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 Distinguished Scholar Wynne Godley, Research Scholar Gennaro Zezza, and me under the State of the U.S. and World Economies program, along with Zezza's review of the latest Federal Reserve flow-of-funds data. We conclude that the world's economy will not achieve balanced growth and full employment unless the associated institutions replace their total reliance on market forces with an entirely new framework. We foresee a steep rise in the private sector balance and an abrupt drop in GDP in the United States, with employment rising to 10 percent in 2010. The virtual collapse of private spending (and further declines in borrowing) will make it impossible to apply a fiscal and monetary stimulus large enough to return output and unemployment to tolerable levels within the next two years. Moreover, the unprecedented drop in interest rates may not be effective in reactivating standard lending practices. There must be a worldwide recovery of output combined with sustainable balances in international trade.

Under the Distribution of Income and Wealth program, two LIMEW reports and a working paper by Senior Scholars Edward N. Wolff and Ajit Zacharias, and Research Scholar Thomas Masterson analyze the postwar trends in economic well-being in the United States from 1959 to 2004. The authors find that the LIMEW measure is a more reliable guide to changes in living standards than the official measures. They also find that household well-being grew rather sluggishly in comparison to per capita GDP, resulting in higher inequality in 2004 than in 1959. Since net government expenditures play a crucial role in reducing inequality, the authors call for the Obama administration's fiscal stimulus package to improve the broader economic well-being of the poor and middle class, while also creating jobs.

Three public policy briefs and three working papers are included under the Monetary Policy and Financial Structure program. In the first brief, Research Associate Thomas I. Palley foresees an opportunity for Post Keynesian economics to replace the neoliberal economic policy paradigm with a more successful approach to the current crisis (in the face of profound obstacles). That will require placing economics at the center of the political stage, he says. In the second brief, Senior Scholars James K. Galbraith and L. Randall Wray, and Warren Mosler find that intergenerational accounting proposed by the Federal Accounting Standards Advisory Board is a deeply flawed and unsound concept that does not support a case for cutting Social Security and Medicare. In the third brief, Wray's advice to President Obama is to discard all of former U.S. Treasury Secretary Henry M. Paulson's proposals. The fear of large deficits is without merit, so we can afford any necessary spending or bailouts—and these actions will not burden our grandchildren.

In a working paper, Research Associate Jörg Bibow investigates the opportunity costs of self-insurance by holding foreign reserves, and discovers that financial globalization is a handy device for rent extraction from developing countries. The only effective strategy that could put the U.S. economy and the Bretton Woods II regime back on track is a large and sustained fiscal expansion. In another working paper, Julia S. Perelstein analyzes the impact of U.S. macroeconomic imbalances on the international financial system. She finds that the financial crisis is the result of attempts to resolve trade imbalances within global financial markets rather than fraud within U.S. financial markets. In a third working paper, Ewa Karwowski addresses the dimensions of Islamic banking in Malaysia and finds that substantial asset inflation is especially destabilizing in this context. Moreover, banking in emerging markets reproduces the same features that give rise to Minskyan financial instability.

In a policy note under the Employment Policy and Labor Markets program, Research Associate Pavlina R. Tcherneva calls for a bolder Obama stimulus plan where government serves as the employer of last resort. An open-ended job guarantee could reduce the unemployment rate immediately and quadruple the number of new jobs over the next several years, thus kick-starting the private sector. In a working paper under this program, Research Scholar Kijong Kim shows how to incorporate a new hypothetical sector, such as the Expanded Public Works Programme, into a social accounting matrix for South Africa. Failure to do so would underestimate the effect of the program in terms of income distribution and poverty reduction.

Under the Economic Policy for the 21st Century program, a working paper by Research Associate Fatma Gül Ünal affirms that there is a very strong inverse size-yield relationship for farms in Turkey that has far-reaching implications for rural development policy (e.g., redistributive land reforms).

As always, I welcome your comments and suggestions.

Dimitri B. Papadimitriou, *President*

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

Strategic Analysis

Prospects for the United States and the World: A Crisis That Conventional Remedies Cannot Resolve

WYNNE GODLEY, DIMITRI B. PAPADIMITRIOU, and GENNARO ZEZZA

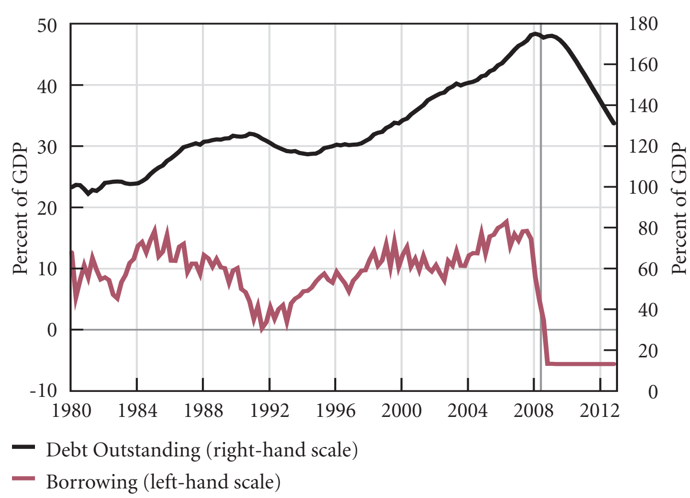
December 2008

Using the Levy Institute's macro model of the U.S. economy, Distinguished Scholar Wynne Godley, President Dimitri B. Papadimitriou, and Research Scholar Gennaro Zezza conclude that the world's economies will not be able to achieve balanced growth and full employment unless the associated institutions replace their total reliance on market forces with an entirely new framework. The authors note that their previous (contrarian) forecasts and remedies were well ahead of the curve: that is, unsustainable imbalances in the U.S. economy would require a large fiscal stimulus, a rise in net exports, and depreciation of the dollar; and both lending and private expenditure relative to income would collapse, leading to a recession in 2008. The authors expect that the (negative) change in the flow of net lending will continue, and that the unprecedented drop in interest rates may not be effective in reactivating standard lending practices. They foresee a steep rise in the private sector balance and an abrupt drop in GDP, with unemployment rising to 10 percent in 2010. The virtual collapse of private spending will make it impossible to apply a stimulus large enough to return output and unemployment to tolerable levels within the next two years.

As early as 2004, the authors argued that continued growth in net lending to the private sector was impossible and that there would be a collapse both in lending and in private expenditure relative to income. The growing imbalances in the U.S. economy were not entirely the consequence of the saving glut in Asian and other surplus countries but were instead an interdependent process in which all parties played an active role. For example, the United States maintained economic growth by permitting private sector borrowing on an unprecedented scale. Between 2000 and 2007, there was a marked acceleration of the level of private debt expressed as a proportion of GDP (Figure 1). This was followed by a violent decline in the flow of net lending to the private sector after the third quarter of 2007 as the credit crunch took its toll. The authors expect gross lending to continue falling below repayments for some time and private debt relative to GDP to decline to pre-2000 levels. Unless confidence in future profits and income growth is restored, the marked drop in interest rates may not be effective in reactivating standard lending practices.

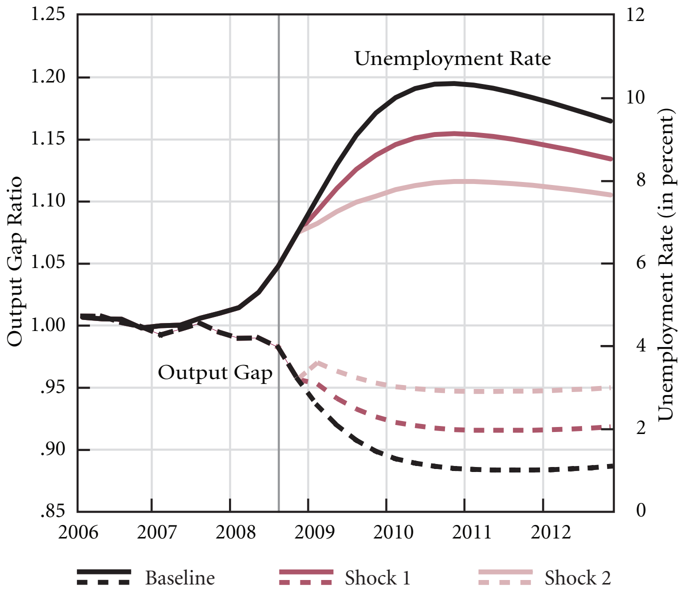
The baseline forecast of a steep rise in the private sector balance combined with an abrupt drop in GDP (12 percent below trend) crucially depends on the dramatic fall in net lending to the private sector. Alternative projections for the main financial balances, output, and unemployment based on unbelievably large fiscal stimuli show that output will not increase enough to prevent unemployment from rising through 2010 (Figure 2). The budget deficits imply that the public debt relative to GDP would rise permanently to 80 percent, GDP would remain below trend, and unemployment would remain above 6 percent. Fiscal policy alone, therefore, cannot resolve the crisis, because a large stimulus would bring back a hefty (and growing) external imbalance, keeping world growth on an unsustainable path. Current recovery plans seem to be concentrated on expansionary fiscal and monetary policies. This approach is

Figure 1 Private Sector Borrowing and Debt



Sources: Federal Reserve and authors' calculations

Figure 2 **Output Gap and Unemployment**



Sources: Federal Reserve and authors' calculations

not sufficient, say the authors. There must be a worldwide recovery of output, combined with sustainable balances in international trade.

For the complete text, go to www.levy.org/pubs/sa_dec_08.pdf.

Flow of Funds Figures Show the Largest Drop in Household Borrowing in the Last 40 Years

GENNARO ZEZZA

January 2009

Research Scholar Gennaro Zezza reviews the latest Federal Reserve flow-of-funds data and finds a steeper drop in borrowing than previous projections in April 2008. While the last two recessions saw a marked fall-off in business borrowing and minor consequences for households, the current recession's drop in credit is having a greater effect on household finances.

Although mortgage debt has fallen sharply, household debt remains very large relative to income. As a result, we can expect a further decline in borrowing, which will immediately lead to a drop in private expenditures. The delayed effects may cause a substantial decline in real GDP and a corresponding rise in unemployment (see December 2008 Strategic Analysis).

For the complete text, go to www.levy.org/pubs/sa_jan_09.pdf.

Program: The Distribution of Income and Wealth

Levy Institute Measure of Economic Well-Being

Postwar Trends in Economic Well-Being in the United States, 1959–2004

EDWARD N. WOLFF, AJIT ZACHARIAS, and THOMAS MASTERSON

LIMEW, February 2009

The Levy Institute Measure of Economic Well-Being (LIMEW) is a more comprehensive measure than either gross money income (MI) or extended income (EI) because it includes estimates of public consumption and household production as well as the long-run benefits of wealth ownership. As a result, it is a more reliable guide to actual changes in living standards, and it provides a picture of economic well-being in the United States that is very different from the official measures.

By construction, both MI and EI (a post-tax, post-transfer measure) have average values that are less than LIMEW. In this report, Senior Scholars Edward N. Wolff and Ajit Zacharias and Research Scholar Thomas Masterson compare the three measures over the 1959–2004 period and find different rates of change in median well-being by subperiod. The official measures show a higher rate of improvement (or, a slower rate of decline) than the LIMEW during the 1960s and '70s, while the pattern is reversed during the 1980s and '90s. All three measures recorded relatively high growth rates between 1982 and 2000, but LIMEW grew much faster than MI and EI; it grew at an even faster pace between 2000 and 2004 (almost 1 percent per year), when the official measures declined in absolute terms. The authors attribute most of the difference to changes in household production and income from wealth.

There was a noticeable drop in median annual hours worked from 1959 to 1982 (0.5 percent per year) that was almost entirely due to a large decline in housework. In contrast, there was a marked rise in total hours worked from 1982 to 1989 (0.7 percent per year) that was entirely due to an increase in market work (i.e., the labor market). During the 1959–2004 period, median hours worked fell by 7.9 percent overall, as median market work fell by 3.3 percent and housework fell by 18.9 percent. There was a sharp drop in housework by women that was partially counterbalanced by an increase in housework by men. Furthermore, women nearly doubled their hours of market work over the period, while men showed a general decline in hours of market work.

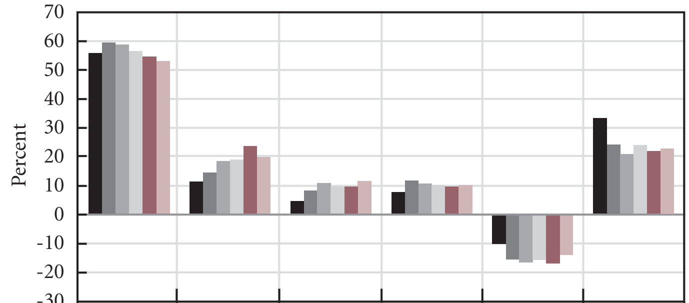
Changes in well-being are sensitive to the business cycle. This is most evident for 1982, when there was a deep recession and the unemployment rate was 9.7 percent (Figure 1). The composition of the LIMEW by income quintile over time (Figure 2) shows that the most notable change regarding the total population was in the income from wealth component (rising from 10.8 percent in 1959 to 22.7 percent in 2000). The fluctuation over time largely reflected the growing magnitude of total wealth, as well as the cycles of boom and bust in the financial markets during the late 1990s and early 2000s. The sharp increase in net government expenditures as a share of LIMEW after 2000 reflects the plunge in average taxes (by $3,300 in 2007 dollars) combined with growth in transfers and public consumption.

From 1959 to 2004, base income as a share of LIMEW declined, particularly after 1972, while income from wealth increased, most notably, between 1989 and 2000. The transformation in the structure of well-being played out differently for households in the lowest and highest quintiles. According to LIMEW, households at the bottom of the distribution relied more heavily on components such as base income (mainly labor income) and net government expenditures, while households at the top of the distribution gained more from the income from wealth component.

Figure 1 **Unemployment Rate and the Annual Change in Per Capita Real GDP, 1959–2007 (in percent)**

Source: U.S. Bureau of Economic Analysis, NIPA, Table 7.1; BLS 2009

Figure 2 **Composition of the LIMEW, 1959–2004 (in percent)**



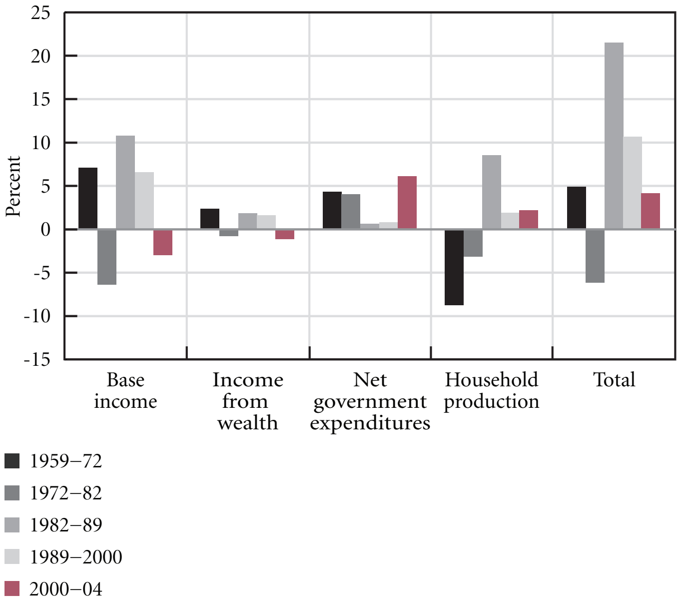
	Base Income	Income from wealth	Govern-ment transfers	Public consump-tion	Taxes	Household production
1959	55.0	10.8	4.3	7.2	-9.7	32.5
1972	58.9	13.9	7.8	11.0	-15.2	23.5
1982	57.6	17.7	10.2	10.1	-16.1	20.5
1989	55.6	18.2	9.1	9.5	-15.4	23.1
2000	54.3	22.7	9.2	9.0	-16.6	21.4
2004	52.2	19.2	10.8	9.4	-13.4	21.8

Source: Authors' calculations

Focusing on mean LIMEW for the third quintile, or the "middle class," allows one to assess the roles played by different components of the LIMEW in the well-being of the average household. The decline in well-being of the third quintile between 1959 and 1982 was due in part to a drop in household production over the period as a whole, and to a marked drop in base income between 1972 and 1982; this decline was partially offset by robust growth in net government expenditures (Figure 3). The relatively high growth rate from 1982 to 1989 and subsequent slowdown in overall growth to 2000 was attributable to all LIMEW components before the composition of the LIMEW shifted dramatically in favor of net government expenditures. Mean LIMEW of the middle quintile grew by 37 percent over the 1959–2004 period. Almost half of the gain was due to an increase in net government expenditures in the form of an increase in transfers and public consumption.

The authors find that, by any measure, median household well-being grew rather sluggishly over 1959–2004 in comparison to the annual growth rate of per capita GDP (2.2 percent). The main factor in the differences in economic well-being is the composition of the measures. The authors note the crucial role of net government expenditures, and therefore call for the Obama administration's fiscal stimulus package to improve the

Figure 3 **Contribution to the Percentage Change in Mean LIMEW of the Third Quintile (in percent)**



Source: Authors' calculations

broader economic well-being of the poor and the middle class, while also creating jobs.

For the complete text, go to www.levy.org/pubs/lmw_feb_09.pdf.

What Are the Long-Term Trends in Intergroup Economic Disparities?

THOMAS MASTERSON, EDWARD N. WOLFF, and AJIT ZACHARIAS

LIMEW, February 2009

In the LIMEW report outlined above, authors Masterson, Wolff, and Zacharias provide a view of postwar trends in economic well-being in the United States that differs markedly from the official measures. They attribute most of the differences to changes in household production, income from wealth, and the public sector, and find that the measure of economic well-being used is critical in attempting to assess changes in disparities between groups.

In this report, the authors examine long-term trends in economic well-being between 1959 and 2004 within various population subgroups based on such household characteristics as race/ethnicity, age, education, and marital status. They also break down the absolute gap in well-being (measured in dollars) between subgroups by component. This is helpful in highlighting the extent to which the sources of changes in disparities are the result of policy or broader economic trends.

In terms of race, the authors find that the gap between nonwhite and white households narrowed between 1959 and 2004 (with the exception of income from wealth) and public consumption increasingly favored nonwhites. The main drivers of the dynamics of nonwhite households' relative economic well-being are the gap in income from wealth, which offset the trend toward greater parity in the other components, and the gap in net government expenditures. These features masked the relatively small increase in the LIMEW gap over the period.

Relative well-being for the 65-and-older age group improved significantly and was 9 percent higher than the average nonelderly household in 2000 (a finding at odds with the official measures). An important part of the story is the impact of tax and transfer policies combined with the income from wealth component. In contrast, the under-35 age group experienced a sizable deterioration in relative well-being. Less educated groups had deteriorating living standards relative to college graduates, due largely to the widening gap in base income. The largest contributors to reducing the LIMEW gap were government transfers and taxes paid.

The gap between families with a single, female head of household and families with a married head of household also widened further over time because of increasing disparities in base income, income from wealth, and household production that were not offset by the relative gain for single females in terms of public consumption and taxes paid. Moreover, the gap in well-being between single, male heads of household and married couples was considerably less than that for single, female heads of household in spite of a dramatic deterioration of relative well-being. The difference in time trends between the mean and median ratios largely reflects the rising share of income from wealth in LIMEW that went primarily to upper-income married couples.

The LIMEW provides a picture of disparities among population subgroups that differs from both of the official measures. Therefore, it is important to recognize these differences when accounting for intergroup economic disparities and formulating appropriate policies to improve the relative well-being of disadvantaged groups.

For the complete text, go to www.levy.org/pubs/lmw_feb2_09.pdf

Long-Term Trends in the Levy Institute Measure of Economic Well-Being (LIMEW), United States, 1959–2004

EDWARD N. WOLFF, AJIT ZACHARIAS, and
THOMAS MASTERSON
Working Paper No. 556, January 2009

This working paper forms the basis for the February 2009 LIMEW reports outlined above. It includes extensive appendices concerning the key techniques of statistical matching that were used to identify and analyze the long-term trends of economic well-being. An area of the paper not already covered in the reports is the section on economic inequality.

Wolff, Zacharias, and Masterson review aggregate income by quintile and find that the middle three quintiles were lower in 2004 than in 1959, according to not only the LIMEW but also the two official measures of well-being—money income (MI) and extended income (EI). They also find that the bottom quintile exhibited modest growth between 1959 and 1982, but lost ground between 1989 and 2004.

In terms of the Gini coefficient, all measures indicate higher inequality in 2004 than in 1959. MI shows the greatest level of inequality because it is a pretax measure and does not account for government noncash transfers. LIMEW indicates a relatively lower level of inequality than MI because it includes public consumption and household production. In terms of time trends, there was no significant change in inequality between 1959 and 1972 according to all three measures. Thereafter, the measures differed by subperiod; for example, the LIMEW showed a significant rise in inequality from 1989 to 2000, followed by a decline between 2000 and 2004.

The authors also calculate the Gini coefficients for two additional measures related to the LIMEW: postfiscal income (PFI), which is equal to LIMEW minus household production; and comprehensive disposable income (CDI), which is equal to PFI minus public consumption. These submeasures of the LIMEW have different coefficients (e.g., higher Gini coefficients) and different time trends because they do not include the equalizing effects of public consumption or household production. The authors find that an equivalence-scale adjustment lowers measured inequality when the correlation between household size and income is factored in (i.e., the bottom rungs of the income distribution have more single-person households and smaller families than the top rungs).

Decomposition of inequality by income component is a standard technique to assess the amount of inequality derived from a measure's constituent components. The authors find that the contribution of base money income to the level of inequality is markedly lower in the LIMEW than in EI or MI. The evidence suggests that the higher contribution of income from wealth to the rise in inequality in the LIMEW between 1959 and 2004 was driven mainly by the sharp increase in the relative size of income from nonhome wealth.

Base income and income from wealth increase inequality, while net government expenditures reduce inequality. However, the effectiveness of net government expenditures in lowering inequality appears to be much less important in the LIMEW than in the official measures (e.g., as a result of the difference in the redistributive effect of taxes between the measures). Rather, household production was the largest single component restraining the growth in inequality in the LIMEW between 1959 and 2004.

In the latest subperiod (2000–04), both LIMEW and EI showed declines in inequality (MI showed a slight increase). The declines stemmed from a sizable fall in income from the nonhome wealth component, a result of the boom and bust in financial markets rather than a reduction in earnings inequality or changes in government redistributive policies. A rise in the share of transfers or a fall in the share of taxes (net government expenditures) did not appear to reduce the level of inequality.
For the complete text, go to www.levy.org/pubs/wp_556.pdf.

Program: Monetary Policy and Financial Structure

After the Bust: The Outlook for Macroeconomics and Macroeconomic Policy

THOMAS I. PALLEY

Public Policy Brief No. 97, 2009

“Change” was the buzzword of the U.S. presidential campaign, in response to a political agenda precipitated by financial turmoil and a global economic crisis. According to Research Associate Thomas I. Palley, the neoliberal economic policy paradigm underlying the current agenda must itself change if there is to be a successful policy response to the crisis. He observes that the financial downturn has exposed the faulty economics of the existing policy paradigm, thus presenting the opportunity for real change. However, there are profound political, intellectual, and sociological obstacles to such change.

The ideology of the economics profession—mainstream economic theory—remains unreformed, says Palley, and he warns of a return to failed policies if a deep crisis is averted. Since Post Keynesians accurately predicted that the U.S. economy would implode from within, there is an opportunity for Post Keynesian economics to replace neoliberalism with a more successful approach.

Palley outlines the policy challenges, noting that there is significant disagreement among economic paradigms about how to ensure full employment and shared prosperity. A salient feature of the neoliberal economy, which is supported by mainstream economic theory (e.g., free trade, deregulation, and the notion of a natural rate of unemployment), is the disconnect between wages and productivity growth that explains widening income inequality. Workers are boxed in on all sides by globalization, labor market flexibility, concern with inflation rather than full employment, and a belief in “small government” that has eroded economic rights and government services. Financialization, the economic foundation of neoliberalism, serves the interests of financial markets and top management. Thus, reversing the neoliberal paradigm requires a policy agenda that addresses financialization and ensures that financial markets and corporations are more closely aligned with the greater public interest.

Palley outlines several major obstacles to changing both economics and economic policy. Social democratic political parties are divided in terms of the merits of the neoliberal economic paradigm. Other obstacles include the dominance of neoliberal economics within the academic community and among policymakers, which is supported by a misplaced belief that neoclassical economics is a scientific fact. This belief is used by the academic establishment to block alternative points of view.

New Keynesian economics is a form of real-business-cycle theory in the tradition of Arthur C. Pigou rather than John Maynard Keynes, says Palley. Though mainstream economists are willing to recommend Keynesian policies in times of economic crisis, they are unwilling to change the core analytical assumptions driving modern neoclassical macroeconomics (an example of so-called “cuckoo” economics). The only satisfactory escape from this intellectual and political stew is the creation of a new, progressive Keynesian consensus. That, says the author, will require placing economics at the center of the political stage.

For the complete text, go to www.levy.org/pubs/ppb_97.pdf.

The Case Against Intergenerational Accounting: The Accounting Campaign Against Social Security and Medicare

JAMES K. GALBRAITH, L. RANDALL WRAY, and WARREN MOSLER

Public Policy Brief No. 98, 2009

“Intergenerational accounting” purports to calculate the debt burden our generation will leave for future generations. The Federal Accounting Standards Advisory Board (FASAB) proposes to subject the entire federal budget to such accounting and is soliciting comments on the recommendations of its two “exposure drafts.”

Senior Scholars James K. Galbraith and L. Randall Wray, and Warren Mosler, Valance Company, Cambridge Centre for Economic and Public Policy, University of Cambridge, and Center for Full Employment and Price Stability, University of Missouri–Kansas City, find that intergenerational accounting is a deeply flawed and unsound concept that should play no role in federal government budgeting. Arguments based on this concept do not support a case for cutting Social Security or Medicare.

The exposure drafts have not made a persuasive argument about basic matters of accounting, say the authors. Federal budget accounting should not follow the same procedures adopted by households or business firms because the government operates in the public interest, with the power to tax and issue money. There is no evidence, nor any economic theory, behind the proposition that government's spending ever need match receipts. Social Security and Medicare spending need not be politically constrained by tax receipts—there cannot be any "underfunding." What matters is the overall fiscal stance of the government, not the stance attributed to one part of the budget.

The authors note that federal government spending has usually exceeded tax revenues since the founding of the United States. In terms of macroeconomic accounting identities, there is no reason why one sector cannot run perpetual deficits, so long as at least one other sector wants to run a surplus (save). The nongovernment (including foreign) sector's "net saving" is equal (by identity) to the U.S. government's deficits. Although debt issued between private parties cancels out, that between the government and the private sector remains, with the private sector's net financial wealth consisting of the government's net debt.

The reporting proposed by the FASAB exposure drafts does not appear to recognize the fundamental differences between public and private budgets. Some of the most basic principles of accounting are neglected, terms are ill defined (e.g., "budgetary resources"), projections are misused, policy prescriptions are unjustified, and revenues are matched to spending for parts of the federal budget (notably, Social Security and Medicare) in ways that have no economic validity. Moreover, the concept of a "fiscal gap" is meaningless, and there is no justification in law or theory to legislate an accounting standard with a debt-to-GDP ratio as a target for economic policy.

The authors point out that Social Security as a (national) liability is an asset to the public, but claims have focused on liabilities without acknowledging the corresponding assets. Since the public debt can be eternal and need never be paid off, a net debt position for Social Security and Medicare can likewise be eternal. We now have two centuries' experience of accumulated federal budget shortfalls with, predictably, no suggestion of government insolvency.

A serious shortcoming of the exposure drafts is that they provide no guidance on the choice of economic assumptions to be used in making projections. The procedures suggested for making budget projections are based on unchanging economic conditions, in spite of change resulting through actions of the government sector that have consequences for the nongovernment sector and the economy. Thus, the proposed reporting fails to promote understanding of the nation's financial condition (e.g., how to consider the U.S. dollar's role as an international reserve asset).

The FASAB's proposed time horizons are also problematic, in that they are arbitary and very long-term; as a result, even very minor changes in assumptions make a huge difference for financial projections. For Social Security and other permanent programs, what matters for long-range projections of future real burdens are demographics, technology, and economic growth. By contrast, financing is virtually irrelevant. Therefore, it serves no useful purpose to project financial shortfalls for Social Security and Medicare into a far distant future, or any purpose whatsoever to revise those programs today on the basis of such projections.

For the complete text, go to www.levy.org/pubs/ppb_98.pdf.

The Return of Big Government: Policy Advice for President Obama

L. RANDALL WRAY

Public Policy Brief No. 99, 2009

In the current global crisis, economists and policymakers have reembraced Big Government as a means of preventing the reoccurrence of a debt-deflation depression. According to Senior Scholar L. Randall Wray, the danger is that policy may not downsize finance and replace money manager capitalism. Moreover, we need a permanently larger fiscal presence, with more public services. His advice to President Obama is to discard (and reverse where possible) all of former U.S. Treasury Secretary Henry M. Paulson's actions. Wray believes that we can afford any necessary spending and bailouts, and that these actions will not burden our grandchildren.

The interrelated factors largely responsible for America's "golden age" immediately following World War II include pent-up demand, the baby boom, moderate inflation, and Big Government. Based on the teachings of Hyman P. Minsky, Wray also includes factors such as a high wage / high consumption bias, a high government debt ratio and low private debt, external markets for U.S. output, and a government spending "ratchet" where spending grows faster than GDP. He notes that policy aimed to push private investment (e.g., tax credits for saving and investing) introduces inflationary pressures, promotes inequality, and creates excessive productive capacity (unless demand rises sufficiently). Investment-fueled economic growth tends to produce private debt ratios that increase financial fragility. Government spending–led growth is more sustainable because the growth of private sector spending will be based on income rather than debt.

A macroeconomic turning point occurred in the early 1970s, when saving depressed demand and investment produced fragility. This was followed by a major transformation in the 1990s when innovations in the financial sector increased access to credit and consumption was financed by debt, which eventually led to debt deflation and a deepening recession. A sustainable growth path will require job creation, income growth (especially wages), debt relief, public infrastructure investment, more public services, and a greater role for government.

Policies to deal with the immediate crisis include liquidity (the Federal Reserve must lend without limit to any financial institution); a "too big to save" doctrine (owners of troubled institutions either inject their own capital or face receivership and bankruptcy); tax relief that strengthens household balance sheets (e.g., suspension of the OASDI portion of the payroll tax); fiscal stimulus, including state and local government assistance; mortgage relief, including the renationalization of Fannie Mae and Freddie Mac; and higher budgets for the pursuit of fraud (i.e., jail the crooks).

Policies to encourage sustainable economic growth in the medium to long term include environmental (green) policy, combined with the stoppage of commodity market speculations; payroll tax reform (taxes are too high, inflationary, and reduce competitiveness); the recognition that Social Security promises are commitments by a sovereign government to credit bank accounts on schedule; funding by the federal government to states that take actions to eliminate regressive taxes and reverse trends of rising inequality and household debt; health care reform; government control of social services such as education, health care, and military services; financial reform (self-regulation does not work); and job creation.

Capitalism has no internal processes to guarantee full employment of labor resources, and policy always intervenes to ensure that full employment is not reached (based on the false belief that full employment generates inflation). Obama was on the right track when he set a goal of creating millions of new jobs, says Wray, but he should provide jobs without limit to anyone willing and ready to work. This policy action is not inflationary if there is a fixed price (nominal wage); the quantity is floated (hiring those that show up for work); and the government offers a living wage, with benefits, that does not bid against the (higher paying) private sector. A government jobs program would operate like a buffer stock—expanding in a recession and shrinking in a boom.

The fear of large deficits relates to inflation, investment crowding-out, and insolvency. According to Wray, this fear is without merit. The key to mitigating inflation is to ensure that the correct nature and composition of government spending grows at a pace consistent with the level of fiscal stimulus. This is achieved with a federal jobs program.

The solution to resource crowding-out is not to hire away the resources needed by the private sector. In terms of financial crowding-out, the theory that government deficits push up interest rates and replace private investment is wrong. Central bankers target the short-term interest rate, so higher rates in response to budget deficits are merely a policy decision. Moreover, Treasury debt is an inconsistent policy variable, because the market dictates the interest rate on each maturity. It makes more sense for the Fed to manage the term structure of interest rates by providing loans at various maturities and offering interest rates on deposits at different maturities (and ending any confusion about the link between deficits and interest rates). In fact, government spending pushes interest rates down, an action relieved through bond sales.

In terms of insolvency, a sovereign government that issues its own floating-rate currency can never become insolvent in its own currency. Therefore, analogies to household budgets are completely erroneous. In conclusion, we must envision a new form of capitalism that is more economically, financially, socially, politically, and environmentally sustainable.

For the complete text, go to www.levy.org/pubs/ppb_99.pdf.

Insuring Against Private Capital Flows: Is It Worth the Premium? What Are the Alternatives?

JÖRG BIBOW

Working Paper No. 553, December 2008

The "global capital flows paradox" refers to the fact that the developing world is both a hoarder of reserves, in the form of U.S. Treasury securities, and a net capital exporter to rich countries. Research Associate Jörg Bibow argues that the breakdown of the Bretton Woods system in the early 1970s did not fundamentally change the hegemonic position of the U.S. dollar or the lead role of the U.S. economy as the driver of global demand. Contrary to expectations, Bretton Woods II is unlikely to get back on track anytime soon, so there is the possibility that consumer retrenchment in the United States could pose a serious threat to global stability.

Bibow investigates the opportunity costs of self-insurance by holding foreign reserves, and rejects the idea that these reserves represent low-cost protection against the vagaries of global finance. Rather, the risks offer no rewards to developing countries because financial globalization is a handy device for rent extraction. He proposes comprehensive capital account management as an alternative to liberalization in order to maintain sufficient macro policy space, and to ensure that foreign direct investment complements a country's development strategy.

Bibow analyzes the post–World War II international U.S. dollar standard, together with the U.S. balance of payments, in view of the United States' special status in the Bretton Woods regime. He notes that the United States had a current account surplus position until 1970. The Bretton Woods regime of pegged interest rates failed for reasons of dollar abundance rather than scarcity, as Europe's refusal to either accept currency revaluation or accumulate more dollars put mounting pressure on the dollar's supposed gold backing. The subsequent era of floating dollar exchange rates led to the economic and financial instabilities of the 1970s.

The first wave of financial globalization featuring increased bank lending to developing countries set the stage for the developing-country debt crisis in the 1980s. At that time, a surging U.S. current account deficit became the key source of foreign acquisitions of U.S. assets. The buildup of U.S. deficits after 1991 was the result of protracted domestic demand stagnation in key industrialized countries, the emergence of China, and the price of oil, while the buildup of global imbalances was in response to current account improvements in Germany, Japan, China, and Saudi Arabia. Moreover, the developing world changed its behavior in the aftermath of the Asian crises in the 1990s, becoming a net capital exporter and hoarder of U.S. reserves. The Federal Reserve, the issuer of the world's key currency, stimulated U.S. domestic demand whenever there were deflationary pressures from abroad.

According to Bretton Woods II, current account imbalances indicate a sustainable symbiosis between deficit and surplus countries. Bibow doubts that Bretton Woods II is sustainable because it neglects factors other than the neomercantilist development strategy of prominent emerging-market economies and the United States cannot continue to play its assigned role. Moreover, the accepted explanation for the "bond market conundrum" as expressed by former Fed Chairman Alan Greenspan is based on flawed loanable funds theory. The U.S. economic expansion was possible not by "excess saving" but by dollar liquidity, which (based on credit creation) spilled over to the rest of the world through U.S. spending growth in excess of income growth, and soaring global imbalances.

There is little doubt that the global boom was sponsored by highly expansionary U.S. fiscal and monetary policies. While fiscal policy was successfully used in an anticyclical fashion to stabilize the U.S. economy, monetary policy drove private (not public) spending, which in turn drove an excess of domestic demand growth over GDP growth as well as higher external deficits. The U.S. consumer became the world's spending power of last resort, but the consumer boom was built upon the liberal creation of huge amounts of rather unsafe assets (e.g., subprime mortgages). Continued global growth will therefore require a change in behavior on the part of a number of players, including the (stagnant) industrialized and commodity-rich countries. The only effective strategy that could put both the U.S. economy and the Bretton Woods II regime back on track is a large and sustained fiscal expansion, such as a U.S. budget deficit of 5 percent of GDP in the medium term.

Bibow outlines various approaches to assessing the cost of holding foreign reserves as self-insurance. The prevailing view is that the cost is rather low or may even represent a free lunch, but this is based on an approach that narrowly measures the "fiscal cost" of sterilized interventions. When the developing world runs current account surpluses and exports capital, present consumption and domestic investment opportunities are foregone in exchange for a higher potential for future consumption. Bibow questions how future consumption is possible when investing in low-yielding foreign assets denominated in a depreciating foreign currency, and when the social rate of time preference—society's willingness to trade off consumption today against consumption tomorrow—is fairly high. Rather, capital account convertibility appears to be a mechanism for rent extraction, working through the defensive behavior of developing countries under the existing international monetary "nonorder."

Bibow seriously doubts the supposed wisdom of full capital account convertibility in developing countries. Contrary to orthodoxy, capital accumulation in the developing world has not been augmented by foreign saving since the Asian crises. From a macroeconomic perspective, capital inflows should be restricted to foreign direct investment (and the use of depository receipts), and there is no role for portfolio investments and bank lending (beyond trade finance). From a microeconomic perspective, the focus should be on matching external business expertise with a national development strategy. This general approach also applies to capital outflows. Policy based on a cost-benefit analysis should be geared toward national development goals not a private microeconomic perspective.

A key issue is the relatively small size of institutional investors in the developing world and the fact that access to foreign finance does not lead to development when there are net capital outflows. Bibow cautions against handing over the proceeds of economic growth to foreign rentiers (comprehensive foreign exchange controls are at the heart of the matter). He proposes a strategy in the spirit of John Maynard Keynes's vision for the postwar world in terms of an international monetary order featuring symmetry in adjustment pressures (e.g., pursuing domestic demand-led growth through deliberate management of economies). He also proposes that developing countries decouple from the U.S. growth engine, since export-driven growth is not a valid option when the U.S. economy contracts.

For the complete text, go to www.levy.org/pubs/wp_553.pdf.

Macroeconomic Imbalances in the United States and Their Impact on the International Financial System

JULIA S. PERELSTEIN

Working Paper No. 554, January 2009

This paper seeks to break new ground in the analysis of financial instability in the United States. It shows how instability links with macroeconomic imbalances and inflation in the U.S. economy. It also identifies the key structural features that describe the dynamics of an international financial system dependent on the U.S. trade deficit, whereby the United States has a comparative advantage in banking and finance.

Julia S. Perelstein, *Mandag Morgen*, Oslo, Norway, accounts for the global integration of capital markets by analyzing the relationship between U.S. trade imbalances and global financial markets. She concludes that the 2007–08 crisis was a consequence of the U.S. trade deficit, that there is global financial dependence on the United States when dollars are reinvested in U.S. capital markets (creating excess liquidity and sequential bubbles relating to housing and commodities), and that U.S. macroeconomic imbalances cannot be resolved without affecting the rest of the world.

The author notes a lack of theory addressing the consequences of the U.S. trade deficit on the international financial system, since the academic debate has centered on whether or not the U.S. trade deficit is sustainable. Monetarists do not see the deficit as an immediate threat to the U.S. economy (e.g., the dollar is the international reserve currency and dollars are reinvested in the U.S. financial markets) and believe that global trade imbalances will eventually be resolved. The author also notes that the monetarist arguments preceded the subprime mortgage crisis in 2007.

The skeptics, or heterodox economists, claim that the deficit is unsustainable and may lead to disastrous consequences for the global economy (e.g., a speculative attack against the dollar). U.S. debt to other countries is paid for by outflows in the financial account, and these liabilities have to be paid back in the future. If the money is spent on consumption rather than investment, then the U.S. dollar may no longer be seen as a good investment. The skeptics' solution to the deficit is deflation, which leads to unemployment and other serious consequences.

Federal Reserve Chairman Ben Bernanke's "global saving glut" hypothesis states that increased savings and current account surpluses in developing countries have to be counterbalanced by deficits somewhere else (savings equal investment and the sum of national current account balances must be zero). The solution to the problem, then, must also involve other parts of the world (e.g., China and the dollar exchange rate of the yuan). Bernanke therefore rejects the idea that the decline in public and private saving in the United States is the main reason for macroeconomic imbalances.

Perelstein notes that the U.S. external deficit is creating an export stimulus demand close to 2 percent of world GDP. The central issue is not who has lent the money but the amount of debt. While the focus of debate on reducing global trade imbalances (i.e., reducing U.S. import-led growth) has been the impact on the U.S. economy in domestic terms, one must also consider the consequences for other (heavily indebted) countries. The U.S. trade deficit is necessary to sustain the international financial system, since crises arise when the United States closes its trade deficit (e.g., the Asian financial crisis in 1997–98). In reality, says Perelstein, it might be in the interest of countries indebted in dollars to function under the auspices of a weak dollar and a large current account deficit, since global growth is dependent on the creation of dollars.

The author points out that the United States is the world's largest debtor nation, and maintains a current account deficit with every trading partner. (The U.S. trade deficit hit a record level of 6.2 percent of GDP in 2006.) The decline in U.S. saving did not cause the deficit, but rather the rise in U.S. consumption has not matched the rise in U.S. industrial production or exports because of underinvestment (other countries use their savings to finance U.S. consumption). The (monetarist) global equilibrium view has never been borne out in practice, since the international credit system finances trade imbalances that in turn determine exchange rates.

There is instability in the international financial markets when countries do not have enough secure assets, such as government bonds, in their portfolios. The U.S. subprime mortgage crisis is an example of how quickly a problem in one part of the international financial system can affect the global economy. The U.S. budget deficit is used to finance the U.S. current account deficit and bring an unbalanced economy into temporary equilibrium (until asset market bubbles burst). The increasing dependence of U.S. economic growth on inflation in asset markets underpinned consumption, while the growth in insurance, banking, and financial consulting firms underpinned employment growth in the United States.

The dollar outflow from the United States has flooded the international capital markets, feeding asset or financial inflation worldwide. This situation encourages moral hazard and creates a sequence of (commodity) bubbles that increase prices due to excess liquidity and profoundly affect the poor. On the other hand, U.S. macroeconomic imbalances are a way of keeping the international economic system stable, since many countries rely on exports to pay their debts and depend on dollar outflows from the United States.

This field needs further investigation if the problems of the international financial system are to be resolved, says Perelstein. The current financial crisis is the result of attempts to resolve trade imbalances within global financial markets rather than the result of fraud within U.S. financial markets.

For the complete text, go to www.levy.org/pubs/wp_554.pdf.

Financial Stability: The Significance and Distinctiveness of Islamic Banking in Malaysia

EWA KARWOWSKI

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Islamic banking prohibits interest and collateral, while adhering to the idea that banks should channel funds toward productive investment. Profit is generated by primary and secondary modes of Islamic finance (e.g., profit-sharing arrangements such as partnerships and equity participation). Its perceived superiority to conventional banking is derived from its morality, social welfare dimension, and greater stability.

Ewa Karwowski, School of Oriental and African Studies, University of London, reveals the dynamic interaction between the Islamic and non-Islamic economy in Malaysia, and extends the theories of financialization and excess capitalization to emerging markets. Using a flow-of-funds approach in line with Hyman P. Minsky's methodology, Karwowski finds a financial business cycle where domestic firms have been overcapitalized. She also finds that Islamic banking contributes to asset inflation by channeling surplus funds from the corporate sector to the household sector.

Islamic banking is turning from a niche market into a mainstream financial product, with phenomenal growth rates in the Middle East and Southeast Asia (total assets are estimated at 0.5 percent of international banking assets). Its distinguishing features are the prohibition of interest or collateral, along with some compulsory charitable spending. The prohibition of interest is incompatible with the common belief that banks should channel funds toward productive investment—for example, the models used by Western economists include a supply price for credit.

This paper addresses the moral, developmental, and stability dimensions of Islamic economics. The absence of interest (demanded by the Qur'an) constitutes the moral dimension, since injustice is associated with charging interest (e.g., interest on consumption credit exploits the needy). The developmental dimension explicitly refers to social welfare, including need fulfillment and full employment (i.e., a more equitable distribution of wealth). In terms of the stability dimension, however, the author observes potential issues concerning the main instruments of redistribution, such as the Islamic practice of *Zakat* (a compulsory contribution toward charity) and Muslim inheritance law. These instruments might have an inflationary effect on commodity or capital markets by penalizing investors' liquidity preference and favoring fund inflows into highly liquid assets such as Islamic bonds.

The economy of perfect competition, information, and market clearing is a parallel to the perfect Muslim community. However, the assumption that credit supply is infinitely elastic is questionable when Islamic banks are required to hold reserves equivalent to demand deposits and their discretionary disposal of credit is limited (only funds held in investment and special investment deposits can be transformed into loans).

The author reviews and criticizes various studies that have attempted to compare the stability of Islamic banks with conventional ones. She notes that no Islamic scholar has succeeded in establishing a causal link between interest, on the one hand, and employment and trade cycles, on the other. She doubts that a profit-and-loss sharing-based credit system is more stable than a debt-based system because debt has a stabilizing influence on the financial system. Substantial asset inflation is especially destabilizing in the case of Islamic banking, since deposit holders exercising control over their investment funds also bear the investment risk that is usually absorbed by banks (and investors can withdraw their funds on relatively short notice, leading to deflation). In times of crisis, an ad hoc switch to non-Islamic investment can cause a greater fall in asset prices and even greater losses for investors.

Typically, Islamic banking is not isolated from conventional finance and emerging markets have to copy international financial institutions controlled by financially advanced countries. Thus, says Karwowski, it is crucial to place Islamic finance in the context of domestic and global economics, and financial flows dominated by non-Islamic finance. Minsky's methodology offers a systemic way to examine the flow of funds and analyze financial sector dynamics.

Malaysia has an internationally integrated and open financial system, along with a structural current account surplus (14.5 percent of GDP). The author examines the balance sheets of a representative sample of (large) Malaysian firms and finds that these companies hold a significant and increasing share of liabilities in financial and banking assets. And despite claims of stabilizing the economic system, the Islamic banks channel funds from the corporate to the household sector. Funds flow from companies to households rather than the other way around.

The evidence validates the author's initial hypothesis that Islamic banks in Malaysia channel funds from the overcapitalized nonfinancial corporate sector toward households, which invest in housing and durable consumer goods. Furthermore, companies that place deposits in Islamic banks earn their deposits in non-Islamic businesses. Thus, banking in emerging markets reproduces the same features that give rise to (Minskyan) financial instability.

For the complete text, go to www.levy.org/pubs/wp_555.pdf.

Program: Employment Policy and Labor Markets

Obama's Job Creation Promise: A Modest Proposal to Guarantee That He Meets and Exceeds Expectations

PAVLINA R. TCHERNEVA

Policy Note 2009/1

Job creation is once again at the forefront of policy action. While President Obama's Keynesian bent is a welcome change, Paul Krugman and Robert Reich have raised concerns that Obama's plan does not go far enough, and that a large-scale public investment program may face shortages of skilled labor, put upward pressure on wages, and leave women and minorities behind.

Research Associate Pavlina R. Tcherneva calls for a bolder Obama stimulus plan and she proposes an amendment to the plan whereby the government serves as employer of last resort, since a job guarantee can reduce the unemployment rate drastically and immediately. This policy represents a genuine bottom-up approach to the recovery that offers employment opportunities to all, including minorities and women, and creates jobs and valuable work at a much smaller price. Because the private sector will continue to streamline its operations and shed jobs, a job guarantee is absolutely essential, says Tcherneva. A job guarantee must also be coupled with a community jobs program and a program for enhancing human capital that will eventually bring higher quality jobs to the inner city. This approach will allow President Obama to fulfill his promise of three million jobs within his first few months in office, while an open-ended employment guarantee could even quadruple the number of jobs created over the next several years. This action would bring the economy close to full employment and allow the president to concentrate on the strategic long-term goals of his plan.

Tcherneva notes that fiscal policy is executed in a manner completely opposite from what John Maynard Keynes had in mind (i.e., the most bang for the buck is achieved via direct job creation by the public sector and there should be a focus on closing the labor demand gap, not the aggregate demand gap). Counting on the private sector to generate the desired job growth is a far too lengthy and sluggish road to recovery. Because the fiscal stimulus enters the economy through a "leaky bucket" (some of it is lost because of administrative costs and some of it has no direct job creation effects), not all of the money reaches the poor and unemployed (and the GDP-to-unemployment relationship is rather weak). Moreover, the Keynesian take on fiscal policy has eluded most economists and has consequently been misinterpreted as a "make work" approach.

Since there are more jobs than manpower to do them, Tcherneva suggests that a government program should not be capped at three million jobs. An unconditional job guarantee is more cost effective than the pump priming contained within the current proposal, since it would offer a base living wage at a cost that is only a fraction of the current budget. For example, a direct job guarantee program could create 10 million jobs for $250 billion, which is even cheaper than the proposed tax cut that has no immediate and direct job creation effect. Furthermore, a job guarantee is entirely consistent with all of the objectives of Obama's plan (e.g., new jobs would include staffing government programs, improving education and health care facilities, creating new green infrastructure, and repairing old infrastructure). Since newly employed individuals will spend their incomes on private sector goods and services, they will kick-start the private sector and subsequently reduce the government labor force, as private firms hire public sector employees and provide better-paying jobs.

For the complete text, go to www.levy.org/pubs/pn_1_09.pdf.

Hypothetical Integration in a Social Accounting Matrix and Fixed-price Multiplier Analysis

KIJONG KIM

Working Paper No. 552, December 2008

In 2004 the South African government initiated a direct job creation initiative—the Expanded Public Works Programme (EPWP). Research Scholar Kijong Kim shows how to incorporate a new hypothetical sector such as EPWP into a social accounting matrix (SAM) for South Africa (SAM-SA) in order to accurately capture the impact of the program and its proposed expansion in terms of sectoral development, job creation, and poverty reduction.

Multiplier analysis based on a SAM supposes that the technical coefficients of production remain constant. A new technology, therefore, requires modification of the SAM. Since the projects associated with the EPWP sectors designated for job creation are labor intensive and atypical of the existing economic structure, a new, separate hypothetical sector needs to be added to SAM-SA. Moreover, there needs to be a simple hypothetical integration method to circumvent rebalancing the SAM without sacrificing the accuracy of the multiplier analysis.

A SAM is a double-entry table (matrix) that provides a consistent framework of national accounts and incorporates the distributional and social dimensions of an economy (i.e., the interactions between production, factors of production, institutions, capital accounts, and the external balance). While a SAM can show how total income is distributed between capital and labor at an aggregate level, it can also show the relationships at a disaggregated level (e.g., labor specified by gender or skill). SAM-SA includes 26 sectors, including four labor factor groups and 20 household types. According to Kim, an outstanding feature of SAM-SA is the extremely biased income distribution toward nonpoor households that cuts across both gender and skill levels.

Kim describes how to reformulate SAM-SA and incorporate the specifics of EPWP's targeted employment policy, coupled with poverty reduction. The composition of the EPWP social sector in terms of labor and skill inputs is different from that of other relevant sectors (education and health). The separate accounts are necessary to incorporate an employment-targeting scheme for the bottom 50th percentile that reflects the poverty reduction efforts of EPWP. Reducing unemployment and poverty results in a complicated configuration of job allocation among various household types. A specific benefit of the method is that the matrix does not need to be rebalanced.

A SAM-based fixed-price multiplier analysis assumes that any increase in exogenous demand is satisfied by a corresponding increase in output, not prices; and it suggests the prevalence of excess capacity, unused resources, and constant prices. Since this assumption holds for South Africa, the magnitude of the results of the analysis can be treated as useful first approximations.

Kim finds that modifying SAM-SA with the EPWP social sector and factor accounts lifts aggregate incomes of poor and ultrapoor households by 151 and 374 percent, respectively, while that for nonpoor households increases by only 21 percent. The enhancement of poor and ultrapoor households comes from EPWP job targeting and wage payments for unskilled workers. The multiplier analysis would underestimate the effect of EPWP unless SAM-SA were reformulated, notes Kim. Income distribution and poverty reduction are much better captured when the modeling allows for employment targeting. Furthermore, decomposing the changes in GDP with EPWP also justifies the process of reformulating SAM-SA.

In the case of South Africa, modifying the SAM lifts aggregate income of poor and ultrapoor households in response to EPWP job targeting. Without modifying SAM-SA, the multiplier analysis would underestimate the effect of the public works program in terms of income distribution and poverty reduction. The author shows that fixed multiplier analysis using a SAM can articulate any multiplicative effects of economic policy instruments and provide valuable insights to policymakers.

For the complete text, go to www.levy.org/pubs/wp_552.pdf.

Program: Economic Policy for the 21st Century

Small Is Beautiful: Evidence of an Inverse Relationship between Farm Size and Yield in Turkey

FATMA GÜL ÜNAL

Working Paper No. 551, December 2008

The inverse relationship between farm size and yield per acre has crucial and far-reaching implications for rural development policy; for example, it may provide economic justification for redistributive land reforms. Despite more than 40 years of research, however, there is no consensus on what causes the inverse relationship.

This paper by Research Associate Fatma Gül Ünal affirms that there is a very strong inverse size-yield relationship (IR) in Turkey. The relationship is driven by labor input per decare (1,000 square meters, or .25 acre), where land fragmentation appears to have a positive impact on productivity. The author's findings negate recent "market-friendly" agricultural reforms, while favoring land redistribution supported by technical and financial assistance for farmers. Given current macroeconomic policy, she foresees rising inequality and poverty in Turkey.

Two common characteristics of developing countries are the large share of agriculture in the economy and poorly functioning factor markets that produce IR; that is, as farm size increases, yield per acre decreases. Ünal focuses on the overall land utilization of the available land resource and the related use of labor. She notes that the relationship between size and yield became a focal point of agrarian debates after the 1960s, when the empirical basis was first established by farm management surveys in India. She also notes that land reforms have contributed toward the economic transformation (industrialization) and political stability of countries like Japan, South Korea, and Taiwan, with important outcomes for employment (i.e, small-scale farming is labor intensive), the environment, and communities.

An explanation for IR is the misidentification hypothesis, which posits that IR is a statistical artifact due to omitted variables (e.g., land quality and farmer heterogeneity). Ünal believes that looking at technical efficiency rather than resource utilization is not very meaningful for developing countries because land, not labor, is generally the scarce factor. The majority of explanations for IR are based on intensive labor inputs on smaller farms due to imperfections in factor markets. The main theme is that farms use different proportions of inputs as a result of different factor prices, which then give different incentives to farmers operating on different scales. After reviewing the IR literature, the author concludes that the empirical analysis of labor-based theories explains IR (and the fact that markets are not efficient in allocating resources) more accurately in the context of agriculture in developing countries. Thus, a labor-based hypothesis is used in the empirical investigation of IR in Turkey.

No existing study examines the size-productivity nexus in Turkish agriculture, says Ünal, and only one paper underlines the importance of smallholder agriculture. Using a 2002 World Bank quantitative household survey of 5,302 rural households, she finds that productivity per acre for small farms (less than 20 decares) is substantially higher than that of large farms in all regions of Turkey. The same inverse trend is also observed for labor and nonlabor input per decare, and in terms of credit per decare. The general demographic picture is typical for a developing country: uneducated middle-aged males managing small family farms.

Regressions to test for IR were conducted for each region and for the country as a whole. Ünal finds that there is a very strong inverse size-yield relationship in rural Turkey even after disaggregating the data and controlling for village fixed effects. At the national scale, doubling the farm size results in a 51 percent decrease in productivity per decare. IR is most pronounced in the Black Sea region and least pronounced in the Marmara region. On average, a 1 percent rise in farm size results in a 0.75 and a 0.47 percent decline in labor and nonlabor input per decare, respectively. Contrary to claims by the Organisation for Economic Co-operation and Development and the Food and Agriculture Organization of the United Nations, land fragmentation is positively and significantly correlated to productivity.

For the complete text, go to www.levy.org/pubs/wp_551.pdf.

INSTITUTE NEWS

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April 16–17, 2009

Organized by The Levy Economics Institute of Bard College with support from the Ford Foundation

On April 16 and 17, top policymakers, economists, and analysts will gather at the Ford Foundation's headquarters in New York City to offer their insights and policy guidelines on the extraordinary challenges posed by the global financial crisis. Topics will include: current conditions and forecasts; macro policy proposals by the Obama administration and others; the rehabilitation of mortgage financing and the banks; financial market reregulation; proposals to limit foreclosures and modify servicing agreements; regulation of alternative financial products (derivatives and credit default swaps); the institutional shape of the future financial system; and international responses to the crisis.

The current conference program is outlined below. For further information, visit www.levy.org.

Preliminary Program

Thursday, April 16

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

9:00–9:30 a.m. **Welcome and Introduction**
DIMITRI B. PAPADIMITRIOU, The Levy Economics Institute

9:30–10:30 a.m. **Speaker**
BRUCE KASMAN, JPMorgan Chase & Co.

10:30 a.m. – 12:15 p.m. **Session 1**

Assessment of Fed/Treasury Response to Crisis

Speakers:

WILLIAM KURT BLACK, University of Missouri–Kansas City
MARSHALL AUERBACK, RAB Capital PLC
JANE D'ARISTA, Financial Markets Center
THOMAS FERGUSON, University of Massachusetts Boston

12:15–2:30 p.m. **Lunch**

Speaker: DENNIS P. LOCKHART, Federal Reserve Bank of Atlanta

2:30–3:15 p.m. **Speaker**

JAMES GRANT, *Grant's Interest Rate Observer*

3:15–5:00 p.m. **Session 2**

Proposals on Alternative Financial Regulation

Speakers:

ALAN S. BLINDER, Princeton University
CHRISTINE M. CUMMING, Federal Reserve Bank of New York
MICHAEL GREENBERGER, The University of Maryland School of Law
MARTIN MAYER, The Brookings Institution

5:00–5:15 p.m. **Coffee Break**

5:15–6:30 p.m. **Session 3**

Levy Institute–Ford Project Proposals on Reregulation of the Financial System

Speakers:

C. P. CHANDRASEKHAR, Jawaharlal Nehru University
JAN KREGEL, The Levy Economics Institute and University of Missouri–Kansas City
MARIO TONVERONACHI, University of Siena
ÉRIC TYMOIGNE, The Levy Economics Institute and California State University, Fresno

6:30–7:30 p.m. **Reception**

7:30 p.m. **Dinner**

Speaker: JANET L. YELLEN, Federal Reserve Bank of San Francisco

Friday, April 17

8:30–9:00 a.m. **Breakfast**

9:00–10:00 a.m. **Speaker**

ROBERT J. BARBERA, ITG

10:00–11:15 a.m. **Session 4**

The Institutional Shape of the Future Financial System

Speakers:

RICHARD BOOKSTABER, Author and financial economist
RANDALL S. KROSZNER, The University of Chicago
ALEX J. POLLOCK, American Enterprise Institute
WALKER F. TODD, American Institute for Economic Research

11:15–11:30 a.m. **Coffee Break**

11:30 a.m. – 1:30 p.m. **Session 5**

Current Conditions and Forecasts

Speakers:

NORBERT WALTER, Deutsche Bank
DEAN MAKI, Barclays Capital
JAMES W. PAULSEN, Wells Capital Management
LAKSHMAN ACHUTHAN, Economic Cycle Research Institute

1:30–3:15 p.m. **Lunch**

Speaker: HENRY KAUFMAN, Henry Kaufman & Company, Inc.

3:15–4:00 p.m. **Speaker**

JOSEPH E. STIGLITZ, Columbia University

4:00–6:00 p.m. **Session 6**

Alternative Stimulus and Bailout Proposals

Speakers:

JAMES K. GALBRAITH, The Levy Economics Institute and University of Texas at Austin
WARREN MOSLER, Valance Co., Inc.
ROBERT W. PARENTEAU, The Levy Economics Institute and MacroStrategy Edge
L. RANDALL WRAY, The Levy Economics Institute and University of Missouri–Kansas City

6:00–6:30 p.m. **Reception**

PUBLICATIONS AND PRESENTATIONS

Publications and Presentations by Levy Institute Scholars

RANIA ANTONOPOULOS *Research Scholar*

Presentations: "Socio-Economic Empowerment of Women," Expert Consultation on the 2009 World Survey on the Role of Women in Development, organized by the Danish Ministry of Foreign Affairs and the United Nations Division for the Advancement of Women (UNDAW), Copenhagen, Denmark, February 17–19, 2009; "The Current Job Crisis and Policy Responses," public roundtable discussion organized by the Ministry of Foreign Affairs, Copenhagen, February 20; "Costing for Financing Gender Equality: Market Failure or Investing in People and Development?" workshop on "Costing for Financing Gender Equality and Women's Empowerment in National Development Plans: Poverty Reduction Strategies and the MDGs," United Nations Development Fund for Women (UNIFEM), Dakar, Senegal, February 23–25; "The Equal Sharing of Responsibilities between Women and Men, including Caregiving in the Context of HIV/AIDS," roundtable organized by UNDAW, 53rd Session of the Commission on the Status of Women, United Nations, New York, N.Y., March 2; "Economic Crisis and Gender Issues," panel organized by the United Nations Development Programme Gender Team, 53rd Session of the Commission on the Status of Women, March 4; "Caregiving in the Context of HIV/AIDS," panel organized by UNIFEM, 53rd Session of the Commission on the Status of Women, March 4.

PHILIP ARESTIS *Senior Scholar*

Publications: *Issues in Economic Development and Globalization: Essays in Honour of Ajit Singh* (ed., with J. Eatwell), Palgrave Macmillan, 2008; "Financial Liberalization: The Current State of Play," in P. Arestis and J. Eatwell, eds., *Issues in Finance and Industry: Essays in Honour of Ajit Singh*, Palgrave Macmillan, 2008; "Unemployment and the Natural Interest Rate in a Neo-Wicksellian Model," in P. Arestis and J. McCombie, eds., *Unemployment: Past and Present*, Palgrave Macmillan, 2008; "Assessing Inflation Targeting Through Intervention Analysis" (with A. Angeriz), *Oxford Economic Papers*, Vol. 60, No. 2 (April); "Atheoretical and Theory-based Approaches to the Natural Equilibrium Real Interest Rate" (with G. E. Chortareas), *Eastern Economic Journal*, Vol. 34, No. 3 (Summer); "A Critical Reconsideration of the Foundations of Monetary Policy in the New Consensus Macroeconomics Framework" (with M. Sawyer), *Cambridge Journal of Economics*, Vol. 32, No. 5 (September); "The New Consensus Macroeconomics: An Unreliable Guide for Policy," *Revista Análise Econômica*, Vol. 26, No. 50 (September); "New Consensus Macroeconomics and Inflation Targeting: Keynesian Critique," *Economia e Sociedade*, Vol. 17, Special Issue (December); *Critical Essays on the Privatization Experience* (ed., with M. Sawyer), Palgrave Macmillan, 2009; "Fiscal Policy within the 'New Consensus Macroeconomics' Framework," "Minsky's Financial Instability Hypothesis: The Crucial Role of Fiscal Policy" (with E. De Antoni), and "The Intertemporal Budget Constraint and the Sustainability of Budget Deficits" (with M. Sawyer), in J. Creel and M. Sawyer, eds., *Current Thinking on Fiscal Policy*, Palgrave Macmillan, 2009; *Missing Links in the Unemployment Relationship* (ed., with J. McCombie), Palgrave Macmillan, 2009.

Presentations: "New Consensus Macroeconomics and Keynesian Critique," conference on "Macroeconomic Policies on Shaky Foundations—Whither Mainstream Economics?" Berlin, Germany, October 31–November 1, 2008; "New Consensus Macroeconomics and Keynesian Critique," conference on "The Big Crunch and the Big Bang: How to Get Out of the Global Financial Mess," The Cambridge Trust for New Thinking in Economics, Murray Edwards College, November 21; "Current Credit Crunch and Regulatory Implications," staff/postgraduate seminar, Department of Economics, Greenwich University, November 12, and University of the Basque Country, December 3; "Policy Implications of the Current Financial Crisis," workshop on "Developing Joint UK Policy Responses to the Financial and Economic Crisis," School of Oriental and African Studies, University of London, December 15; "Inequality Adjusted Growth Rates in Developing Countries," Allied Social Science Associations Annual Meetings, San Francisco, Calif., January 3–5, 2009; "Current Financial Crisis and Regulatory Implications," Political Economy Seminar series, St. Catharine's College, University of Cambridge, January 20.

JAMES K. GALBRAITH *Senior Scholar*

Publications: "James K. Galbraith Says Predator State Hit Wall: Year in Review," *Bloomberg.com,* December 31, 2008; "We Are All Keynesians Again," *The Washington Monthly* (January–February);

"A Biophysical Approach to Production Theory" (with J. Chen), UTIP Working Paper No. 55, February 1; "The Generalized Minsky Moment" (with D. Munevar Sastre), UTIP Working Paper No. 56, February 2; "The Evolution of Economic Inequality in the United States, 1969–2007" (with J. T. Hale), UTIP Working Paper No. 57, February 2.

Presentations: "The Johnson Legacy and the Obama Challenge," panel on "Employment, Cities, and Housing," Policy Challenges for the New President and the LBJ Legacy Meeting," Lyndon B. Johnson School of Public Affairs, Austin, Tex., December 4, 2008; "Inequality, Unemployment, and Growth," panel on "Inequality: Economic, Fiscal, Financial, and Societal Dimensions," Allied Social Science Associations (ASSA) Annual Meetings, San Francisco, Calif., January 3–5, 2009; "Inequality, Unemployment, and Growth: New Measures for Old Controversies," panel on "Understanding the Persistence of Inequality: Toward the Development of New Analytical Approaches," ASSA Annual Meetings; "Earnings Inequality in the United States," panel on "The Persistent Problem of Inequality: A Roundtable on Policy Advice for the Next Administration," ASSA Annual Meetings; "The Crisis and the Road Ahead," Americans for Democratic Action conference, Washington, D.C., January 20; "The Financial Crisis and the Economy Looking Forward," Metropolitan Breakfast Club, Austin, Tex., February 18.

KIJONG KIM *Research Scholar*

Presentation: Interview regarding the effectiveness of a fiscal stimulus plan for Georgia with Molly Corso, *Investor.ge*, January 23.

THOMAS MASTERSON *Research Scholar*

Publication: Review of *The World Bank, A Critical Primer* by E. Toussaint, *Labour/Le Travail,* Vol. 62 (Fall 2008).

Presentation: "Long-Term Trends in the Levy Institute Measure of Economic Well-Being (LIMEW), United States, 1959–2004," Allied Social Science Associations Annual Meetings, San Francisco, Calif., January 3–5, 2009.

DIMITRI B. PAPADIMITRIOU *President*

Publication: "Global Imbalances: The U.S. and the Rest of the World," in E. Hein, T. Niechoj, P. Spahn, and A. Truger, eds., *Finance-led Capitalism: Macroeconomic Effects of Changes in the Financial Sector*, Metropolis-Verlag, 2008.

Presentations: "The Economic Crisis: What Went Wrong and What to Do Now," Bard College, Annandale-on-Hudson, N.Y., November 20, 2008; interview regarding President Obama's choice for Treasury Secretary with Daniel Sturgeon, *Tokyo News*, November 21; interview regarding the credit crisis approach that focuses on injecting government funds into healthy institutions with David Ress, *Richmond Times-Dispatch*, December 3; interview regarding the current economic situation with Lorna Tychostup, *Chronogram*, December 9; interview regarding predictions for the new year with Bonnie Langston, *Daily Freeman*, December 29; interview regarding the TARP plan with Zachary Roth, *TalkingPointsMemo.com*, January 15, 2009; interview regarding a profile piece on James K. Galbraith with Pat Regnier, *Fortune*, January 16; interview regarding the Federal Reserve and monetary policy with Greg Robb, *MarketWatch.com*, January 23; interview regarding Bank of America with Paul Davis, *American Banker*, February 6.

EDWARD N. WOLFF *Senior Scholar*

Publications: "The World Distribution of Household Wealth" (with J. B. Davies, S. Sandström, and A. Shorrocks), in Davies, ed., *Personal Wealth from a Global Perspective,* Oxford University Press, 2008; review of *The Warhol Economy: How Fashion, Art and Music Drive New York City*" by E. Currid, *Journal of Economic Literature*, Vol. 46, No. 4 (December); *Poverty and Income Distribution,* 2nd ed., Wiley-Blackwell, 2009.

Presentation: "Long-Term Trends in the Levy Institute Measure of Economic Well-Being (LIMEW), United States, 1959–2004," Allied Social Science Associations Annual Meetings, San Francisco, Calif., January 3–5.

GENNARO ZEZZA *Research Scholar*

Presentations: "Fiscal Policy in a Model of the U.S. Economy," 12th Conference of the Research Network Macroeconomics and Macroeconomic Policies, "Macroeconomic Policies on Shaky Foundations—Whither Mainstream Economics?" Berlin, Germany, October 31–November 1, 2008; "Empirical Stock-flow Consistent Modeling," seminar, IMK, Düsseldorf, Germany, November 4; "Fiscal Policy and the Economics of Financial Balances," seminar, Université Paris Nord, February 13, 2009.