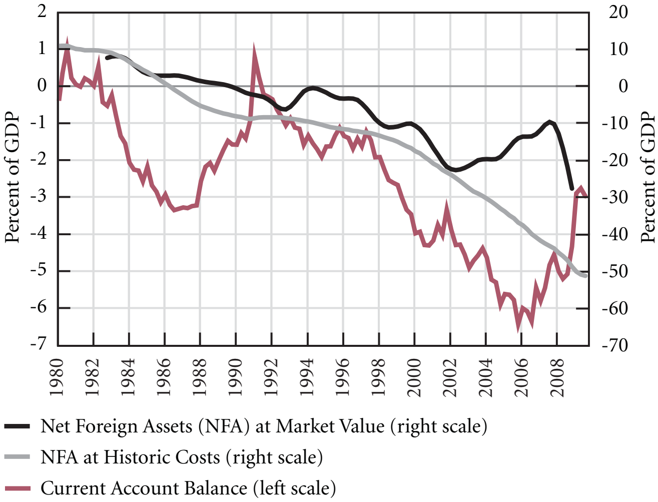
Real GDP Growth Rate (right scale)

Current Account Balance, Divided by GDP (left scale)

Private Sector Deficit, Divided by GDP (left scale)

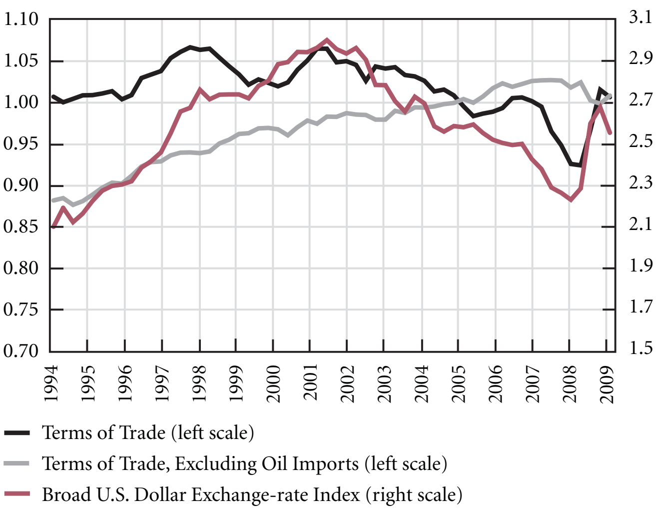
Sources: BEA; authors' calculations

Figure 3 U.S. Net Foreign Assets and Current Account Balance



Sources: BEA; International Monetary Fund (IMF); authors' calculations

Figure 4 Terms of Trade and the U.S. Dollar Exchange Rate



Sources: BLS; Federal Reserve; BEA; authors' calculations

sector enjoyed a long period of relative calm. An abundant supply of securities with minuscule default risk suggests a continuation of stimulative fiscal policy until the economy stabilizes.

The most dramatic sign of the recession's severity is the state of the labor market. The employment rate has tumbled (from 65 to 59 percent), the unemployment rate stands at 17.5 percent if one includes discouraged and part-time workers who want full-time work, and the real wage growth rate is negative. These statistics add up to a picture of hardship for many Americans, and to weak consumer demand.

By national accounting identity, the three financial balances sum to zero. Public or private sector deficits can drive the economy forward, but they also increase financial fragility. The private sector played this role in the late 1990s and early 2000s, but surpluses have returned as households and businesses cut spending to pay off debt. This reversal has been accompanied by a soaring government deficit and a narrowing current account deficit (from 5.1 to 3.2 percent of GDP) in the past year (Figure 2).

According to common measures of the housing market, there are no grounds for a robust recovery, since investment has collapsed. The favorable third-quarter profit reports released by many large banks reflect trading gains rather than a lending recovery. Although borrowing has turned negative, household and nonfinancial debt continues to exceed historical norms, and will act as a drag on consumer spending.

Current readings of U.S. net foreign assets (NFA) warrant deep concern (Figure 3). A further slowdown in the buildup of debt to foreigners will reduce debt-financed spending by U.S. businesses, households, and governments. If substantial current account deficits persist and reduce NFA, there is increased risk of a catastrophic drop in the dollar exchange rate. If policymakers succeed in staving off serious financial turmoil and controlling the dollar's decline, the current account balance may improve. A weaker dollar, however, leads to higher oil prices and deteriorating terms of trade between the United States and its trading partners (Figure 4).

Dollar devaluation has been a main tool to reduce the trade deficit. However, the "terms-of-trade effect" reduces the effectiveness of this policy instrument, since Americans spend more on imported goods and services when prices rise. This perverse relationship is shown in Figure 5, suggesting a departure from exchange-rate devaluations in favor of policy responses to large international imbalances, including measures such as energy conservation to reduce the demand for imported goods.

Using International Monetary Fund GDP projections, the authors devise a baseline scenario that shows world output growth returning to trend in 2011 without replenishing the net loss in output as a result of the current recession. Net household borrowing will remain negative but improve as a percentage of

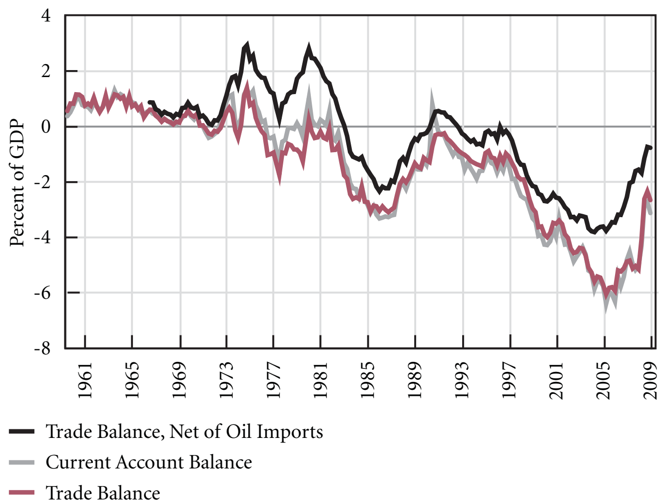
GDP until 2013. These assumptions on borrowing are more optimistic than those adopted by the authors a year ago. Using Congessional Budget Office projections, Papadimitriou, Hannsgen, and Zezza verify the consequences of an end to the government's fiscal stimulus (from 11.2 percent of GDP to 3 percent by 2012) in association with a rise in income tax revenues and a steady increase in outlays related to servicing the debt.

The baseline scenario implies that real GDP growth will resume but remain sluggish, staying well below the rate required to push unemployment back into the single digits. All financial imbalances will converge toward zero (Figure 6). Slow growth will help shrink the current account deficit to 1 percent of GDP by 2015. Sustained government deficits will increase the government debt from 61 to 91 percent of GDP, but this debt is sustainable provided interest rates remain at current levels. It is clear that the fiscal stimulus has strongly supported aggregate demand without lowering unemployment, thus leading to a "growth recession."

In scenario 1, the authors assume that the government maintains its current fiscal policies, postponing measures to address the deficit. Government expenditures and transfers are kept at the prerecession trend in nominal terms, and the Bush tax cuts are extended. Unemployment falls below 7 percent and GDP growth rates average above 3 percent, but these rates are not high enough to close the output gap. The government deficit declines very slowly, government debt exceeds that in the baseline scenario, and the current account deficit widens from 2.6 to 4.1 percent of GDP (Figure 7). Thus, any policy that sustains growth in order to reduce unemployment is likely to reignite the current account imbalance problem.

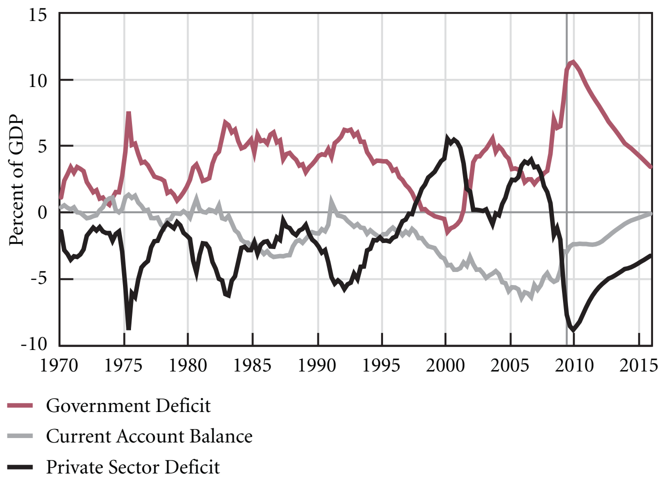
In scenario 2, the dollar is 11.9 percent lower than its value in the third quarter of 2009 but only 2 percent below its value in the second quarter of 2008. This devaluation will raise the cost of oil imports but increase net exports and aggregate demand, thus permitting tighter fiscal policy than in scenario 1. Unemployment drops below 7.5 percent and the government deficit falls faster than that in scenario 1 (to 5.6 percent of GDP in 2015). The adverse effects of faster domestic growth on the current account balance are countered by the growth in net exports, so the deficit stabilizes at a sustainable 1.3 percent of GDP (Figure 8). Thus, a modest dollar devaluation could be a very effective pro-employment policy, while directly addressing the medium-term threat posed by large imbalances.

Figure 5 **U.S. Current Account and Trade Balances**



Sources: BEA; authors' calculations

Figure 6 **Main Sector Balances in Baseline Scenario**

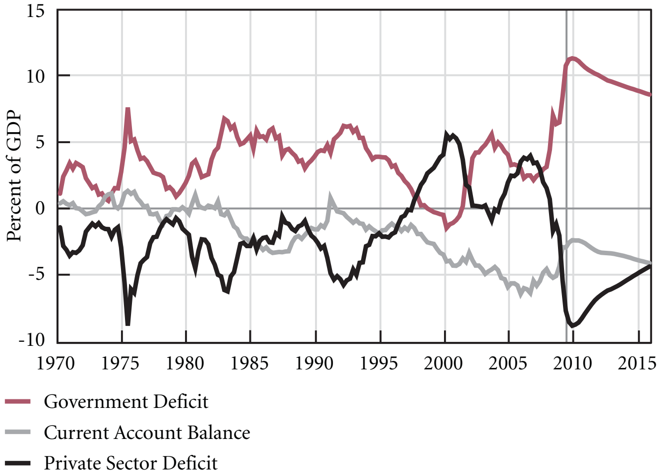


Sources: BEA; authors' calculations

Since market forces may not achieve an orderly dollar devaluation, the authors favor a multilateral agreement between the Fed and the central banks of major surplus countries. Failure to do so could lead to adverse consequences, such as a sudden collapse of the dollar and a return to financial fragility. It is also important to pursue an international pact to support efforts to develop alternative energy sources.

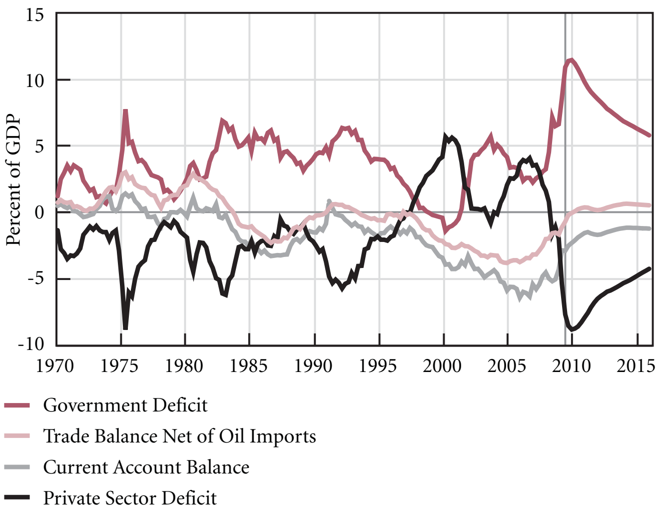
For the complete text, go to www.levy.org/pubs/sa_dec_09.pdf.

Figure 7 **Main Sector Balances in Scenario 1, Postponed Deficit Reduction**



Sources: BEA; authors' calculations

Figure 8 **Main Sector and Trade Balances in Scenario 2, U.S. Dollar Devaluation and Some Deficit Reduction**



Sources: BEA; authors' calculations

The *New* New Deal Fracas: Did Roosevelt's "Anticompetitive" Legislation Slow the Recovery from the Great Depression?

DIMITRI B. PAPADIMITRIOU and GREG HANNSGEN

Public Policy Brief No. 104, 2009

President Dimitri B. Papadimitriou and Research Scholar Greg Hannsgen look at two key laws enacted during a time that has been on many Americans' minds lately. In his first 100 days in office, President Franklin D. Roosevelt, facing the worst economic crisis of the 20th century, sent several important pieces of legislation to Congress. Among them was the National Industrial Recovery Act (NIRA) of 1933, which Roosevelt called "the most important and far-reaching legislation ever enacted by the American Congress." On the one hand, the Act called for industry codes that ultimately had the effect of stifling competition in many product markets, through measures that included minimum prices. On the other hand, the path-breaking union rights and labor protections mandated by the law were not well enforced. Labor prospered to a much greater extent after the National Labor Relations Act (NLRA) was enacted in 1935. This law revived many of the labor rights guaranteed in the earlier act—which by then had been declared unconstitutional by the Supreme Court—and was enforced more rigorously.

The issues of that period were again brought to the fore by two recent developments, one cultural and one political. First, in 2007, Amity Shlaes's *The Forgotten Man* became a best seller. This book argues that many New Deal laws, including NIRA and NLRA, "helped to make the Depression Great." Second, President Obama's election in 2008 stoked hopes for a strong governmental response to the current recession and financial crisis, a response that might be patterned after the New Deal.

These events have in turn sparked a renewed and vigorous public debate among scholars about the economic impact of the New Deal; in particular, NIRA and NLRA. A number of economists have joined this debate, citing research conducted during the past 15 years. This brief focuses on *The Forgotten Man* and a 2004 paper by Harold Cole, now at the University of Pennsylvania, and Lee Ohanian of the University of California, Los Angeles. The article's thesis is that NIRA and NLRA hindered recovery from the Depression after 1933, in part by allowing companies to conspire to reduce output and raise prices. Cole and Ohanian also argue that NIRA and NLRA reduced employment by raising wages.

This brief points out some facts that cast into doubt the way Cole and Ohanian measure the effects of the two laws. First, cartels, monopolies, and industries controlled by a few powerful firms were common long before the New Deal, and many of these would have survived throughout the 1930s even without NIRA. Second, industry generally flouted NIRA's labor provisions, using time-honored but illegal methods to quash union activities. The wage and hours codes were usually drafted by boards with no labor representation. NLRA was a far more effective piece of legislation, but coming as late as it did, that bill probably had only a minor effect on overall macroeconomic performance during the 1930s. Moreover, economists have found evidence that good unions can accomplish more than raising their members' wages, to the benefit of the wider economy.

The thrust of Papadimitriou and Hannsgen's analysis is that NIRA and NLRA did not prolong or worsen the Great Depression. Fiscal policy and jobs programs had a much greater impact on economic growth in the 1930s, as Keynesian economics has long taught. This impact was positive and significant. Of course, unemployment remained high, if only because the federal government did not hire everyone who was willing and able to work. For all practical purposes, that did not happen until after the war effort began. Hence, it is the public works and relief programs of the New Deal that offer the most relevant lessons for legislative efforts to end the current recession and probable employment slump, though the authors agree with Cole and Ohanian that vigorous antitrust enforcement is beneficial to consumers and the economy.
For the complete text, go to www.levy.org/pubs/ppb_104.pdf.

Fiscal Stimulus, Job Creation, and the Economy: What Are the Lessons of the New Deal?

GREG HANNSGEN and DIMITRI B. PAPADIMITRIOU
Policy Note 2009/10

A group of academics disputes the notion that President Roosevelt's fiscal and job creation programs helped end the Great Depression. However, Research Scholar Greg Hannsgen and President Dimitri B. Papadimitriou believe that the New Deal era strengthens the case for the effectiveness of fiscal policies and jobs programs. They note that John Maynard Keynes's general theory of an economy is still apropos, and recommend a permanent employer-of-last-resort (ELR) program, as proposed by Hyman P. Minsky, to mitigate the effects of today's Great Recession.

The authors observe that the period between the Great Crash in 1929 and the beginning of Roosevelt's first term in 1933 offered little evidence that the economy could recover on its own. They also observe that many New Deal programs created jobs indirectly (e.g., by making mortgages more affordable and bringing electricity to rural areas). Moreover, when Washington sharply increased spending (1933–36), tax-revenue shortfalls forced state and local governments to cut expenditures, partially offsetting the federal stimulus packages.

The application of fiscal policy represented an unsteady path during the 1929–45 period. However, there was resurgence in growth (1933–37) following a rapid rise in the deficit but a return to recession (1937–38) when the deficit declined significantly. The persistence of mass unemployment throughout the 1930s should be blamed on the enormity of the task at hand and Roosevelt's reluctance to run deficits, say Hannsgen and Papadimitriou. And the number of jobs created by the Works Progress Administration and other federal agencies was perhaps more important than the size of the fiscal stimulus.

In light of arguments that there will be either a very sluggish recovery or a double-dip recession related to the current economic downturn, the authors suggest that the most pressing need is to deal with unemployment (there are currently six job seekers per opening). There is good reason to believe that what worked in the Great Depression will work again, they say. An ELR program would provide cost-effective and noninflationary insurance against unemployment, and allow the government to cut spending on other safety-net programs (since some types of stimulus are more effective than others in creating jobs).
For the complete text, go to www.levy.org/pubs/pn_09_10.pdf.

Lessons from the New Deal: Did the New Deal Prolong or Worsen the Great Depression?

GREG HANNSGEN and DIMITRI B. PAPADIMITRIOU

Working Paper No. 581, October 2009

This working paper forms the basis for Public Policy Brief No. 104 (see pp. 9–10) and Policy Note 2009/10 (opposite).

For the complete text, go to www.levy.org/pubs/wp_581.pdf.

Program: Monetary Policy and Financial Structure

The Global Crisis and the Implications for Developing Countries and the BRICs: Is the *B* Really Justified?

JAN KREGEL

Public Policy Brief No. 102, 2009

The term *BRIC* was coined by Goldman Sachs and refers to the fast-growing developing economies of Brazil, Russia, India, and China—a class of middle-income emerging market economies of relatively large size that are capable of self-sustained expansion. Their combined economies could exceed the combined economies of today's richest countries by 2050. However, there are concerns about how the current financial crisis will affect the BRICs, and Goldman Sachs has questioned whether Brazil should remain within this group.

Senior Scholar Jan Kregel reviews the implications of the global crisis for developing countries, based on the factors driving global trade. He concludes that there is unlikely to be a return to the extremely positive conditions underlying the recent sharp increase in growth and external accounts. The key for developing countries is to transition from export-led to domestic demand-led growth. From this viewpoint, Brazil seems much better placed than the other BRIC countries.

When Brazil had the highest return on equities of any country in the world and the *real* became a large positive-carry currency (which translated into higher incomes and growth rates), the *B* in BRIC was justified. Its strong national development bank and greater financial stability (e.g., its derivatives market is tightly regulated), combined with an increase in the minimum wage, enabled Brazil to generate balanced growth during a global recession. However, the (indirect) impact of exchange rate appreciation and rising asset prices produced conditions that were typical of prior crises.

The factors driving global trade are all linked directly or indirectly to changes in financial regulation and competition in the United States. The evolution of the current financial crisis stems from the collapse of the markets for U.S. subprime mortgages and derivatives. The outcome of the crisis will be a decline in returns due to rising capital requirements and a reduction in leverage. Thus, the liquidity machine based on structured investment vehicles, margin positions, and default insurance will not be part of the new financial system. Deleveraging and falling asset prices should not have any bearing on the surety of BRIC banking systems, but the high levels of liquidity have an impact on (higher) commodity prices and the BRIC equity markets.

Although Brazil's positive performance and initial membership in the BRIC group appears to be linked to a financial model and financial flows that are unlikely to be reestablished—a result of structural changes (e.g., a reduction in U.S. households' propensity to consume and the disappearance of leverage from the global financial system)—Brazil's financial system has been relatively untouched by the crisis. However, says Kregel, Brazil should not return to a development strategy designed to attract external capital and build on external demand (in spite of temptations posed by domestic demand recovery in China). Rather, the most obvious path is the transition to growth based on domestic income growth and consumption through diversification of markets and production. This path is particularly important in economies where large peasant or agricultural populations and associated income inequalities remain.

Kregel notes that Brazil already has a transition policy in place, along with programs that seek to augment the rate of domestic demand and growth through government-sponsored infrastructure investment projects. He suggests that these programs should be implemented in conjunction with a national job guarantee program in order to mitigate the increase in unemployment, which has been one of the major repercussions of the crisis. In addition, the domestic financial market should transform from a structure providing government financing to one providing long-term capital for domestic productive investment.

For the complete text, go to www.levy.org/pubs/ppb_102.pdf.

Financial and Monetary Issues as the Crisis Unfolds

JAMES K. GALBRAITH

Public Policy Brief No. 103, 2009

A group of experts associated with Economists for Peace and Security and the Initiative for Rethinking the Economy met recently in Paris to discuss financial and monetary issues. Senior Scholar James K. Galbraith summarizes the group's viewpoints, which are largely at odds with those of the global political and economic establishment. Despite noting some success in averting a catastrophic collapse of liquidity and a decline in output, the group was pessimistic that there would be sustained economic recovery and a return to high employment. The general consensus was that the precrisis financial system should not be restored, that reviving the financial sector first was not the way to revive the economy, and that governments should not pursue exit strategies that permit a return to the status quo. Rather, the crisis has exposed the need for profound reform to meet a range of physical and social objectives.

The group's outlook was based on the belief that the influence of private equity on global investment patterns will not return, and that the growth of rich-country, consumer debt will not be restored. Moreover, no region outside the United States is prepared to step up and play the role of consumer of last resort, and there is no offset to the global demand for savings. Thus, the world economy will not grow its way out of depression and widespread unemployment without major and sustained public initiatives.

Neoliberal reform and neoclassical economics have veered away from general welfare by substituting the market for the functions of the state. The concept of public interest disappears from theory, and markets, by definition an alliance of the rich against the middle class and the poor, serve only private interests. The slippage from liberal to neoliberal thinking has been especially clear in banking and is present in the U.S. administration's response to the crisis.

Fundamental reform and "bottom up" recovery strategies are blocked by preserving the existing (unstable) system and by failing to prosecute fraud. The group favors a major strengthening of national and transnational regulatory agencies, including rules for citizens dealing with such agencies (e.g., rules of taxation and for mortgages); aligning the reach of banks with the regulatory framework, and government enforcement (i.e., public power). Moreover, there is merit in achieving (smaller) public-purpose financial structures that are not "too big to fail."

There was broad agreement that a mixed financial system, with liberal (public-private) institutional underpinnings and a market context, requires regulation of both institutional conduct and governance, as well as market instruments. In this context, the reform packages in both the United States and Europe fall short. Further, there is no particular need for the U.S. Treasury to establish separate entities as receptacles for toxic assets, and no excuse for the government to fail to redefine and set economic accounting standards for the conduct of banks, or to fully employ human potential.

The design of economic policy has relegated environmental, health, and inequality indicators to secondary roles in favor of the monetarist goal that ties central bank conduct to the drive for price stability. A preferred alternative is to design policy that focuses on global public goods, nonrenewable resources, human resource use, and the sharing of knowledge goods. The correct approach to increase economic activity and employment includes a program of general fiscal assistance or revenue sharing, relief from payroll taxes, and expanded Social Security benefits. Moreover, a public job at a fixed wage for all takers functions like a buffer stock for human labor, stabilizing both total employment and the bottom tier of the wage structure.

According to the group, the main justifications for a dollar-based system are no longer persuasive, and present international monetary institutions are weak and dysfunctional (e.g., the International Monetary Fund is, essentially, beyond repair). It favors developing regional monetary authorities and freeing developing countries from a compulsive need to serve the export sector on any terms. The group notes that the problem of unemployment is easily cured without threat to profitability or as a source of inflation, and that the problem of liquidity can be solved only at the level of the currency unit. In sum, the group warns that the crisis is not over, that policies set in motion are not sufficient, and that the goals set by the authorities are neither desirable nor possible.

For the complete text, go to www.levy.org/pubs/ppb_103.pdf.

It Isn't Working: Time for More Radical Policies

ÉRIC TYMOIGNE and L. RANDALL WRAY

Public Policy Brief No. 105, 2009

The Obama administration has implemented several policies to "jump-start" the U.S. economy. Two core premises are that monetary measures are required to strengthen the financial system before the rest of the economy can recover, and that most major banks have only a temporary liquidity problem induced by malfunctioning financial markets. The administration's efforts have largely focused on preserving the financial interests of major banks.

Research Associate Éric Tymoigne and Senior Scholar L. Randall Wray believe that maintaining the status quo is not the solution, since it overlooks the debt problems of households and nonfinancial businesses: re-creating the financial conditions that led to disaster will set the stage for a recurrence of the Great Depression or a Japanese-style "lost decade." They recommend a more radical policy agenda, such as federal spending programs that directly provide jobs and sustain employment, thereby helping to restore the creditworthiness of borrowers, the profitability of firms, and the fiscal position of state and federal budgets.

The authors describe the leveraging of income and equity by households, firms, and financial institutions as the underlying cause of the crisis. As the level of risky assets on the banks' balance sheets rose, the rate of profit in the finance, insurance, and real estate sectors accelerated. According to Hyman P. Minsky, banks with higher leverage and profit rates must grow faster in order to maintain a certain level of profitability. History shows that lending against expected increases in asset values is almost always a recipe for trouble. Since leverage is highly procyclical, an unconstrained financial system will tend toward explosive growth during a boom. The notion that legislated capital requirements (such as those inherent in the Basel agreements) can constrain growth and risk is, therefore, flawed. And the argument that the U.S. government had to inject capital and get the bad assets off the books in order to encourage banks to lend again is nonsensical. More lending, say the authors, is not a solution to excessive leverage and debt.

There has been a long-term trend toward nonbank financial institutions (the "shadow banking sector") and the "originate to distribute" model. The public scolding of banks for "not providing credit" is misplaced, since the "shadow" sector is shrinking balance sheets and cutting off credit. The market wants more deleveraging because of solvency risks, not liquidity problems, so there will be no sustainable recovery until these debts are reduced and incomes begin growing again.

While Washington's focus is on the staggering government debt and unsustainable fiscal deficits, the real concern should be the debt level of the private domestic sector. It is important to recognize that government debt is low relative to the size of the U.S. economy, say the authors, and deleveraging in the private sector cannot happen without an expansion of the government deficit. Otherwise, there is risk of a full-blown debt-deflation process.

The current approach of the financial institutions that created the mess is to discourage loan renegotiations and modifications because preventing resolution is more profitable, based on the money to be made by squeezing debtors with fees and penalties. This explains why current policies have failed to keep people in their homes. And the promise to create three million new jobs when there are already 9.5 million fewer jobs than at the start of the downturn indicates that current efforts are grossly insufficient. The financial bailout has crowded out more sensible spending policies.

The authors maintain that the government's programs will not work unless they deal with the core issue: many financial institutions are probably insolvent and should not be saved because they form a barrier to sustainable recovery. Policy should downsize the trade- and fee-driven financial sector, reduce monopoly power, increase supervision and regulation (and restore proper underwriting), and favor small, independent financial institutions. Policy should also support countercyclical government employment programs such as those created under the New Deal, help households to restructure their finances and remain in their homes, and reallocate commitments that favor the financial sector.

For the complete text, go to www.levy.org/pubs/ppb_105.pdf.

Can Euroland Survive?

STEPHANIE A. KELTON and L. RANDALL WRAY
Public Policy Brief No. 106, 2009

Social unrest across Europe is growing as Euroland's economy collapses faster than the United States', the result of falling exports and a weaker fiscal response. The controversial title of this brief is based on a belief that the nature of the euro itself limits Euroland's fiscal policy space. The nations that have adopted the euro face "market-imposed" fiscal constraints on borrowing because they are not sovereign countries. Research Associate Stephanie A. Kelton and Senior Scholar L. Randall Wray foresee a real danger that these nations will be unable to prevent an accelerating slide toward a depression that will threaten the existence of the European Union (EU).

Economic performance throughout Euroland has converged to one that is uniformly poor for all members (i.e., chronically high unemployment and slow growth), a situation consistent with nonsovereign nations' relying on export-led (mercantilist) policy. Moreover, the capital markets have doubts about the ability of member governments to cover their debts. Thus, bond yield spreads have widened during the downturn, indicating that liquidity and default risks are expected to rise, and that national defaults are plausible.

The U.S. Federal Reserve (Fed) is lending to foreign central banks via swap lines and acting as the global lender of last resort. The authors maintain that the Fed does not face currency risk when it engages in overseas lending and that its actions have been a form of life support for Euroland. The question is whether there is sufficient political will for U.S. policymakers to continue this support as the Fed's financial services explode.

Kelton and Wray outline how fiscal policy operates in a sovereign nation that issues its own currency. Since a sovereign government spends by crediting bank accounts, its spending is never constrained by taxes or bond sales. There is no reason for rating agencies to downgrade government debt because it is sovereign debt with no default risk. Moreover, a sovereign government can bail out its state and local governments. This option as it relates to the European Parliament is unknown, since the European Central Bank is practically prohibited from taking over the debts of member states.

The only way out of this crisis is to use sovereign power and ramp up government spending. Rather than shoring up investor confidence, spending increases in Euroland have fueled concerns about the impact on government debt levels and the future of the euro. Nearly half of all member states are projected to breach the 3 percent deficit-to-GDP limit—debt that has to be purchased in (substantially tightened) private capital markets. The financial markets are expressing an unprecedented preference for German treasury issues, resulting in a dramatic widening of yield premiums against the bund. And in response to the threat of budgetary-related penalties by the EU's executive arm, some states may simply abandon the euro.

The authors believe that the Maastricht Treaty does not constrain government spending, so any changes to this legislation would do little to increase fiscal freedom. This argument is based on the notion that financial markets (by pricing risk) are likely to discipline governments before the treaty limits are reached. When a nation is perceived to be a "weak" issuer, the markets can effectively shut down its ability to stabilize conditions within its borders—a fundamental flaw that the authors have warned about since the euro zone's inception. Unless these nations can avert such financial constraints—for example, by establishing a sizable EU budget and giving the European Parliament fiscal authority on par with that of the U.S. Congress—prospects for stabilizing the euro zone appear grim. Such measures are likely to be politically, culturally, and socially difficult, so a trend toward dissolution remains a possibility.
For the complete text, go to www.levy.org/pubs/ppb_106.pdf.

Banks Running Wild: The Subversion of Insurance by "Life Settlements" and Credit Default Swaps

MARSHALL AUERBACK and L. RANDALL WRAY
Policy Note 2009/9

Through the credit-default-swap (CDS) "insurance" market, it is possible to take on the risk of a mortgage-backed security without purchasing or holding the security. Since the market for these products is moribund, Wall Street is looking for the next asset bubble by securitizing life insurance policies and creating huge financial incentives in favor of personal calamity; that is, by making bets on the death of human beings.

Marshall Auerback, RAB Capital PLC, and Senior Scholar L. Randall Wray argue that CDSs give the participants a vested interest in financial instability by creating perverse incentives, since the product subverts the nature of true insurance by separating the insuring party from his insurable interest. They believe that most of the problems created in the securitized mortgage business will be re-created in the market for securitized life insurance policies as leveraged money flows in and creates an unsustainable bubble (e.g., indiscriminate sales without normal underwriting, little documentation, a lack of due diligence by rating agencies, and defrauding of policyholders). The authors call for the banning of CDSs and so-called "life settlement" securities since they operate against the public interest. In essence, they say, this is financial engineering run amok.

A recent example of moral hazard and perverse incentives is when the hedge funds holding CDS "insurance" tried to force the U.S. auto industry into bankruptcy because these funds would make more from the auto industry's demise than from its resurrection. Similarly, most holders of troubled mortgages cannot gain relief because the firms that service these mortgages gain more from foreclosure than from a workout loan. And worse, securitization of life insurance policies creates incentives to ensure that our system does not provide the healthiest outcomes and that people die younger (e.g., an alliance of Big Pharma and Big Finance could increase health care costs and enhance the value of these securitized policies).

The authors outline a number of actions associated with downsizing the financial system and eliminating both the riskiest assets and those that serve no useful public purpose. They propose that all bank assets and liabilities must be brought onto balance sheets, made subject to reserve and capital requirements, and be subject to the normal oversight of appropriate regulatory agencies. They also propose that all CDSs must be bought and sold on regulated exchanges. They further propose that securitization of products such as life insurance policies should be prohibited, unless approved by Congress. The FDIC should unwind all CDS contracts between the largest insured banks in order to reduce systemic risk and identify and resolve the insolvent banks, avoiding resolution methods that favor large institutions.

For the complete text, go to www.levy.org/pubs/pn_09_09.pdf.

Securitization, Deregulation, Economic Stability, and Financial Crisis, Parts I and II

ÉRIC TYMOIGNE

Working Paper Nos. 573.1–.2, August 2009

Research Associate Éric Tymoigne analyzes the trends in the U.S. financial sector over the past 30 years and argues that unsupervised financial innovations and lenient government regulation are at the root of the current financial crisis and recession. He blames an economic setup that requires Ponzi processes for enduring economic expansion, and a regulatory system that is unwilling to recognize the intrinsic instability of market mechanisms. We need to change our approach to regulating financial institutions, says Tymoigne, and recognize the interests of the socioeconomic system (i.e., financial and systemic stability) rather than the interests of Wall Street or Main Street, he says.

The first part of this detailed study assesses the evolution of securitization and how it contributed to Ponzi processes in the mortgage industry and other sectors. The second part focuses on the regulatory changes that contributed to the worst financial crisis of the past 80 years. Tymoigne argues that regulation and supervision should be oriented toward managing the growth of systemic risk at all levels through an analysis of creditworthiness that includes the detection of Ponzi financial practices. In addition, the government should put in place an industrial policy that limits mergers and acquisitions, counters the Ponzi tendencies of market mechanisms, and manages financial innovations.

Since 1970, securitization has been understood as a kind of off-balance-sheet operation to transfer financial (credit and liquidity) risks embedded in the illiquid claims held by financial institutions. In its pure form, it is a type of nonrecourse funding operation involving four parties: the investor, the servicer, the special purpose entity (SPE), and the security buyers (savers). However, there are many different versions that can take on more or less complex forms. Credit-rating agencies are an important element because they inform buyers about the quality of securities issued by the SPE.

The intent of securitization has changed over time. More recently, it has concerned financial claims in secondary rather than primary markets. A collateral manager buys these claims in the secondary market and creates an SPE, which can enter into complex management strategies to maximize return on equity. The SPE is a bankruptcy-remote entity that is legally and financially isolated, so that risk is transferred off the balance sheet of the claim's originator (servicer). Structured finance aims at correcting the flaws of SPE structures and accommodating the preferences of buyers by creating different classes of securities (e.g., "tranching"). Thus, securitization allows the servicer to reduce the amount of capital required and create a new source of revenue. As a result, there has been an unprecedented redistribution of profitability away from Main Street and toward Wall Street. The main potential social benefit is an increase in the willingness of banks to finance and fund economic activities that raise standards of living and provide financial stability.

The types of activities affected by securitization have broadened, and they have been progressively decoupled from economic activities. A long period of low default rates created a need to increase leverage in order to boost returns. The boom during the past decade was a textbook case of increased financial fragility (from hedge to Ponzi financing) as described by Hyman P. Minsky's financial instability hypothesis. Securitization was found to transform rather than transfer risk, to compound risk, to move but not eliminate credit and liquidity risk, and to increase systemic risk by increasing the interdependence of cash flows. Rather than fulfilling social needs, Wall Street used securitization for its own interests—for example, innovative financial instruments in the mortgage market (backed by artificial assets) created the housing boom.

The change in financial products and structures represented a progressive shift away from income-related activities with low leverage requiring little refinancing and toward capital-related activities with high leverage requiring constant refinancing at low interest rates. This change precipitated increasingly daring financial practices. All sectors affected by securitization engaged in Ponzi processes, and there was strong sociopolitical pressure to let these processes go unchecked. Although the crisis put a halt to the innovation frenzy, future innovations will likely increase the number of SPE products and counter regulatory barriers and other limits to market growth.

The financial sector needs to be carefully monitored and regulated, and the social interest must prevail, says Tymoigne. The U.S. government should motivate financial firms to innovate and ensure that the country has a sound and reliable financial system, even if short-term profitability suffers. Two central criteria for judging innovations should be safety and the capacity to improve a society's standard of living. Creditworthiness should be a key concept that depends on the capacity to meet financial commitments through cash inflows from core operations.

The crisis shows that there is a need to understand and measure systemic risk, and to reprioritize the goals of the central banks. Subprime lending, speculation, and greed are contributing but not the main factor behind the crisis. Rather, the main factor relates to Minsky's insight that "stability is destabilizing." A means to promote financial stability (the social interest) is a regulatory and supervisory framework oriented toward analyzing cash flows at the individual, sector, and systemic levels, and discouraging Ponzi financial practices; that is, changing the economic paradigm.

For the complete texts, go to www.levy.org/pubs/wp_573_1.pdf and wp_573_2.pdf.

A Critical Assessment of Seven Reports on Financial Reform: A Minskyan Perspective, Parts I–IV

ÉRIC TYMOIGNE

Working Paper Nos. 574.1–.4, August 2009

This four-part study by Research Associate Éric Tymoigne critically analyzes reports dealing with U.S. financial system reform. It uses Hyman P. Minsky's analytical framework and focuses on the implications of Ponzi finance for regulatory and supervisory policies. The main conclusion is that all of the reports fail to deal with the socioeconomic dynamics that emerge during periods of economic stability, and therefore their proposals are unlikely to limit financial fragility. Any meaningful systemic and prudential regulatory changes should analyze cash flows rather than capital equity, and prevent Ponzi processes whether they are legal or not (see also, Working Paper Nos. 573.1–.2).

The Department of the Treasury's *Blueprint for a Modernized Financial Regulatory Structure* (2008) argues that the functional approach is inappropriate when dealing with systemic risk, and proposes to reform the regulatory system in terms of market stability, prudent behavior, and business conduct. The report's core concern is the competitiveness of the U.S. financial sector rather than financial stability. Tymoigne criticizes the emphasis on innovation to enhance the competitiveness of the financial sector and asserts that the report was not written with the current crisis in mind. Based on arguments by Minsky, there is a need to orient regulation and supervision toward monitoring systemic risk and stability, and to emphasize the role of the discount window rather than open-market operations. Moreover, a patent system could be created that rewards safe innovation.

The Counterparty Risk Management Policy Group III's *Containing Systemic Risk: The Road to Reform* (2008) focuses on reforms internal to financial companies and explains the causes of the crisis using elements similar to Minsky. It recommends changes centered on core principles for improving the management of financial institutions such as the enhancement of corporate governance and risk monitoring at the level of the firm, including liquidity stress tests and a clearinghouse for over-the-counter transactions. The report describes the destabilizing effects of competition and highlights the importance of cash flows and reserves. However, it does not account for the interrelationships between financial companies and the growth of Ponzi tendencies at the aggregate level. And since bankers are the financial experts, they should determine what is best for borrowers, while promoting sound financial practices. The Group recommends that off-balance-sheet positions should be included in risk management accounting as well as in calculating capital and liquidity requirements, eliminating the need for off-balance sheet accounting.

The *Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience* (2008) is the closest to Minsky's analytic framework in terms of explaining the crisis and making policy recommendations. Its recommendations are similar to those of the Counterparty Risk Management Group regarding the need for more liquidity management and off-balance-sheet exposure, and removing the stigma of the discount window. Tymoigne recommends that further work should be devoted to the distinction between creditworthiness, the probability of default, and credit-rating scores in order to measure the risk of loss for the lender. A very destabilizing feedback loop can emerge from the credit history approach to creditworthiness, and the rating process can encourage a Ponzi process. One method is to develop credit ratings that provide information about the expected method of repayment.

The main goal of the Group of Thirty's *Financial Reform: A Framework for Financial Stability* (2009) is to set up a regulatory framework oriented toward containing systemic risk and maintaining close oversight of financial companies, with an emphasis on systemic stability. According to Tymoigne, the report does not go far enough in recognizing that all financial institutions should be well regulated. The focus should be on financial practices that rely on liquidation and refinancing as a means to complete financial deals rather than moral hazard because noninsured institutions can be a source of Ponzi finance. As Minsky noted, leverage and debt-to-income ratios are too narrow in determining financial fragility. We need smaller institutions in combination with constructive competition that provides the incentive to generate welfare gains for society.

The *OECD Strategic Response to the Financial and Economic Crisis* (2009) focuses on finance, competition, corporate governance, and long-term economic growth. The report favors a highly competitive market structure and an improvement in consumer protection and education, along with temporary government intervention. The best way to promote growth is to avoid protectionism; keep sound macroeconomic, fiscal, and labor market policies; and support an innovation-led recovery. It is inappropriate to emphasize competition and innovation, says Tymoigne, because we need better (not more) competition that rewards meaningful innovations and prevents harmful financial practices. There is a problem in aligning compensation and risk management systems with shareholder interests because systemic stability and ensuring companies' continued operation are what matter. Moreover, capital equity does not provide sufficient protection against issues of moral hazard.

The Government Accountability Office's *Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System* (2009) notes that voluntary regulation does not work, while regulatory and supervisory frameworks are unable to deal with financial holding companies and systemic risk. It expresses a need for systemwide measures of risk and financial reform that include hedge funds, credit-rating agencies, and special purpose entities. According to Tymoigne, the report's suggestions are especially relevant, but there is a lack of guidance regarding how to reform regulation and capture systemic risk. What is needed is a criterion to measure safe financial practices prior to implementation, and Minsky provides that criterion: Ponzi finance.

The International Center for Monetary and Banking Studies' *Fundamental Principles of Financial Regulation* (2009) emphasizes maturity mismatch as a central cause of the debt-deflation process. The crisis shows that a project's risk depends on its intrinsic expected profitability and funding. The report aims to improve risk management by introducing the importance of liquidity and improving the measurement of risk. It recommends a greater focus on systematic risk within financial regulations (e.g., in the calculation of capital and liquidity requirements) and proposes two main tools: making capital requirements countercyclical (i.e., sensitive to proxies related to funding liquidity risk such as the capital adequacy ratio) and valuing assets using a "mark-to-funding" approach.

Tymoigne notes that this report has many similarities with the Minskyan framework, such as the importance of funding methods. He criticizes the report's recommendation to improve risk management (which has several flaws) rather than radically reform financial regulation through a proactive and flexible regulatory framework that accounts for innovation. Matched maturities, low leverage ratios, and high liquidity ratios do not necessarily reflect a well-managed business. Therefore, the framework should be built around the core concept of position-making operations based on the financial practices of specific entities (including the whole economy), and coupled with Minsky's financial instability hypothesis. There is also a need to refocus banking activity toward detecting cash-flow mismatches rather than collateral value, which is conducive to fragile financial structures. The "visible hand of government" should constrain financial practices because market mechanisms *always* end up generating financial instability. Powerful supervisory agencies that focus on Ponzi financial practices can manage excessive risk taking and fraud.

For the complete texts, go to www.levy.org/pubs/wp_574_1.pdf; wp_574_2.pdf; wp_574_3.pdf; and wp_574_4.pdf.

A Financial Sector Balance Approach and the Cyclical Dynamics of the U.S. Economy

PAOLO CASADIO and ANTONIO PARADISO

Working Paper No. 576, September 2009

Paolo Casadio, Intesa Sanpaolo Bank, and Antonio Paradiso, University of Rome La Sapienza, develop a small-scale econometric model of the U.S. economy based on a financial balances model by Goldman Sachs (2003) that was inspired by the works of Distinguished Scholar Wynne Godley. Their analysis includes the private and external sectors of the economy, and introduces the idea of financial fragility in capitalist economies that was originally developed by Hyman P. Minsky.

The authors find that the financing gap—the difference between internal funds and the business investments of nonfinancial firms—is a leading indicator of business cycles, while business investment is a lagging indicator. They also find that all sector balances depend on asset market variables and that discrepancies from equilibrium affect the growth in output (e.g., a negative financial balance has a negative effect on GDP, while a negative household balance has a positive effect).

It is important to understand the cyclical nature of the financing gap because it plays a crucial role in determining business-cycle phases, in accordance with Minsky's theory of financial fragility. Using data from the Federal Reserve Flow of Funds Accounts for the period 1976–2007, the authors derive some stylized facts about the U.S. sector balances by focusing on the relationship between sector dynamics and the GDP cycle, as well as on the drivers of the balances. The methodology includes two analyses: the determination of equilibrium sector financial balances on the basis of asset market variables and the impact of the sector balances on the GDP growth rate. An important distinction becomes apparent when personal net savings are divided into households and nonfinancial corporate business, since these categories exhibit different decisions and patterns over time. The nonfinancial corporate business variable summarizes Minsky's theory and is a leading indicator of the economic cycle (as opposed to business investment, which is a lagging indicator).

The authors summarize three important stylized facts about the financing gap and its components: the cyclical pattern of the gap; the relationship of internal funds with profits and dividend policy; and the relationship linking investment to business cycles, internal funds, equity prices, and the cost of external corporate finance. They find that, at a disaggregated level, the financing gap is a leading (by five quarters) procyclical variable with the GDP cycle.

Using a simulation model, the authors explain the pattern of the financing gap—that is, the underlying forces driving the sector balances and the correlation of the balances with output. Regarding internal funds, for example, there is a negative correlation of dividend policy with the yield spread (a leading indicator of the business cycle). Another stylized fact regarding business investment is that the ratio of fixed investment to GDP is positively correlated with the internal funds ratio (with a lag of four quarters). Equity prices are positively correlated with investment and they capture profit expectations about the firm.

An analysis of the household balance (disposable income less consumer outlays and residential investment) shows a countercyclical pattern due to the behavior of housing investment, which has a high positive correlation with housing prices and a negative correlation with long-term interest rates (consumption is a variable that depends on equity and housing investment rather than disposable income). Cross-correlation suggests that the household balance has a negative (leading) correlation with the business cycle by approximately two quarters. Consumption expenditures lag, and move together with equity prices and house price inflation.

In this analysis, net wealth changes are affected by housing and equity price dynamics. Moreover, the current account surplus exhibits countercyclical (leading) behavior in relation to output growth because it is correlated positively with the household balance. The foreign balance has a negative correlation with oil prices and the exchange rate. These results help to explain the underlying forces driving the sector balances and the correlation of the various sector balances with output.

In general, profits and output have a common dynamic and are driven by common factors. In the first phase, the financing gap is positive because corporations wait to invest. In the second, corporations push investment beyond internal funds as GDP growth is fueled by business investment and optimism spreads, leading to a financial imbalance (and a negative financing gap) à la Minsky.

For the complete text, go to www.levy.org/pubs/wp_576.pdf.

Money Manager Capitalism and the Global Financial Crisis

L. RANDALL WRAY

Working Paper No. 578, September 2009

According to Senior Scholar L. Randall Wray, the economic crisis cannot be explained within the context of a "Minsky moment" because it represents a slow transformation of the financial system and economy toward fragility. Basing his arguments on Hyman P. Minsky's financial instability hypothesis, Wray blames "money manager capitalism," which is an economic system characterized by highly leveraged funds seeking maximum returns in an environment that systematically underprices risk. He suggests that the money manager phase of capitalism may be ending.

Wray notes that the trend has been toward more severe and frequent crises. He proposes policy responses such as regulatory constraints and new standards to prevent boom/bust cycles; massive fiscal stimulus to allow growth without relying on private sector debt; mortgage relief; higher wages; greater employment; and revised monetary policy. We must return to a model with enhanced oversight of financial institutions and a financial structure that promotes stability rather than speculation, Wray says.

Minsky insisted that there are two essential propositions of his hypothesis: two financing "regimes" that are consistent with stability or instability, and endogenous processes that tend to move a stable system toward fragility ("stability is destabilizing"). He argued that the strongest force in a modern capitalist economy operates toward an unconstrained speculative boom. Thus, the current crisis is a natural outcome of these processes—an unsustainable boom in real estate prices, mortgage debt, and leveraged positions in collateralized securities, in conjunction with a similar unsustainable boom in commodity prices. According to Minsky, those who got caught up in the boom behaved "rationally" as opposed to the notion of "irrational exuberance."

Wray outlines the long-term transition away from tightly regulated banking and toward "market-based" financial institutions, including the "originate-to-distribute" model represented by securitization and the use of "off balance sheet" operations. Ironically, the creation of international standards as adopted by the Basel agreements encouraged this transition, which greatly increased systemic risk. Minsky understood the true potential of securitization and argued that it reflected the globalization of finance and the relative decline of banks in favor of "markets," which were encouraged by the experiment in monetarism. He observed that banks require a spread of approximately 450 basis points between interest rates earned on assets and those paid on liabilities, but financial markets require much lower spreads. In order to restore profitability for banks and thrifts, they were allowed to earn fee income for loan origination and move mortgages off their books to escape reserve and capital requirements. Investment banks purchased and pooled these mortgages, and sold securities to investors based on high credit ratings and affordable insurance.

Low interest rate policy by the Federal Reserve meant that traditional money markets could not offer adequate returns. Incentives to increase throughput along with credit enhancements encouraged the purchase of securities with the riskiest underlying debts. The new arrangement offered an almost infinite supply of impersonal mortgage credit without any need to evaluate the borrowers' ability to repay. A virtuous cycle was created that led to a boom and subsequent bust, and the financial system moved through structures that Minsky labeled hedge, speculative, and Ponzi. Instead of a closely regulated industry, home finance became an unsupervised and highly leveraged speculative activity. The subprime market unraveled, and by January 2009 U.S. financial institutions had written off $1 trillion in bad assets and the crisis had enveloped the whole money manager system.

There are three explanations for the explosion in commodity prices: supply and demand, market manipulation, and speculation in the commodities futures market. These mechanisms are mutually reinforcing, says Wray, but index speculation is the most important cause. Commodities represent the latest asset class to be identified by money manager capitalism. Index speculators have driven commodity prices to historic levels, so that these markets deviate substantially from the textbook models: prices are administered rather than set by the fundamental forces of supply and demand. A perfect storm was created in which almost every participant's interest lay in continued price gains. Thus, it is necessary to close the loopholes that allow commodities speculation to escape regulation and oversight.

In addition to the policy responses outlined above, Wray proposes that Congress ramp up global food aid, subsidize alternative energies, enforce new regulations and standards for mortgage originators, and discourage the consolidation of financial institutions. The current crisis represents a failure of the Big Government/neoconservative model that promotes deregulation, reduced supervision, privatization, and consolidation of market power. Monetary policy's proper role is to stabilize interest rates, to direct credit controls and prevent runaway speculation, and to supervise markets.

For the complete text, go to www.levy.org/pubs/wp_578.pdf.

A Perspective on Minsky Moments: The Core of the Financial Instability Hypothesis in Light of the Subprime Crisis

ALESSANDRO VERCELLI

Working Paper No. 579, October 2009

Most definitions of the "Minsky moment" establish a link between crucial features of the subprime financial crisis and Minsky's financial instability hypothesis (FIH). However, the features are different and not always clearly defined. Alessandro Vercelli, University of Siena, Italy, provides a more rigorous definition of a Minsky moment based on a restatement of the core of Minsky's hypothesis. He perceives a Minsky moment to be the starting point of a Minsky process, and suggests an alternative to Minsky's threefold taxonomy (hedge, speculative, and Ponzi units) that classifies a unit's financial conditions based on continuous measures of liquidity and solvency.

A hedge unit does not have problems with liquidity, but speculative and Ponzi financial units do (i.e., outflows exceed inflows). The author believes that Minsky's narrow, threefold classification has likely hindered the development of analytical models of the FIH. For example, all units (including Ponzi) are considered solvent, since insolvent units would become bankrupt. However, an insolvent unit may be rescued by a bailout or by adopting extraordinary measures. In the case of big banks, bankruptcy does not fully discontinue a unit's economic and financial consequences. As observed during the subprime crisis, the economic impact of virtually insolvent units may be particularly important in a financial crisis (when opinion favors their rescue) due to contagion (e.g., Lehman

Brothers). Therefore, the dynamic behavior of distressed financial units is crucial when analyzing a financial crisis and choosing policy strategies that will keep the crisis under control.

Rather than restrict a unit to banks or firms, Vercelli applies his classification to all economic units, including households. In the last decades, households have become increasingly dependent on the vagaries of financial markets, which in turn have become increasingly dependent on the behavior of households. He notes that units have different degrees of liquidity (or illiquidity), so a unit's net worth is measured in association with its solvency index. To eliminate some of the shortcomings of Minsky's taxonomy, he classifies a unit's financial conditions based on modified continuous measures of liquidity and solvency that can be represented within a Cartesian diagram. This methodology favors a rigorous analytic formulation of the core FIH under infinite financial conditions, while maintaining Minsky's original classification. An additional essential ingredient is that units choose a margin of safety in order to minimize the risk of bankruptcy. This approach refines Vercelli's classification into six postures: hyperhedge, hedge, hyperspeculative, speculative, distressed, and highly distressed.

The author introduces a financial fragility variable in order to understand the financial behavior of economic units. This variable represents a unit's vulnerability as measured by the smallest shock that leads to bankruptcy. The behavior of a financial unit is cyclical but it fluctuates irregularly because it is affected by shocks, decisions of financial units and policy authorities, and the macroeconomic cycle. The cyclical tendency is also enhanced by the procyclical behavior of expectations. In a crisis, the number and size of insolvent units increase as safety margins progressively break down, unless the debt-deflation process is promptly aborted by massive policy measures.

Vercelli describes the tendency toward persistent financial fluctuations and financial fragility brought about by the interaction of liquidity and solvency ratios. Financial units are connected via a network of financial relations that are affected by the dynamic behavior of the economy as a whole, and their behavior is interdependent. Market pressures push units to accept similar risk-taking positions, while mass psychology results in insufficient perceptions of risk during a boom and excessive perceptions of risk during a bust. In order to account for financial instability, it is necessary to introduce the relationship between cognitive psychology and expectations formation.

A Minsky moment is the starting point of the Minsky process whereby a substantial number of economic units suffer from both liquidity and solvency problems (and try to deleverage all at the same time). This progression does not need to degenerate toward a Minsky meltdown if, for example, the monetary authorities create a sufficient amount of liquidity.

Many interpreters of Minsky consider the concepts of financial instability and fragility as variants of *dynamic* instability. Vercelli suggests that financial fragility is a variant of *structural* instability (i.e., a disturbance of a particular size induces a qualitative change in the dynamics of the system). A unit that trespasses the solvency line undergoes a radical change in its dynamics and greatly increases the fragility of the financial system (and most financial units) and the probability of triggering a Minsky meltdown, which is actually a rare event.

The author shows how to further refine his model by considering liquid reserves or adding safety margins such as a liquidity constraint (a cap for the imbalance between outflows and inflows) or compulsory illiquidity and leverage caps. These measures would reduce the length and gravity of a Minsky process and mitigate the likelihood of a Minsky meltdown. However, mitigating a Minsky process requires (government) intervention long before the process begins.

To understand and control financial crises, says Vercelli, we need a comprehensive vision of the working of a sophisticated financial economy that avoids any form of reductionism. A few policy insights on how to mitigate the financial cycle and stabilize the economy include stricter capital requirements and well-designed constraints on the units' illiquidity and indebtedness. He recommends that the financial authorities enforce these rules irrespective of the phase of the economic cycle.

For the complete text, go to www.levy.org/pubs/wp_579.pdf.

An Alternative View of Finance, Saving, Deficits, and Liquidity

L. RANDALL WRAY

Working Paper No. 580, October 2009

According to orthodoxy, the current crisis is a result of excessive liquidity and a euphoric real estate boom. Senior Scholar L. Randall Wray believes that the crisis stems from the long-term transformation of the global financial system by "money managers" who control huge pools of institutional funds. The liquidity crisis could have been resolved very quickly if the Federal Reserve (Fed) had immediately opened the discount window to all financial institutions, he says. The United States now faces a massive insolvency problem and rapidly declining employment and production. The unrecognized problem is that gross insolvencies at the larger financial institutions are the result of unprecedented fraud rather than subprime loans. Moreover, the planned fiscal stimulus will fall far short of what is needed, despite the fact that the United States can financially "afford" to resolve the crisis.

The conventional view on the causes of the global financial crisis includes excessive U.S. trade deficits, the Fed's low interest rate policy, and a rapid increase in the demand for commodities. Solutions to the crisis include balancing the U.S. current account, fiscal responsibility, and higher interest rates. This position follows from orthodox, out-of-paradigm views on saving (derived from loanable funds theory) and the belief that saving is necessary to finance investment. Government and current account deficits are seen to "soak up" saving and hinder growth. Furthermore, government measures to bail out financial institutions threaten long-run government solvency, burden future taxpayers, and perpetuate U.S. reliance on external funding. Thus, there is the threat of dollar devaluation, inflation, and national insolvency.

Contrary to this view, Wray outlines an in-paradigm view based on a stock flow–consistent balances approach initiated by Distinguished Scholar Wynne Godley; that is, a sector's spending flow must equal its income flow plus changes to the sector's financial balance. Deficit spending by one sector generates the surplus (saving) of another, so deficit spending by the government provides the income that allows the nongovernment sector to accrue an equal amount of saving. Government spending comes first by crediting bank accounts, so this process reverses the orthodox causal sequence. Government deficits lead to net reserve credits, and if excess reserves are created, they are drained through bond sales. Asset prices and interest rates adjust to ensure that the nongovernment sector's portfolio preferences are aligned with the quantity of reserves and deposits from government spending. If the central bank does not want short-term interest rates to veer from its target rate, then the bank intervenes in the open market. The interest rate is discretionary, but the quantity of reserves is not.

It is not possible for federal government deficits to exceed nongovernment saving (domestic plus the rest of the world). A similar accounting identity holds for the domestic and external sectors—the domestic private sector balance plus the government balance equals the external sector balance. U.S. import purchases provide dollar savings accumulated in the form of U.S. debt held by foreigners. A current account deficit can affect both the structure of interest rates and the rate of exchange as dollar recipients make portfolio allocation decisions. So long as the claims are in dollars, there is little difference between debts held domestically or externally. In terms of exchange rate risk under a flexible exchange rate regime, Wray concludes that there is no default risk on government liabilities denominated in the domestic currency, and that the default risk on private sector liabilities is the same whether the holder is a U.S. resident or not.

A government deficit (surplus) adds (subtracts) private sector net financial wealth. Portfolio adjustments affect prices and returns on financial assets, which in turn affect future spending and saving decisions. When the rest of the world is added to the model, its net accumulation of dollar-denominated financial wealth is equal to the U.S. current account deficit. In this case, portfolio adjustments also affect the exchange rate, which can impact future production, consumption, and saving decisions. Wray explains that there can be no "glut" or "shortage" of domestic or global dollar saving. All domestic and external saving is fully accounted for by investment spending, the government budget stance, and the current account outcome. For example, the recent decline in the U.S. current account deficit had nothing to do with a sudden shortage of "savings" in the rest of the world but rather the curtailment of consumption in the United States. And the decade-long U.S. consumption boom that preceded the crisis had nothing to do with the glut of savings in the rest of the world but rather the current account deficit's providing the rest of the world with dollar savings.

It is unlikely that the crisis will lead to another Great Depression, says Wray, because we now have a "big government" and a "big bank," a floating exchange rate, and the willingness and ability to run very large budget deficits and act as lender of last resort (to financial institutions). A sovereign government can always afford to lend without limit and cover losses on deposits, so the United States has the domestic policy space to deal with the crisis through a combination of Fed reserves, Treasury coverage of insured losses, and ramped-up Treasury spending to replace private sector demand.

The preferred orthodox solution—Treasury purchases of bad assets or nonvoting equity shares—will not resolve the crisis. Recovery will require the resolution of insolvent financial institutions and a large fiscal stimulus package, but the Obama government's efforts fall far short of what is needed in terms of total spending, number of jobs created, and sectors covered. According to Wray, "too big to save" is a better doctrine than "too big to fail" if we're to close down Ponzi schemes and focus efforts on saving the small-to-medium-size financial institutions that are necessary for economic recovery. He also favors household tax relief through a payroll tax holiday, as well as a universal job guarantee through a permanent employer-of-last-resort (government) program.

For the complete text, go to www.levy.org/pubs/wp_580.pdf.

Minsky Moments, Russell Chickens, and Gray Swans: The Methodological Puzzles of the Financial Instability Analysis

ALESSANDRO VERCELLI

Working Paper No. 582, November 2009

This companion paper discusses methodological issues of a heuristic model based on Hyman P. Minsky's financial instability hypothesis (FIH) that was developed by Vercelli in Working Paper No. 579 (see pp. 20). In the author's view, these issues have hindered the development of a research program based on Minsky's insights.

The author notes that periods of regular behavior cannot necessarily be projected into the future and an analysis of an economic system cannot be restricted to stationary processes, equilibrium states, or steady paths (as in conventional economics). Equilibrium plays a role but only as a reference point for analyzing the complex dynamics of the system. Minskyan financial instability is a combination of dynamic and structural instability that have different degrees of regularity. The dynamic behavior of euphoria, for example, is more irregular, and subject to sudden changes that depend on a host of factors. Following Minsky, Vercelli concurs that the crucial factor in a financial system is the periodic increase in financial instability that gradually emerges in periods of tranquility. A stylized fact is that the interaction between liquidity and solvency conditions of financial units brings about persistent fluctuations that do not have an *intrinsic* tendency to change through time. Change depends on factors that are exogenous to the FIH.

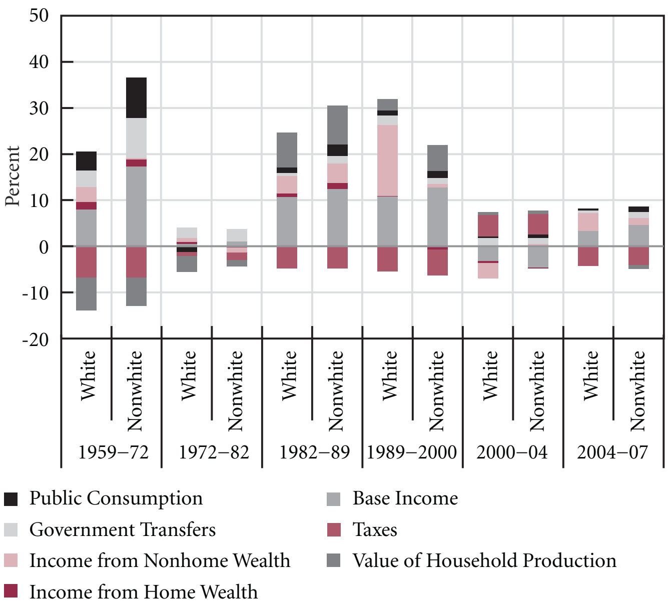
Another controversial methodological issue is the role of shocks in a model of financial fluctuations. The conventional macroeconomic view is based on the equilibrium approach devised by R. E. Lucas in the 1970s, whereby business cycles are seen as a consequence of random shocks displacing, but not disrupting, equilibrium. In a model based on the FIH, however, shocks are not essential in explaining persistent financial fluctuations or crises. In a fragile system, even a "slight disturbance" may precipitate a financial crisis. The concept of financial fragility is the vulnerability to shocks that is periodically increased for endogenous reasons. Vercelli suggests distinguishing between an exogenous shock (a factor not explicitly interacting with the endogenous variables of the model) and an uncorrelated shock (a factor exogenous to the model and also independent of endogenous variables in the real world). In sum, disturbances play a role in Minsky's FIH, but the role is very different from that played by disturbances in conventional models of the business cycle.

According to the FIH, the economic system is open and characterized by irreversible time and complex dynamics that are intrinsically unpredictable; that is, we cannot rely on traditional probability and decision theories unless we are in a period of tranquility. Rather, we have to resort to unconventional probability or decision theories (e.g., the Choquet theory of capacities), and we should expect the periodic emergence of financial fragility and the risk of recurrent crises—unless we take structural measures to mitigate them. Moreover, the relationship between microeconomics and macroeconomics is much more complex than in conventional economics. A comprehensive behavioral analysis of a unit's dynamic behavior requires macroeconomic foundations, while the study of aggregate fluctuations requires microeconomic foundations (i.e., an analysis of a single unit). A unit's financial behavior is heavily influenced by the behavior of all units, as expressed by aggregate indexes.

Vercelli points out that Minsky's contributions are topical as a result of his underlying vision concerning the workings of a sophisticated monetary economy rather than his analytical constructs. The FIH's relevance for mitigating financial crises has increased with time and will continue to do so if we analyze Minsky's insights and fully understand his powerful methodological approach.

For the complete text, go to www.levy.org/pubs/wp_582.pdf.

Figure 1 **Contributions of Components to LIMEW Growth by Race, 1959–2007 (in percent)**



Source: Authors' calculations

Program: The Distribution of Income and Wealth

Levy Institute Measure of Economic Well-Being

Has Progress Been Made in Alleviating Racial Economic Inequality?

THOMAS MASTERSON, AJIT ZACHARIAS, and
EDWARD N. WOLFF
LIMEW, November 2009

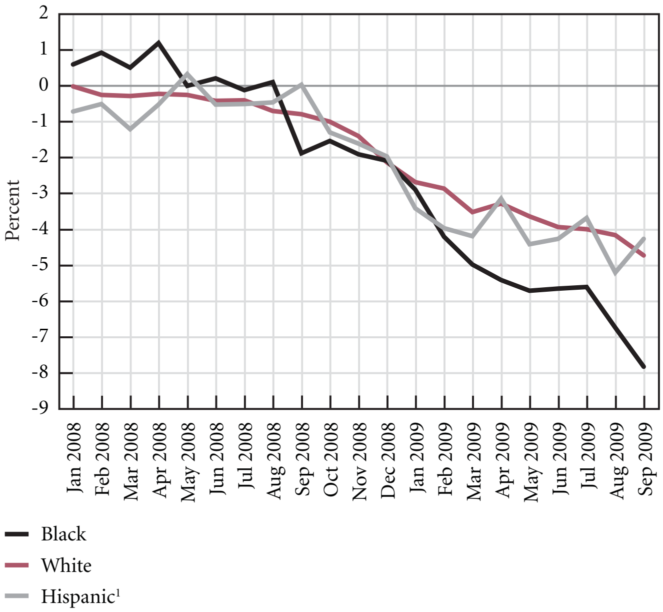
In this report, the authors examine trends in economic well-being between 1959 and 2007 based on the race/ethnicity of households. Using the Levy Institute Measure of Economic Well-Being (LIMEW), they find that changes in household wealth and net government expenditure are the key elements in the story that unfolds about racial differences.

The standard measures used to assess economic inequality lack an accounting of the impact of important components of economic well-being, such as household production, taxes, and government spending on public services for households (public consumption). In addition, these measures do not capture the effect of wealth. The LIMEW is a more comprehensive measure that includes estimates of public consumption as well as household production and wealth (other than homes).

The authors find that the gap between white and nonwhite households showed a relatively small increase over the period (from \$26,100 in 1959 to \$30,600 in 2007). However, this increase conceals a significant deterioration in the well-being of blacks and Hispanics relative to whites due to the influence of the Asian group, which has the highest average income of all the groups surveyed. It also obscures the large decrease in the gap that occurred in the 1960s (roughly \$7,000), when nonwhites benefited from an improvement in base income and net government expenditures (transfers and public consumption).

The introduction of Medicaid and increased public spending on education and infrastructure went a long way toward alleviating racial inequality in economic well-being. The significant reversal in the 1990s was dominated by an increase in the gap due to the income from wealth component, a result consistent with nonwhites' pervasive disadvantage in asset accumulation (Figure 1). As a result, the average net worth of blacks relative to whites remained essentially unchanged at 19 percent between 1983 and 2007, while that for Hispanic households rose from only 16 percent to 26 percent. These

Figure 2 **Change in Monthly Employment Relative to Prerecession Employment by Race, January 2008 – September 2009 (in percent)**



[1] "Hispanic" can be of any race.

Source: Authors' calculations based on Bureau of Labor Statistics Table A-4, "Employment Status of the Civilian Noninstitutional Population by Race, Hispanic or Latino Ethnicity, Sex, and Age, Seasonally Adjusted," ftp://ftp.bls.gov/pub/suppl/empsit.cpseea4.txt (accessed October 8, 2009).

observations are particularly significant in the context of the current economic downturn. Employment losses have been especially severe among blacks, and foreclosure rates have been much higher among black and Hispanic households (Figure 2). This indicates that the asset gap has worsened.

The level of racial disparity in economic well-being has stagnated over the past 40 years. The experience of the 1960s, which includes poverty alleviation, public education, affirmative action, and increased public sector employment for nonwhites, shows that government policy can be instrumental in diminishing racial inequality. Therefore, it is imperative to contemplate serious policy initiatives to address this issue, such as a proactive strategy that combines elements of both asset building and job creation.

For the complete text, go to www.levy.org/pubs/limew_nov_09.pdf.

How Well Do Individuals Predict the Selling Prices of Their Homes?

HUGO BENÍTEZ-SILVA, SELCUK EREN, FRANK HEILAND, and SERGI JIMÉNEZ-MARTÍN

Working Paper No. 571, August 2009

Housing wealth represents more than 60 percent of the average net wealth of U.S. households and is a key variable in decisions regarding retirement, consumption, savings, and debt. However, housing wealth is typically self-reported in household surveys and is therefore prone to measurement error. Understanding the accuracy of self-reported housing wealth is important because it is a pervasive explanatory variable in most behavioral models about decision making in the household.

As real estate prices have become more volatile, one imperative is that we study the investment component of housing wealth. This paper by Hugo Benítez-Silva, SUNY Stony Brook; Research Scholar Selcuk Eren; Frank Heiland, Florida State University; and Sergi Jiménez-Martín, Universitat Pompeu Fabra and FEDEA, is the first to use an econometric framework to test the accuracy of one of the most important wealth measures: the self-reported home value.

Using sales data from the University of Michigan's biannual Health and Retirement Study, the authors compare self-reported housing values and sale prices for the period 1992–2006. They find that, on average, homeowners overestimate the value of their properties by 5–10 percent due to the large expected capital gains implicit in self-reported home values. They also find a strong correlation between the accuracy of homeowners' estimates and the business cycle. In periods of high interest rates and declining incomes, buyers have lower expectations as a result of declining house prices and, on average, are more likely to accurately assess the value of their homes—in some cases, even underestimating the properties' value. During economic downturns, buyers tend to be more educated and better informed about housing values. These results are consistent with the growing evidence that many homeowners (especially first-time buyers) who purchased houses in the last decade with soft (and risky) mortgages had unrealistically high expectations that appreciating home values would rescue them in the case of rising interest rates, which then jeopardized their ability to meet their financial commitments.

The authors investigate whether the two components of self-reported house values—the original price and capital gains—play different roles in predicting the market value of a property. Their analysis suggests that homeowners are much less accurate with respect to the role of capital gains compared to the purchase price. Homeowners may significantly overestimate the contribution of capital gains to the sale price and are unlikely to accept offers below the original purchase price. Thus, it is possible that there is a business-cycle effect on the accuracy of self-reported home values.

There is a high (negative) correlation between nominal and real interest rates, and the number of home sales in the United States. The correlation between interest rates, borrowing costs, and housing prices is well documented, and interest rate measures can predict the evolution of the U.S. economy (e.g., the link between monetary policy and the housing market). As a result, the authors introduce business-cycle measures (interest rates and macroeconomic variables in the year of purchase) in their models and compare the results with the evolution of the business cycle. They conclude that in good economic times there are larger numbers of buyers who are overly optimistic regarding their property's worth. During the first half of this decade, a wave of buyers with overly optimistic expectations about house prices responded to easy credit conditions and planted the seeds of the current mortgage crisis (by accepting mortgage terms that were set to balloon in the short-to-medium period).

The authors note that their underlying methodology can be extended to the analysis of many other components of household portfolios that may be affected by the overestimation of capital gains, such as stock market wealth, real estate investments, and pension wealth.

For the complete text, go to www.levy.org/pubs/wp_571.pdf.

Program: Gender Equality and the Economy

The Unequal Burden of Poverty on Time Use

BURCA KIZILIRMAK and EMEL MEMIS

Working Paper No. 572, August 2009

Widespread income poverty has been a major challenge in postapartheid South Africa, and little attention has been paid to the linkages between poverty and time-use patterns. Using the 2000 time-use survey for South Africa and Tobit estimation methods, Burca Kizilirmak, Ankara University, Turkey, and Research Associate Emel Memis analyze the impact of income poverty on time-use patterns.

The authors find that poverty and marriage increase women's time spent on unpaid work but not that of men's (i.e., the unpaid work burden is not shared equally within the household), while higher education increases (decreases) the time spent on social care by men (women). As a result, gender inequalities in time-use patterns should be considered when designing antipoverty policies and promoting gender equality.

In an analysis of poverty and time-use patterns it is important to consider the close association of poverty and gender-based inequalities because its goes beyond deprivation of income and includes (bargaining) power relations within the household and the social community. The authors document the social structure of income poverty with respect to household size, number of children, employment, marital status, and residential location. Households are also grouped according to their poverty status, using household income levels as a criterion.

In 2000, 59 percent of South Africa's population was living in poverty, which was distributed unevenly among the provinces (ranging from 40 to 74 percent). More women were poor than men (62 versus 55 percent) and the ex-homeland areas had almost twice the poverty rate as the urban formal residential areas (82 versus 42 percent). Sixty percent of the poor lived in urban areas. While three quarters of unemployed people were poor, half of employed people were also poor, raising a serious issue about the sufficiency of wage levels. Poverty rates were higher among the single population and increased with household size.

South Africa's time-use survey consists of one member's response to a household questionnaire, in combination with a survey of the functional activities of two household members aged ten years or more. These activities were grouped according to half-hour time slots for the previous day and included up to three activities per slot. The survey showed that women spend less time for paid work (2.4 versus 4.6 hours) and more time for unpaid work (4.4 versus 1.5 hours) than men.

The authors regress the components of time use on a common set of explanatory variables in order to estimate the factors affecting the various time allocations. The dependent variables in the bivariate Tobit model are paid and unpaid work. The model's estimated coefficients confirmed most of the authors' a priori expectations: women's unequal burden in terms of unpaid work (particularly for women living in the ex-homeland areas); the effect of poverty on increasing the time spent by women on unpaid work; and urban women's spending relatively less time on unpaid work than those in more rural areas. By comparison, poverty is not significant in terms of time spent on unpaid or paid work by men. The results confirm the traditional division of work at home, where women do the unpaid work and men assume the role of breadwinner. In opposition to expectations, young children do not impact significantly the time spent on unpaid work and education (years of schooling) does not impact time use by women or men.

The authors disaggregate the time spent on unpaid work into different housework categories and implement a multivariate Tobit model where the time-use categories are paid work, water and fuel collection, social care, and home maintenance. They find that (1) the impact of poverty on time-use patterns varies within a household; (2) poverty raises a woman's unpaid work burden (e.g., water and fuel collection); (3) marriage or cohabiting increases women's time spent on unpaid work but decreases that of men; and (4) more schooling decreases women's time spent on unpaid care and increases men's time spent on social care. The authors propose further research in order to fully account for household inequalities between members, including children's time-use patterns.

For the complete text, go to www.levy.org/pubs/wp_572.pdf.

Explaining the Gender Wage Gap in Georgia

TAMAR KHITARISHVILI

Working Paper No. 577, September 2009

Gender equality was lauded as one of the greatest achievements of the Soviet Union and the former socialist-bloc countries. Using the Georgian household budget survey for the period 2000–04, Research Associate Tamar Khitarishvili assesses the economic dimension of gender inequality in Georgia. The study aims at establishing a baseline for the analysis of the impact of recent gender-targeted policies by the Georgian government.

The paper focuses on the gender wage gap, which was found to be substantial as a result of factors such as occupational differences. Female employment is concentrated in industries with the lowest mean wages—education, health care, and culture—but there are indications that women are increasingly engaged in high-skilled sectors such as finance, manufacturing, and energy. The irony is that the difficult economic environment, together with caretaking responsibilities, has shielded women from experiencing more significant discrimination in the labor market.

The Georgian government has taken specific steps aimed at advancing the cause of gender equality, such as the National Action Plan (2005) and the Gender Equality Strategy of Georgia document (2006). However, these steps have not translated into any plan of action for internalizing the gender framework into political, social, and economic decision making. It appears that gender equality, as a societal goal, is perceived to be an external (foreign) concept that is threatening the traditional way of life.

Khitarishvili focuses on gender wage differentials among individuals who work for pay. Based on the peculiarities of the household questionnaire, she suspects that both the labor force participation rate and the unemployment rate are overestimated, particularly for women. Moreover, the different retirement ages between women (59 years) and men (64 years) will influence the labor force participation rate. With these observations in mind, the labor force participation rate for men is 7 percentage points higher than that for women and the female unemployment rate is significantly higher than that for men. On average, women earn approximately 57 percent of what men do, and the situation appears to have worsened during the 2000–04 period.

In order to compare Georgia with other countries the author uses an augmented version of the conventional Mincerian earnings equation. She tests and corrects for sample selection bias using the Heckman correction method and performs a Blinder-Oaxaca decomposition analysis to identify the causes of the wage gap. Her findings are consistent with the literature, such as higher returns to education for women than men (although these returns are low compared to other countries), the insignificance of experience, and earnings similarities in the provincial regions. Marriage is a key variable in determining the probability of employment (higher for men but lower for women), while the presence in the household of children under six has a negative effect on the probability that women will be employed. Education plays a more important role for women than for men, and men are less likely to work for pay in provincial regions.

Sample selection bias was shown to be significant for men but not for women (contrary to previous studies of transition countries). Men are more likely to accept jobs with wages in the lower segment of their wage-offer distribution than women (due to women's primary caretaking responsibilities). This result is important because it indicates that the reasons for entering the labor force differ by gender. Correcting for sample selection bias increases the gender wage gap.

To complement the analysis with respect to firm size and ownership, and an individual's position within a company, the author incorporates the results of the 2006 and 2007 sociological survey in Georgia. The survey shows no differences in the proportion of women represented in large or small firms and in public or private firms. An important avenue for future work includes investigating the differences between income groups and the need to pay attention to self-employment.

For the complete text, go to www.levy.org/pubs/wp_577.pdf.

Program: Economic Policy for the 21st Century

Market Failure and Land Concentration

FATMA GÜL ÜNAL

Working Paper No. 575, August 2009

According to conventional theory, perfectly competitive markets allow the full utilization of land, labor, and capital, as well as their efficient allocation across alternative uses. This paper by Research Associate Fatma Gül Ünal studies the link between land ownership inequality and the functioning of rural factor markets in Turkey. Her analytical method of measuring the relationship between market malfunctioning and asset distribution contributes to the dialogue on why free market policies fail and fills an important empirical gap in the development literature.

In the developing world, there is an inverse relationship between farm size and yield per acre, so the unequal distribution of land as a major productive asset results in the overutilization of land and underutilization of labor. Ünal's investigation supports the claim that factor markets are structurally limited in reducing inequalities as a result of landownership concentration. Rural factor markets have a tendency to perpetuate rather than ameliorate land-related inequalities, resulting in a failure to distribute economic opportunities.

The author reviews the literature on the nexus of rural factor markets and inequality, and determines that heterodox approaches provide a better understanding of the functioning of factor markets in developing countries, where markets are less developed and land concentration is high. Inequality is not only an outcome but also a major determining factor of a malfunctioning market. Furthermore, markets are both part and product of a larger entity (e.g., monopoly land power not only affects rural land and labor markets but also affects inequality and poverty). As a result, Ünal reviews the causes of rural inequality both as an outcome of malfunctioning markets and as a factor that causes factor markets to malfunction. Her central concept is the *connectedness* of land ownership inequality and factor market malfunctioning (the term "connectedness" is from Abhijit Sen's pioneering work on agrarian market failure).

The paper's general hypotheses are that Turkish labor is not fully utilized because of malfunctioning markets, which are connected to land ownership inequality, and that any improvement in market functioning reduces income inequality. Its uniqueness is to show that land ownership inequality distorts market functioning in the direction predicted by theory. The main argument is that, while factor markets diminish inequality, the extent of the reduction depends on how well the markets function and is structurally limited.

The author begins with a mathematical modeling framework of a neoclassical agrarian economy by Dwayne Benjamin and Loren Brandt (1997). The Quantitative Household Survey (2002) provides data on the degree of land and income inequality at the household level on a per capita basis. Ünal estimates five different per capita incomes where the labor market is assumed to be perfectly neoclassical (in the sense that fragmented markets, transaction costs, and unemployment do not exist). On the basis of these incomes, she computes a neoclassical inequality index and derives an index to measure market malfunctioning. After establishing that factor markets are non-neoclassical in rural Turkey, she finds a positive and significant correlation between land ownership inequality and market malfunctioning at the provincial level, and for most towns and villages. Ünal also finds a very strong connectedness between the distributions of land holding and land ownership.

Given these findings (and in the presence of structural problems such as land concentration), the author argues that rural factor markets, when left on their own, are very ineffective in achieving allocative efficiency, thus adding to rural unemployment as well as to income and asset inequality.

For the complete text, go to www.levy.org/pubs/wp_575.pdf.

INSTITUTE NEWS

Upcoming Events

The 19th Annual Hyman P. Minsky Conference

After the Crisis: Planning a New Financial Structure

April 14–16, 2010
Ford Foundation, New York City

The focus of the Levy Institute's 19th Annual Hyman P. Minsky Conference will be post-recession exit strategies and the new financial architecture. Complete program information will be posted on our website, www.levy.org, as it becomes available.

The Hyman P. Minsky Summer Seminar

June 19–29, 2010
Blithewood
Annandale-on-Hudson, N.Y.

The Levy Economics Institute is pleased to announce that it will hold The Hyman P. Minsky Summer Seminar in June 2010. The Seminar will provide a rigorous discussion of both theoretical and applied aspects of Minsky's economics, with an examination of meaningful prescriptive policies relevant to the current economic and financial crisis. The Seminar will consist of a Summer School from June 19 to 26, followed by an International Conference on June 27, 28, and 29, both to be held at the Levy Institute in Annandale-on-Hudson, N.Y.

For more information, visit www.levy.org.

PUBLICATIONS AND PRESENTATIONS

RANIA ANTONOPOULOS *Research Scholar and Program Director*

Presentations: "Government Policy in the Midst of Crisis: What Constitutes a Progressive Agenda from a Gender Perspective?" Annual International Meeting of the National Council for the Prevention of Discrimination, Government of Mexico (CONAPRED), Mexico City, Mexico, September 29 – October 1; "The Current Economic and Financial Crisis: A Gender Perspective," 13th Conference of the Research Network Macroeconomics and Macroeconomic Policies (FMM), "The World Economy in Crisis—The Return of Keynesianism?" Hans Böckler Stiftung, Berlin, Germany, October 30–31.

PHILIP ARESTIS *Senior Scholar*

Publications: "Price and Wage Determination and the Inflation Barrier: Moving Beyond the Phillips Curve" (with M. Sawyer), in G. Gnos and L.-P. Rochon, eds., *Monetary Policy and Financial Stability: A Post-Keynesian Agenda*, Edward Elgar, 2009; "New Consensus Macroeconomics and Keynesian Critique," in E. Hein, T. Niechoj, and E. Stockhammer, eds., *Macroeconomic Policies on Shaky Foundations: Wither Mainstream Macroeconomics?* Metropolis, 2009; "The New Consensus in Macroeconomics: A Critical Appraisal," in G. Fontana and M. Setterfield, eds., *Macroeconomic Theory and Macroeconomic Pedagogy*, Palgrave Macmillan, 2009; "The Future of Public Expenditure" (with M. Sawyer), *Renewal*, Vol. 17, No. 3 (Autumn).

Presentations: "New Consensus Macroeconomics and Keynesian Critique," and "Current Financial Crisis and Regulatory Implications," 7th International Summer School of History of Economic Thought, Lucca, Italy, September 9–12; "New Consensus Macroeconomics and Inflation Targeting: Relevance to CAREC Countries," "Economic Policies after the New Consensus Macroeconomics," and "Economic Policies after the New Consensus Macroeconomics," CAREC Institute Workshop, organized by the Asian Development Bank, Almaty, Kazakhstan, October 21–24.

JAMES K. GALBRAITH *Senior Scholar*

Presentations: "The Financial Crisis—An American Perspective," conference on "Nykredit Financial Sustainability 2009: A Global Perspective," Copenhagen, Denmark, September 29; "The Great Crisis and the Dismal Science," Royal Society at King's College–University of Cambridge, England, October 7; "The Predator State and the Great Crisis," conference on "The Economics of Peace," sponsored by Praxis Peace Institute and RSF Social Finance, Sonoma, California, October 18–23; "The Great Crisis and the Predator State," The Holland Lecture Series, sponsored by the First Unitarian Church of Omaha, Nebraska, October 20; "No Return to Normal: The Great Crisis, the Dismal Science, and the Exit Strategy Illusion," conference on "From Crisis to Opportunity: Investing for a Sustainable Economy," for the 20th Annual SRI in the Rockies, Tucson, Arizona, October 25–28.

JAN KREGEL *Senior Scholar and Program Director*

Publication: "A Crise Global e as Implicações para os Países Emergentes: O *B* de BRICs se Justifica?" in J. P. dos Reis Velloso, ed., *A Crise Global e o Novo Papel Mundial dos BRICS*, Olympio Editora, 2009.

Presentations: "Financial Markets and Specialization in International Trade: The Case of Commodities," presented at "Consultation on Financial Crisis and Trade: Toward an Integrated Response in Latin America and the Caribbean," Sistema Económico Latinoamericana y del Caribe (SELA), Caracas, Venezuela, September 1; "The U.S. Financial Crisis and Its Global Implications," Pontifical Catholic University, Porto Alegre, Brazil, September 8; "Basic Principles for Formulating Crisis Policy," 2nd International Conference of the Associação Keynesiana Brasileira, Porto Alegre, September 9; "How to Reregulate in Light of Past Experience," workshop on "Financial Crises and Regulation: Experiences and Perspectives in Europe and the U.S.," University of Siena, Italy, September 18; "Testimonial," presented at "Academic Actus in Honor of Carlota Perez," Tallinn University of Technology, Estonia, September 21; "Is Reform of the Regulation of the Financial System an Oxymoron?" The 4th Bi-annual Cross-border Post Keynesian Conference, State University of New York at Buffalo, October 9; "Causes and Effects of the Current Crisis—The Work of the Commission of Experts of the President of the United Nations General Assembly on

Reforms of the International Monetary and Financial System," Norwegian Financial Crisis Commission, Oslo, October 14; "The Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System: The Vision, the Process, the Results," conference on "The Other Canon," Tallinn University of Technology, Estonia, October 15; "Is This the Minsky Moment for Reform of Financial Regulation?" 13th Conference of the Research Network Macroeconomics and Macroeconomic Policies (FMM), "The World Economy in Crisis—The Return of Keynesianism?" Hans Böckler Stiftung, Berlin, Germany, October 30–31; "A Crise e as Transformações Internacionais: Um Novo Paper do Brasil no Cenário Global?" Seminario Internacional INCT-PPED, "Promovendo Respostas Estratégicas a Globalição," Istituto de Economia, Universidade Federal do Rio de Janiero, Brazil, November 3.

DIMITRI B. PAPADIMITRIOU *President*

Presentations: interview regarding the expiration of the Treasury guarantee for money market mutual funds with Paul Davis, *American Banker*, October 8; interview regarding Treasury pricing on gold with Martha C. White, *Slate.com's: The Big Money*, October 8; interview regarding employer-of-last-resort programs with Paul Glastris at *Washington Monthly*, October 16; interview regarding the influence of Hyman Minsky with Michael Hirsh at *Newsweek*, October 26; "Addressing Global Imbalances after the Economic Crisis" (with G. Zezza), 13th Conference of the Research Network Macroeconomics and Macroeconomic Policies (FMM), "The World Economy in Crisis—The Return of Keynesianism?" Hans Böckler Stiftung, Berlin, Germany, October 30–31; "Global Imbalances after the Economic Crisis," conference on "Financial Globalization: Culprit, Survivor or Casualty of the Great Crisis?" Yale Center for the Study of Globalization, New Haven, Connecticut, November 12–13; roundtable, "Is There Still a Paradigm for Monetary Policy Today?" Euro50 Group Meeting, Paris, France, November 19; seminar on "The 'Great Recession' and Beyond: Economic Outlook for the U.S. and Global Economy," University of Athens, Greece, November 24.

JOEL PERLMANN *Senior Scholar and Program Director*

Publication: "Secularists and Those of No Religion: 'It's the Sociology, Stupid (Not the Theology),'" *Contemporary Jewry*, August 24.

Presentations: "Evaluations of *A Just Zionism* by Chaim Gans," Annual Meeting of the American Political Science Association, Toronto, Canada, September 3; "Ethnic Intermingling through Four Generations: A Preliminary Report Based on the Forward Linkages of NAPP and IPUMS Data," 34th Annual Social Science History Association Meeting, Long Beach, Calif., November 12–15.

EDWARD N. WOLFF *Senior Scholar*

Presentation: "Trends in American Living Standards, 1959–2004," Columbia University Center for the Study of Wealth and Inequality Seminar Series, New York, N.Y., October 8.

GENNARO ZEZZA *Research Scholar*

Presentations: "The Current Crisis Through the Lens of a New 'New Cambridge' Model," 50th Meeting of the Italian Economist Society, Università Luiss, Rome, Italy, October 23–24; "Addressing Global Imbalances after the Economic Crisis" (with D. B. Papadimitriou), 13th Conference of the Research Network Macroeconomics and Macroeconomic Policies (FMM), "The World Economy in Crisis—The Return of Keynesianism?" Hans Böckler Stiftung, Berlin, Germany, October 30–31.

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