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.

Editor: W. Ray Towle Text Editor: Barbara Ross

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LETTER FROM THE PRESIDENT

To our readers:

Distinguished Scholar Wynne Godley, longtime head of our Macro-Modeling Team, passed away in May. Much of his work focused on the strategic prospects for the world economies and creating accounting macroeconomic models to reveal structural imbalances. According to the London *Times*, he was "the most insightful macroeconomic forecaster of his generation." Wynne's intellectual achievements in macroeconomics and his courage in going against conventional wisdom were due to a systematic framework of analysis that enabled him to determine the impact of economic policies, a framework he first applied to Britain's economy and, subsequently, to America's. Personally, I will always remember his dedication to the Levy Institute and his contribution to our *Strategic Analysis* reports.

This issue begins with coverage of the 19th Annual Hyman P. Minsky Conference, under the State of the U.S. and World Economies program. Held in April in New York City with support from the Ford Foundation, the conference focused on many Minskyan themes, including the reconstitution of the financial structure, the reregulation and supervision of financial institutions, the moral hazard of the "too big to fail" doctrine, and the economics of the "big bank" and "big government." In addition, participants considered central bank exit strategies.

Three public policy briefs are included under this program. Senior Scholar James K. Galbraith addresses the financial crisis and the role played by the economics profession (including Godley and Minsky). He observes that even though we have managed to sidestep a second Great Depression, fiscal austerity could interfere with the ability of economies to grow constructively. I along with Senior Scholar L. Randall Wray and Yeva Nersisyan call for a major reconstruction of the European project in terms of a permanent fiscal arrangement between the central eurozone authorities and member states. Research Scholar Greg Hannsgen and I are adamant that there is no justification for cutting spending or raising taxes in order to reduce the U.S. federal deficit or to permit solid economic growth.

A policy note by Paul McCulley asserts that Godley's financial balances approach should be the workhorse of discussions on global rebalancing. Moreover, without current fiscal deficits, a second Great Depression would have been unavoidable.

Five working papers are also included under this program. Research Associate Jörg Bibow advises developing countries to pursue policies in direct opposition to the preaching of the International Monetary Fund. In a second paper, he finds that a Bretton Woods 3 regime could arise, where U.S. current account deficits continue. Research Associate Claudio H. Dos Santos and Antonio C. Macedo e Silva argue that modified versions of the New Cambridge approach to macroeconomic modeling (led by Godley) are an important contribution to the tool kit for applied macroeconomists. G. E. Krimpas considers the currency recycling problem in the European Monetary Union and advocates an entity that is a lender as well as a spender of last resort. Nersisyan and Wray analyze *This Time Is Different* by Carmen Reinhart and Kenneth Rogoff, and determine that the book's policy prescriptions are not relevant for a sovereign nation like the United States.

The Monetary Policy and Financial Structure program begins with a brief by Nersisyan and Wray. They argue that deficits do not burden future generations with debt, nor do they crowd out private spending. Automatic stabilizers, not government bailouts or the stimulus package, have prevented the U.S. economic contraction from devolving into another depression.

Six working papers are included under this program. Luiz Carlos Bresser-Pereira reviews the world financial markets and concludes that global capitalism will change for the better because it will be neither financialized nor neoliberal. Using a simple schematic model that focuses on consumption, Amit Bhaduri formally captures the crucial mechanisms, such as a loss of confidence in the financial sector, that paved the way to crisis. Bernard Shull evaluates the underlying motives of authorities and concludes that structural reforms to contain the problems of too-big-to-fail should limit further concentration among the largest financial companies. Senior Scholar Jan Kregel observes that the best policies affect both balance sheets and the flow of funds—measures that would cost much less than the Obama administration's stimulus package. Gary A. Dymski recommends modifying regional compact rules to serve the social and economic needs of development. Using macroeconomic data, Research Associate Éric Tymoigne shows that Ponzi processes can be detected well in advance of

crisis. He recommends a return to sound underwriting practices based on income.

Three working papers are included under the Gender Equality and the Economy program. Research Associate Lekha S. Chakraborty focuses on incorporating gender-sensitive fiscal policies at the local level in India that depart from one-size-fits-all budgeting policies. Research Associate Fatma Gül Ünal, Mirjana Dokmanovic, and Rafis Abazov find Eastern European policy mixes with differential impacts on women and the poor. They recommend policies that target the lower-middle class and prioritize job creation. Using South Africa's time-use survey, Research Scholar Rania Antonopoulos and Research Associate Emel Memis find that time spent on unpaid work is as binding as time spent on paid work, while hindering participation in paid work.

In a policy note under the Employment Policy and Labor Markets program, Charles L. Whalen observes that the United States is facing not simply a cyclical or an employment crisis but rather the latest phase in a decades-long "silent depression."

Under the Immigration, Ethnicity, and Social Structure program, a working paper by Research Associate Sanjaya DeSilva, Anh Pham, and Michael Smith concludes that the spatial dispersion of households in Kingston, New York, is caused by the demand for amenities, not by racial prejudice.

In a working paper under the Economic Policy for the 21st Century program, Research Scholar Greg Hannsgen finds evidence to support the derivation of a better model than structural vector autoregressions for some macro data.

As always, I welcome your comments and suggestions.

Dimitri B. Papadimitriou, *President*

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

19th Annual Hyman P. Minsky Conference
After the Crisis: Planning a New Financial Structure

The Levy Economics Institute, with support from the Ford Foundation, held its annual Hyman P. Minsky conference at the Foundation's headquarters in New York City on April 14–16. This year's conference focused upon many Minskyan themes, including reconstituting the financial structure; the reregulation and supervision of financial institutions; the relevance of the Glass-Steagall Act; the roles of the Federal Reserve, Federal Deposit Insurance Corporation, and Treasury; the moral hazard of the "too big to fail" doctrine; debt deflation; and the economics of the "big bank" and "big government." In addition, participants at the conference compared the European and Latin American responses to the global financial crisis, and the proposals for reforming the international financial architecture. They also considered both national and international central bank exit strategies.

Minsky studied the conditions that produced a sequence of economic booms and busts, and his proposals for reforming the financial sector were wide ranging and far reaching. He helped us understand how financial innovation reinforces the dynamics of speculative finance that decrease debt quality and increase volatility, both of which are characteristic of current times. And he predicted in 1987 the explosion of home mortgage securitization that eventually led to the meltdown of the mortgage-backed securities market. Unlike other analysts who looked to causes relating to shocks and foolish policy, Minsky argued that the processes generating financial instability are natural and endogenous to the system. He was convinced that economic systems were prone to financial instability and crisis, and urged that lessons be learned from the crisis of 1929–33, so that "it"—the Great Depression—could not happen again.

Minsky offered a number of proposals for reforming the financial system. He preferred policies that encourage equity finance rather than debt finance and support small- to medium-size banks. He cautioned against banks being allowed to move activities off their balance sheets and was a strong supporter of the Federal Reserve's increasing its oversight of banks by expanding the use of its discount window. He also advocated the creation of a system of community development banks that would provide financial services to underserved neighborhoods, and favored the institution of a system of narrow banks that would offer deposits while holding only the safest of assets, such as Treasury securities.

Presenters at the conference were top policymakers, economists, and analysts from government, industry, and academia who offered their insights into and policy guidelines for the extraordinary challenges posed by the global financial crisis. For the complete text of the speakers' presentations and a summary of the various sessions, visit the News & Events section at www.levyinstitute.org for the 19th Annual Hyman P. Minsky Conference and Proceedings.

The Great Crisis and the American Response

JAMES K. GALBRAITH

Public Policy Brief No. 112, 2010

In this new brief, Senior Scholar James K. Galbraith addresses the nature of the financial crisis in the United States, and, in particular, its relationship to the role played over the last generation by the economics profession.

The global abatement of the inflationary climate of the past three decades, combined with continuing financial instability (e.g., the Asian and Russian crises of the late 1990s), helped to promote the worldwide holding of U.S. dollar reserves as a cushion against financial instability outside the United States, with the result that, for the United States itself, this was a period of remarkable price stability and reasonably stable economic expansion.

For the most part, the economics profession viewed these events as a story of central bank credibility, fiscal probity, and accelerating technological change coupled with changing demands on the labor market, creating a mental model of self-stabilizing free markets and hands-off policymakers motivated by doing the right thing—what Galbraith calls "the grand illusion of the Great Moderation." A dissenting line of criticism focused on the stagnation of real wages, the growth of deficits in trade and the current account, and the search for new markets, with its associated costs. This view implied that a crisis would occur, as the situation was intrinsically unstable, but that it would result from a rejection of U.S. financial hegemony and a crash of the dollar, with the euro and the European Union (EU) the ostensible beneficiaries.

A third line of argument went beyond these two broadly opposing and symmetric views, a line articulated by two figures with substantially different perspectives on the Keynesian tradition: Wynne Godley and Hyman P. Minsky. Galbraith discusses the approaches of these Levy distinguished scholars, including Godley's correlation of government surpluses and private debt accumulation and Minsky's financial stability hypothesis, as well as their influence on the responses of the larger economic community.

Galbraith himself argues the fundamental illusion of viewing the U.S. economy through the free-market prism of deregulation, privatization, and a benevolent government operating mainly through monetary stabilization. The real sources of American economic power, he says, lie with those who manage and control the public-private sectors—especially the public institutions in those sectors—and who often have a political agenda in hand. Galbraith calls this the predator state: a state that is not intent upon restructuring the rules in any idealistic way but upon using the existing institutions as a device for political patronage on a grand scale. And it is closely aligned with deregulation.

In the last decade, as clear signals were sent that previous laws, regulations, and supervisory standards would be relaxed, the financial industry was overrun by the most aggressive practitioners of the art of originating and distributing mortgages *that were plainly fraudulent*. The rewards of involvement were extraordinary, to the point that 40 percent of reported profits in the United States were earned in the banking sector by enterprises that paid out about half of their gross revenues in compensation.

The game came to an end, of course, in September 2008, with the failure of Lehman Brothers. The Troubled Asset Relief Program effectively quelled a panic, but at the price of forestalling restructuring and reform that would get at the root of

the financial crisis. And even though we have managed to sidestep a second Great Depression, that success is marked by extreme limitations: by a decimated housing sector and a reeling middle class; by the functional dismantling of the major institutions of the American welfare state; and by a loss of trust in the financial sector that cannot be regained until those responsible for the mortgage fraud are identified and prosecuted, in full.

And there is the issue of Europe. The events in Europe are customarily treated as a Greek crisis, but this is a profoundly misleading narrative, and it misses the essential part of the story. In September–October 2008, as the U.S. financial crisis was peaking, the spreads on Greek government bonds began to diverge from those on German government bonds, and they have been diverging ever since. Clearly, this is related not to Greek profligacy but to the crisis in the United States and a generalized flight to safety. Still to be resolved is the political game between the bond markets and the EU and European Central Bank over whether the latter entities will relieve the large financial institutions of their losses. In Galbraith's view, the only way this game *can* be resolved is with the capitulation of the authorities and the Europeanization of Mediterranean debts. This leaves Europe with a situation very similar to what we have in the United States, in which the banks have been effectively rescued but the economies have not, and the price is paid by relentless rounds of fiscal austerity—with the possibility that the economies on both continents may be unable to move back to a pattern of constructive growth.
www.levyinstitute.org/pubs/ppb_112.pdf

Endgame for the Euro? Without Major Restructuring, the Eurozone Is Doomed

DIMITRI B. PAPADIMITRIOU, L. RANDALL WRAY, and YEVA NERSISYAN
Public Policy Brief No. 113, 2010

In this new public policy brief, President Dimitri B. Papadimitriou, Senior Scholar L. Randall Wray, and Yeva Nersisyan, University of Missouri–Kansas City, observe that the trillion-dollar rescue package European leaders aimed at the continent's growing debt crisis in May might well have been code-named Panacea. Stocks rose throughout the region, and even Greek bond yields tumbled. The reprieve was short-lived, however, as markets fell on the realization that the bailout would not improve government finances going forward.

The entire rescue plan rests on the assumption that, with more time, the eurozone's "problem children" can get their fiscal houses in order. But Greece and some of the other major European debtors are seriously uncompetitive in comparison with countries that are either more productive or have lower production costs. No rescue plan can address the central problem: that countries with very different economies are yoked to the same currency. Lacking a sovereign currency and unable to devalue their way out of trouble, they are left with few viable options—and voters in Germany and France will soon tire of paying the bill.

Critics argue that the current crisis has exposed the profligacy of the Greek government and its citizens, who are stubbornly fighting proposed social spending cuts and refusing to live within their means. Yet Greece has one of the lowest per capita incomes in the European Union (EU), and its social safety net is modest compared to the rest of Europe. Since implementing its austerity program in January, it has reduced its budget deficit by 40 percent, largely through spending cuts. But slower growth is causing revenues to come in below targets, and fuel-tax increases have contributed to growing inflation. As the larger troubled economies like Spain and Italy also adopt austerity measures, the authors say, the entire continent could find government revenues collapsing.

So what is to be done? Greece cannot "afford" default—nor can the EU—but it can restructure its debt. Basically, Greece needs more favorable credit terms: lower interest rates and a longer period in which to pay. The cash-flow improvement in servicing the country's debt, together with the ongoing rebalancing of its public finances, would raise its credit profile and make access to credit from private markets possible—a viable short-term fix.

But a more far-reaching solution is needed, say the authors. For better or worse, it's time to start thinking about a major reconstruction of the European project, along two possible paths.

The first possibility, of course, is an amicable divorce. Yet a coordinated dissolution of the EU would open the door to higher transaction costs and tariffs, and curtail the mobility of labor and capital. The net result would be a more inefficient,

fractured system, of the kind that inspired the creation of the euro in the first place. More broadly, the euro's disintegration would only bolster the preeminence of the dollar in global commerce and affairs—and perhaps leave China as the only plausible rival to American power.

The second possibility? Achieving a more perfect union. Immediate relief could be provided by the European Central Bank, which would create and distribute 1 trillion euros across all eurozone nations on a per capita basis. Each nation would be allowed to use this emergency relief as it saw fit. Greece, for example, might choose to purchase some of its outstanding public debt; others might choose fiscal stimulus packages. Over the longer term, a permanent fiscal arrangement, through which the central eurozone authorities could distribute funds to member states, would be necessary. Ideally, this should be overseen by the equivalent of a national treasury responsible to an elected body of representatives—in this case, the European Parliament. This arrangement would relieve pressures to adopt austerity measures, and limit the necessity of borrowing from financial markets in order to finance deficits.
www.levyinstitute.org/pubs/ppb_113.pdf

Debts, Deficits, Economic Recovery, and the U.S. Government

DIMITRI B. PAPADIMITRIOU and GREG HANNSGEN
Public Policy Brief No. 114, 2010

This brief by President Dimitri B. Papadimitriou and Research Scholar Greg Hannsgen evaluates the current path of fiscal deficits in the United States in the context of government debt and further spending, economic recovery, and unemployment. The authors are adamant that there is no justification for the belief that cutting spending or raising taxes by any amount will reduce the federal deficit, let alone permit solid growth. The worst fears about recent stimulative policies and rapid money-supply growth are proving to be incorrect once again. We must find the will to reinvigorate government and to maintain Keynesian macro stimulus in the face of ideological opposition and widespread mistrust of government.

Very high deficits are necessary for at least a few more years because of a dire economic situation. Moreover, we need to prevent another crisis by tightening regulation of the financial industry. Fiscal policy, while highly potent, has limited power, so we must strive for more profound reforms—for example, preventing loans that are likely to lead to bankruptcy, banning mortgage-related financial innovations that jeopardize borrowers, strengthening the bond-rating system, preventing dubious assets from being moved off the balance sheets of financial companies, returning to the use of the discount window (and reducing reliance on the federal funds market), and fostering community development financial institutions that address the needs of economically distressed communities.

The authors note that the financial boom-bust cycle observed by Hyman P. Minsky is still very much in evidence. America's current fiscal stance is part and parcel of the recession and financial crisis, and not the product of political whims. Moreover, the deficit cannot be treated as a policy problem when it is a nearly inevitable result of low economic growth, which reduces tax revenues. Furthermore, deficit spending helps the private sector, and the effects of higher deficits have moderated, and ultimately ended, most postwar U.S. recessions.

A good fiscal policy takes advantage of the benefits of automatic stabilizers (income taxes and unemployment benefits) that lead to increased spending during recessions without special legislation or government stimulus packages. In fact, Minsky was an early proponent of what we regard as a nearly ideal automatic stabilizer—an employer-of-last-resort program. However, we remain pessimistic about employment recovery in light of the narrow focus of the fiscal policy stance combined with the near absence of many stabilizers that helped in the past.

According to a tally of total liabilities of our consolidated "federal sector," Papadimitriou and Hannsgen find that federal government and Federal Reserve liabilities as a percent of quarterly GDP are much less now than they were at the beginning of 1947. On the other hand, government-sponsored entities (GSEs) and their mortgage pools have added more than 40 percent to federal sector liabilities. The mortgage-backed securities on the Fed's books are there to reduce interest rates on mortgages. And as long as the U.S. government provides its nearly explicit backing, GSE mortgage-backed securities should be easy to sell. In fact, there is no reason to sell these assets unless there is a need to influence interest rates on mortgages as well as other long-term interest rates.

It is time to mend some of the holes in the U.S. social safety net. Poverty and unemployment rates are trending upward, and

these adverse effects of the recession are strongly affecting many of the poorest groups, including minorities. Initiatives that address key economic problems at the household level—such as an employer-of-last-resort program—can never bankrupt a sovereign nation like the United States.
www.levyinstitute.org/pubs/ppb_114.pdf

Global Central Bank Focus: Facts on the Ground

PAUL MCCULLEY
Policy Note 2010 / 2

The developed world faces a cyclical deficiency of aggregate demand, the product of a liquidity trap and the paradox of thrift, in the context of headwinds born of ongoing structural realignments. According to Paul McCulley, PIMCO, front-loaded fiscal austerity would only add to that deflationary cocktail. This is why the market vigilantes are fleeing risk assets, which depend on growth for valuation support, rather than the sovereign debt of fiat-currency countries.

McCulley bases his outlook on the financial balances approach (double-entry bookkeeping) pioneered by the late Wynne Godley, who was a distinguished scholar at the Levy Institute. In McCulley's view, Godley's analytical framework should be the workhorse of discussions on global rebalancing.

The notion that fiscal austerity in the developed world will not be a cyclical drag on global aggregate demand rests on the presumption that the private sector (household and businesses) in the developed world will reduce its surpluses (reverse-Ricardian Equivalence) and/or the emerging world will reduce its surpluses with the developed world. According to McCulley, this notion ignores the fact that the private sector in the developed world is running a financial surplus because of deflated asset prices and the desire to get its financial house in order. This is a profound structural change, as both the demand and supply curves for private sector credit creation have shifted inward. Therefore, the only way for this to happen without risking a deflationary depression is for the developed-country governments to continue to run large financial deficits and/or the emerging countries to reduce their financial surpluses, which represents a secular rather than a cyclical timeframe.

Current fiscal deficits in fiat-currency countries are not the cause but the consequence of the Great Recession. Without these deficits, we would be in a second Great Depression. Fiscal deficits are not crowding out private sector borrowing but rather facilitating saving by the private sector (and the government sector's liability is the private sector's asset). And fiat-currency countries can roll over debt. Inflation is not a concern because the developed world is far from full employment; furthermore, full employment means lower fiscal deficits. Thus, front-loaded fiscal austerity makes absolutely no sense.
www.levyinstitute.org/pubs/pn_2_10.pdf

Global Imbalances, the U.S. Dollar, and How the Crisis at the Core of Global Finance Spread to "Self-Insuring" Emerging Market Economies

JÖRG BIBOW
Working Paper No. 591, March 2010

This paper by Research Associate Jörg Bibow investigates the spreading of the global financial crisis to emerging market economies and the systemic deficiencies in the global monetary and financial order. When the bubble burst, the effectiveness of self-insurance and secure policy space was limited, resulting in a massive macro policy response worldwide. As exports stalled, developing countries had a strong self-interest to stimulate domestic demand, while international cooperation helped to forestall a recourse to beggar-thy-neighbor policies.

The key issue for developing countries is reform of the global order (e.g., an alternative to the U.S. dollar, an international currency regime, or unfettered global finance), but such reform does not appear to be forthcoming. Bibow advises developing countries to pursue comprehensive capital account management policies (as in China and India), which contain rent extraction through foreign (indirect) investment, along with financial liberalization. This approach is in direct opposition to the preaching of the International Monetary Fund.

The analysis begins with an overview of the channels of transmission and crisis contagion. Initially, there was the belief that the turmoil might be contained, as emerging market economies "decoupled" from declining growth in the advanced economies. The decoupling hypothesis was based on the idea that disciplined macroeconomic ("self-insurance") policies had established robust fundamentals across emerging markets, including strong fiscal and external positions, and low

inflation. The hopes for decoupling were dashed for a number of reasons—the high degree of synchronicity in the global trade slump, the sharp decline in commodity prices, the abrupt shrinkage of private capital flows to emerging markets, and the trade credit squeeze. Global finance proved to be both nonneutral and an agent of contagion, helping to spread rather than contain the crisis.

A sample of 14 emerging economies provides the basis for analyzing the effectiveness of "self-insurance" during the crisis. Overall, emerging markets experienced the repercussions of the crisis as a common event in terms of the deleveraging of key global banks, the repatriation of portfolio investments, and the depreciation of currencies against the U.S. dollar. The degree and timing of indirect investment flows, however, varied between countries. Neither current account surpluses nor large foreign exchange holdings insulated countries from the external shock. Self-insurance strategies may have provided a margin of safety that determined whether IMF support was needed or whether there was policy space for implementing countercyclical measures, but they did not reduce global systemic risk—or rather, risk was transferred from one emerging market to another.

The general tendency for countries to self-insure (e.g., by exporting and accumulating dollar reserves) produces strong deflationary forces. Global liquidity is not constrained because of the international U.S. dollar standard and the unlimited supply of dollars. Dollars are made available to the world economy in terms of U.S. current account deficits, U.S. private capital outflows, and official U.S. lending. It is therefore unclear that U.S. current account deficits inevitably pose a risk to global stability. The global monetary and financial order nurtured the U.S. consumer's role as borrower and spender of last resort even as U.S. household balance sheets became increasingly leveraged and fragile.

Bibow critiques Fed Chairman Ben Bernanke's "global savings glut" hypothesis (and loanable funds theory) as an explanation for the U.S. current account deficit and low, long-term, real interest rates. According to John Maynard Keynes, the idea that a savings glut would depress interest rates is nonsense. Rather, the upward pressure on the U.S. dollar produces deflationary forces in the domestic economy. Thus, the combined weakness in U.S. labor markets and downward pressures on wages and prices induces the Federal Reserve to ease interest rates (encouraging private U.S. capital outflows and dollar weakness). Deficient demand in U.S. product and labor markets arises from export-oriented growth strategies in other countries.

In sum, the global dollar glut sponsored the record five-year global boom (2003–07). The subsequent dollar shortage was key in transmitting the financial crisis from advanced economies to developing countries.

www.levyinstitute.org/pubs/wp_591.pdf

Revisiting "New Cambridge": The Three Financial Balances in a General Stock-flow Consistent Applied Modeling Strategy

claudio h. dos santos and antonio c. macedo e silva

Working Paper No. 594, May 2010

The New Cambridge School articulated the comprehensive empirical modeling strategies associated with the theoretical views of Post Keynesians and played an important role in the British macroeconomic policy debate in the 1970s. This school of thought was subsequently adopted by the Levy Economics Institute, whose Macro-Modeling Team, under the leadership of Distinguished Scholar Wynne Godley, anticipated the problems now facing the U.S. and world economies.

Research Associate Claudio H. Dos Santos and Antonio C. Macedo e Silva, University of Campinas, Brazil, base their applied macroeconomic modeling strategy on the New Cambridge three-financial-balances approach, which includes the private, government, and external sectors (and associated agents). The private sector consists of three institutional sectors (households, firms, and banks) and illuminates the Minskyan theme of financial fragility (i.e., financial balances can be interpreted as proxies for changes in the sectors' liquidity). For example, the emphasis by the Levy Institute on the negative U.S. private financial balance after 1997 (and the continuous reduction in liquidity) meant an increase in private financial fragility that proved detrimental when capital gains became losses in the real estate markets. However, financial balances do not tell the whole story about balance sheet dynamics, so a (flexible) stock-flow consistent (SFC) model is required to describe the assets and liabilities of each agent (which has its own specific behavioral functions).

The authors argue that modified versions of the New Cambridge approach to macroeconomic modeling are compatible with modern Post Keynesian SFC macroeconomic models and an important addition to the tool kit for applied macroeconomists. Modern SFC models are important theoretically because they "prove" that certain configurations of effective demand are sustainable or not, and show in detail what happens when the economy deviates far from its steady state. By contrast, New Cambridge–type models are much simpler, and designed to shed light on medium-term trends of capitalist economies and to guide policymaking. The authors doubt the direct usefulness of SFC models for applied purposes, while believing that these models should be used by analysts to understand the precise types of behavior associated with (verifiable) financial balances and stock flows. They therefore believe that the direct estimation of financial balances is useful, and that it does not depend on specific hypotheses about the constancy of SFC ratios.

The authors favor an applied modeling strategy that combines direct estimates of the three New Cambridge financial balances with (1) nonmodel information about household, firm, and bank financial balances and balance sheets; and (2) a stylized (but detailed) theoretical SFC model of the economy. This is the strategy that has been adopted by the Levy Institute's Macro-Modeling Team.

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The Recycling Problem in a Currency Union

G. E. KRIMPAS

Working Paper No. 595, May 2010

G. E. Krimpas, National University of Athens, considers the currency recycling problem in terms of the European Monetary Union (EMU). This union was formed in response to events such as the abandonment of Bretton Woods and earlier visions of a unified Europe under the Marshall Plan. According to Krimpas, the union's architects overlooked the intra-union imbalance problem. National accounts with nominal uniform currencies do not account for competitive differences and imbalances as a result of "real" exchange rates (in spite of balanced budgets). The question is how to devise rules that counteract this imbalance problem.

The stylized facts of EMU disequilibrium are that the EMU is in a marginal surplus position with the rest of the world (i.e., imbalances are internal) and the Maastricht rules only work when there are fiscal imbalances, which lead to falling real wages and employment. Thus, oligopolistic power makes the union disinflationary in terms of, for example, unit labor costs.

Given the Maastricht rule book for the EMU, is there an acceptable mechanism to offset the deflationary impact of deficits? Since all flows are denominated in the same currency, the union effectively consists of surplus and deficit "countries." A single market implies a single price even though everything is not the same, so there are differential markups, margins, and profits. Tracing the path of profits equates to tracing the path of surpluses. Since surplus units are more creditworthy than deficit units, surplus-country profits are retained and cannot be recycled to benefit the deficit country, and the deflationary impact on the deficit country cannot be recycled either (i.e., there is no hoarding prior to banking and John Maynard Keynes's essential principle of banking is nullified).

The Currency Union Central Bank (CUCB) or "lender" can act symmetrically (as "spender") to offset this bias, says Krimpas, if it subsumes the functions entrusted to the European Investment Bank (EIB). The EIB can lend to the private and public sectors of currency union countries based on prospective yield, not collateral (such public borrowing does not have to be counted in the national debt). This institutional twist represents a novel degree of freedom for the adjustment process, since it is more proactive than the conventional discount window of a standard central bank in normal times.

Combining the CUCB and EIB creates an entity that is more than a lender of last resort to the financial system, since it will also be a spender of first resort based on commercial rather than distributional criteria (i.e., the Maastricht principles are not disturbed). EIB principles also remain intact and creditworthiness is enhanced, since the EIB can expand credit autonomously like any central bank. Furthermore, it obviates the need for a deficit government to borrow from the market (at higher rates than a surplus country). Recycling from the surplus to a deficit fiscal authority is not a redistributive transfer or bailout but a straightforward application of Keynes's banking principle.

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Bretton Woods 2 Is Dead, Long Live Bretton Woods 3?

JÖRG BIBOW

Working Paper No. 597, May 2010

According to the Bretton Woods 2 hypothesis, global current account imbalances reflect a symbiosis of interests among deficit and surplus countries (as exemplified by the United States and developing countries, respectively). The global crisis, however, shows that the U.S. domestic counterpart to its external deficit was based on toxic (private) debts.

According to Research Associate Jörg Bibow, a return to precrisis trends is unlikely because of rising (and unsustainable) U.S. household indebtedness. He rejects the global savings glut hypothesis that excess saving flows from developing countries were channeled into the U.S. mortgage markets, causing the housing boom and bust. Since the U.S. dollar is the key global reserve currency, defensive macro policies in the rest of the world prompted expansionary Federal Reserve policies and a global dollar glut. Thus, a Bretton Woods 3 regime could arise where U.S. current account deficits continue, driven by public spending and debt, and safe assets abroad sponsor U.S. spending in excess of income.

The idea of a global savings glut depressing interest rates in capital markets and stimulating a U.S. housing boom is not sound, says Bibow. Rather, deficit demand in the U.S. product and labor markets depresses interest rates in any imaginary (classical) capital market. This occurs whenever the export-oriented (cum self-insurance) growth strategies of other countries trigger a flood of "easy money" from the key global reserve currency issuer (i.e., the United States), which is expected to stimulate global expansion. Amplified by private capital outflows, the easy U.S. monetary stance was transmitted globally through the dollar glut, which reflected the choice of other countries to maintain a competitive exchange rate and accumulate dollars rather than to support more balanced global aggregate demand. The true engine of growth behind Bretton Woods 2 was the U.S. consumer, who acted as both borrower and spender of last resort.

Bretton Woods 3—whereby public debt replaces private debt, the rest of the world resumes a policy of current account surpluses and dollar reserve accumulation, and the United States continues to serve as key reserve currency issuer—implies a more lasting role for U.S. fiscal policy in sustaining domestic demand. However, there are concerns about the sustainability of Bretton Woods 3 relating to rising public debts in underwriting domestic demand, rising external debts pertaining to the dollar's role as key global reserve currency, and the role of the United States in sponsoring global growth. The real issues, however, are how U.S. policies affect investment and growth, and whether tax rates become detrimental due to a rising debt (interest) burden.

Evsey Domar (1944) established the fundamental relationship between an economy's growth rate and its deficit and debt ratios. Reigniting GDP growth is critical in reestablishing a favorable interest rate–growth differential, along with accommodative Fed policy and a rising supply of Treasury securities to meet the portfolio demands of domestic and international investors. Bibow concludes that the United States will likely be able to run permanent primary budget deficits in the aftermath of the crisis, even as the debt ratio stabilizes at 100 percent in the medium term.

Bibow notes that the U.S. net income balance (dominated by net asset income) has remained positive despite a negative net foreign asset position. When the analysis of the U.S. external balance sheet focuses on gross assets and liabilities rather than its net debtor position, the United States enjoys a persistent income-yield advantage.

Under Bretton Woods 3, Fed policy will still be important in keeping interest rates and U.S. external financing costs low, while dollar leveraging will continue to play a crucial role in keeping the U.S. income balance and net foreign asset position in check. The need for and scope of imbalances under Bretton Woods 3 will depend on macro policies abroad, such as domestic demand–led growth in Japan, Germany, and China. Bibow suggests that favorable debt dynamics (and sustainability) are more likely to arise under Bretton Woods 3 than Bretton Woods 2. He observes that the bancor plan proposed by Keynes, which aims to establish an international monetary order that would enable countries to replace mercantilist strategies with domestic demand–led growth through deliberate management of their economies, continues to offer guidance. Moreover, a postdollar standard such as the euro is not a near-term prospect.

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Does Excessive Sovereign Debt Really Hurt Growth? A Critique of *This Time Is Different*, by Reinhart and Rogoff

YEVA NERSISYAN and L. RANDALL WRAY

Working Paper No. 603, June 2010

A study by Carmen Reinhart and Kenneth Rogoff (*This Time Is Different: Eight Centuries of Financial Folly*, 2009) provides empirical evidence of the relations between debt, financial crises, inflation, currency and stock market crashes, sovereign government defaults, and long-run economic growth. Yeva Nersisyan, University of Missouri–Kansas City, and Senior Scholar L. Randall Wray review this historical analysis and find that Reinhart and Rogoff's understanding of financial system processes does not compare with that of John Kenneth Galbraith and Hyman P. Minsky. The study makes no mention of either Galbraith or Minsky, it does not apprehend fundamental monetary operations and the conditions that make sovereign governments "default proof," it has an incomplete understanding of government debt, and its results are not relevant for the United States. Nersisyan and Wray maintain that the belief that a sovereign country should balance its budget over a set period of time is a myth. And the true limit to government spending should be based on inflation rather than a lack of financing.

Reinhart and Rogoff conclude that "serial defaults" are the historical norm worldwide and that these defaults impose large costs in terms of sustained low growth rates. They determine that growth suffers when the sovereign debt-to-GDP ratio exceeds 90 percent. Moreover, the external government debt threshold is much lower (60 percent) and the effect on growth more severe for emerging countries, which typically borrow from abroad. On average, the outstanding government debt increased by 86 percent within three years of the start of a crisis (mostly due to revenue losses). Furthermore, emerging countries encounter higher inflation when they move from a lower to a higher debt ratio, and they rarely grow their way out of this situation. Based on the results of the Reinhart and Rogoff study, and in light of the worst economic crisis since the Great Depression, we face many more years of subpar economic performance worldwide that will continue to increase government debt.

Nersisyan and Wray do not embrace the broad-brush approach of Reinhart and Rogoff's study or agree that their approach toward understanding the current crisis is better than previous detailed narratives. The main problem is that the study simply aggregates, over time, small governments operating on a gold standard and large governments with a nonconvertible currency and a floating exchange rate regime. They suggest that the most important distinction to make between sovereign and nonsovereign debt is the currency in which debt is denominated. A government operating with a nonsovereign currency and issuing debt either in a foreign currency or a domestic currency pegged to a foreign currency (or precious metals) faces operational and solvency risks. By contrast, the issuer of a sovereign currency is not constrained and cannot be forced into default because it can always spend by crediting bank accounts (something that is recognized by markets and credit raters alike).

The authors note that Reinhart and Rogoff do not explain why the average growth rate for both advanced and emerging economies with midrange levels of debt (60–90 percent of GDP) is higher than economies with a lower level of debt (30–60 percent of GDP). Moreover, some countries with debt levels in excess of 90 percent of GDP do not experience declining growth rates. The main drawback of Reinhart and Rogoff's method is that average and median values across different countries and time periods are used to draw conclusions about the correlation between high debt ratios and low growth. Most important, correlation does not necessarily mean causation, so if the cause and effect are mistakenly reversed, the policy response will be wrong. In the United States, the recovery policy prescription is for more fiscal stimulus (i.e., a combination of tax cuts and spending increases) that will simultaneously restore growth and reduce the budget deficit.

The correct way to analyze government finances is to categorize government debt according to the adopted currency and the exchange rate regime. Nersisyan and Wray explain why "sovereign debt" issued by a country that adopts its own floating, nonconvertible currency does not face default risk. When a country adopts a peg, it forces the government to surrender some of its fiscal and monetary policy space. And when a country such as Greece gives up its currency-issuing monopoly to a foreign or supranational institution such as the European Central Bank, it is operationally dependent on using tax and

bond revenues to finance its spending. Although Japan has a higher debt-to-GDP ratio than Greece, it does not pay higher interest rates or face a debt crisis, since its "debt" is denominated in its own currency—a relationship that holds whether its debt is held domestically or by foreigners. Moreover, bond issues by a sovereign government are voluntary, and irrelevant concerning matters of solvency and interest rates. Furthermore, both sovereign and nonsovereign governments can choose if or when to default, even though sovereign governments can always make any payments without demanding higher taxes or generating a trade surplus.

Nersisyan and Wray point out that they could not find a single case of default when a country issued but did not peg its own currency. They also point out another problem with the Reinhart and Rogoff study: lumping public and private external debts. Whereas private debt is *debt*, government debt results in net financial asset creation (wealth) for the private sector. And since public debt denominated in a foreign currency can create serious problems for the government, this option should not be pursued.

The authors maintain that lower taxes and more government spending is not inflationary when an economy is operating well below full capacity. According to Abba Lerner, the government deficit is too low when people are involuntarily unemployed, so the government should either cut taxes or increase spending in order to mobilize the nation's resources. The economic effect of government spending and taxes ("functional finance") is what's important.

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Program: Monetary Policy and Financial Structure

Deficit Hysteria Redux? Why We Should Stop Worrying About U.S. Government Deficits

YEVA NERSISYAN and L. RANDALL WRAY

Public Policy Brief No. 111, 2010

This brief by Yeva Nersisyan, University of Missouri–Kansas City, and Senior Scholar L. Randall Wray argues that deficits do not burden future generations with debt, nor do they crowd out private spending. The authors base their conclusions on the premise that a sovereign nation with its own currency cannot become insolvent, and that government financing is unlike that of a household or firm. Moreover, they observe that automatic stabilizers, not government bailouts and the stimulus package, have prevented the U.S. economic contraction from devolving into another Great Depression. The authors dispense with the (unsubstantiated) concerns about deficits and debts, noting that they mask the real issue: the unwillingness of deficit hawks to allow a (democratic) government to work for the good of the people.

It is important to explain why sustained budget deficits are not a threat since further fiscal expansions may be required, resulting in larger and more prolonged deficits than those projected. The authors point out that the relevant debt figure is the amount of Treasuries held by the public. In this case, the government liability is exactly offset by nongovernment sector assets, and interest payments by the government generate income for the nongovernment sector. In reality, we leave our grandchildren with government bonds that represent net financial assets and wealth. Moreover, deficits today do not condemn future generations to higher taxes. The historical approach is to retain inherited debt and rely on a growing economy to reduce the debt ratio.

Fears that countries such as China will suddenly stop buying Treasuries, and thus no longer "finance" the U.S. economy, are misplaced, since the United States is willing to simultaneously run trade and government budget deficits. Other countries' eagerness to run a trade surplus with the United States is linked to the desire for dollar assets. These are not independent decisions. The complex linkages between balance sheets

and actions will ensure that transitions are moderate and slow. Thus, the current relationships will persist much longer than presumed by most commentators.

In terms of the notion that balanced budgets are desirable for households and firms, and therefore governments, the authors point out that households and firms, unlike most governments, have a relatively limited lifespan, and that they do not have the power to levy taxes, issue currency, or demand that taxes be paid in the currency issued. They also point out that almost every significant reduction in the outstanding U.S. debt has been followed by a depression, as budget surpluses reduce nongovernment sector net saving, income, and wealth.

The U.S. federal government is the sole issuer of the dollar, and it spends by crediting bank deposits. Therefore, it can always service its debt, since tax and bond revenues are not required in order to spend. Thus, perpetual budget deficits are "sustainable." Moreover, large (nondiscretionary) budget deficits almost always result from recessions because automatic stabilizers (not discretionary spending) place a floor under aggregate demand. As a result, the authors caution, taxes should not be raised while there is still danger of further unemployment and deflation.

Guided by flawed economic thinking, governments worldwide have imposed unnecessary constraints on their fiscal capacity to fully utilize their labor resources. Bond sales by a sovereign government, for example, are completely voluntary and self-imposed. While there may be real resource constraints on government spending, there are no financial constraints.

Deficit critics fail to understand the differences between the monetary arrangements of sovereign and nonsovereign nations, and that eurozone countries such as Greece have given up their monetary sovereignty. By divorcing their fiscal and monetary authorities, these nonsovereign nations have relinquished their public sector's capacity to provide high levels of employment and output. In lieu of exiting the eurozone and regaining control of domestic policy space, Nersisyan and Wray suggest that the eurozone countries create a supranational fiscal authority similar to the U.S. Treasury that is able to spend like a sovereign government.

www.levyinstitute.org/pubs/ppb_111.pdf

The Global Financial Crisis and a New Capitalism?

LUIZ CARLOS BRESSER-PEREIRA

Working Paper No. 592, May 2010

The banking and social crisis that began in 2007 represents a turning point in the history of capitalism. Author Luiz Carlos Bresser-Pereira, Getúlio Vargas Foundation, Brazil, summarizes the major changes in the world financial markets since the end of Bretton Woods (i.e., financialization and neoliberalism), and argues that these perverse developments, along with deregulation and the refusal to regulate financial innovations, caused the crisis. And despite the worldwide Keynesian response, he says, the consequences will be particularly harmful to the poor.

Bresser-Pereira foresees further increases in the power of professionals relative to capitalists; greater income inequality in rich countries but declining global inequalities as a result of redistribution to the developing countries; mitigation of capitalism's instability as a result of reregulation; and the emergence of stronger middle-income countries under a new development strategy. In sum, global capitalism will change for the better because it will be neither financialized nor neoliberal.

The author notes that between 1980 and 2007 global financial assets outgrew real wealth (GDP) at a rate of four to one. The financialization process, legitimized by neoliberalism, created artificial wealth, and rentiers gained control over a substantial part of society's economic surplus. He also notes that the frequency of financial crises increased, while average annual growth rates declined, during the neoliberal period as compared to the preceding 30 years under the Bretton Woods regime. Thus, the hegemony of neoliberalism and financialization, within an overarching framework of capitalism, resulted in a permanent crisis rather than cyclical crises.

The present economic crisis could have been avoided, says Bresser-Pereira. When President Nixon suspended the convertibility of the U.S. dollar to gold, the relation between money and real assets (and fixed exchange rates) disappeared in favor of confidence and trust. And when the neoliberal doctrine and the deregulation of national financial markets came to dominate after the mid-1980s, financial liberalization undermined the foundations of world financial stability.

The model developed by Hyman P. Minsky in the 1970s identified the causes of the crisis: poor credit appraisal,

overleveraging, a flawed credit-rating system, and practices that encouraged risk taking and short-term gains. These outcomes were the result of the deliberate (and reckless) deregulation of financial markets and the decision not to regulate financial innovations and Treasury banking practices. Thus, financial operations were highly risky, and opened the way for pervasive fraud and financial instability.

This retrogression was the result of two immediate and rather irrational causes of neoliberalism: the fear of socialism and the transformation of neoclassical economics into mainstream economics. In truth, the competition was between capitalism and statism, which could not compete with capitalism in economic terms. Moreover, the hypothetically deductive neoclassical models were radically unrealistic, serving to justify self-regulated and efficient models. By contrast, surveys support the notion that confidence fell dramatically after the establishment of the neoliberal ideological hegemony. Neoliberalism dominated the last quarter of the 20th century because it represented the interests of a powerful coalition of rentiers and financialists within the professional class.

Domestically, decisions to increase liquidity, recapitalize the major banks, adopt major expansionary fiscal policies, and reregulate the financial system were the correct political response. Global financial regulation and economic coordination, however, have been insufficient, with most responses focusing on a banking crisis and excluding the foreign-exchange and balance-of-payments crises affecting developing countries. A growth policy underwritten by foreign savings (recommended by the rich countries) does not promote growth but substitutes foreign for domestic savings, causing recurrent balance-of-payment crises. Although decisive fiscal actions by government have avoided a depression, the crisis will not end soon, and the problem of insufficient demand worldwide will continue.

www.levyinstitute.org/pubs/wp_592.pdf

A Contribution to the Theory of Financial Fragility and Crisis

AMIT BHADURI

Working Paper No. 593, May 2010

Two general features in a crisis are a loss of confidence in the financial sector and the transmission of the crisis to the real economy through aggregate demand. Using a schematic model driven by debt-financed consumption, author Amit Bhaduri, Jawaharlal Nehru University, Delhi, formally integrates the mechanism of interaction between these features in a developed market economy.

A loss of confidence can arise in two analytically distinct ways: the financial sector may lose the borrowing public's confidence when the public is increasingly burdened with debt; or, in contrast, confidence may collapse when the "fragile" financial sector is unable to cope with its own liquidity requirements (i.e., there is overborrowing by the public in the real sector and overlending by the financial sector). The author notes that his simple model should be judged by its ability to isolate and capture some crucial mechanisms that cause financial confidence to collapse, thus paving the way to crisis.

This paper studies the interaction between financial fragility (arising from sudden changes in the lending behavior of financial institutions) and aggregate demand. Bhaduri outlines how debt-financed consumption drives both the expansion and the contraction of output and economic activity in the real economy. Using plausible assumptions about the lending behavior of financial firms (which fear a "lender's trap" or a version of Ponzi finance), he outlines how similar fluctuating patterns in the level of debt and income can occur. He also points to illiquidity in the system as the origin of financial fragility.

Bhaduri's model highlights a simple mechanism of fluctuations in debt and income based on a stock-flow approach. Higher credit stimulates consumption and income through higher aggregate demand, but it exerts a depressing influence on demand through the repayment of obligations on a higher stock of accumulated debt. Thus, the emphasis is on the stock and flow, and its contradictory impact on consumption rather than investment. The financial positions of firms and households undergo change by relying on sustained capital gains rather than regular income to service debt (i.e., a process of

transition from speculative to Ponzi finance). This process can be sustained on a macro scale because capital gains are not realized but rather used by borrowers and lenders for debt-financed expansion, which increases the debt burden. The fear of adverse shocks is minimized, there is less liquidity held by financial firms for speculative purposes, and the downward shift of the Keynesian liquidity preference applies to financial firms rather than the general public. There is also a rapid expansion of credit to the public via financial innovations in the absence of a regulating monetary authority.

This system becomes particularly vulnerable to unanticipated defaults, even on a small scale, because obligations to repay are augmented due to a highly leveraged structure of loans created by credit expansion and inadequate liquidity to meet these obligations immediately. While expansion of credit is stimulated by rising asset prices, the tendency toward a credit freeze is encouraged by falling asset prices. Another important source of a loss of financial confidence is growing international indebtedness.

www.levyinstitute.org/pubs/wp_593.pdf

Too Big to Fail in Financial Crisis: Motives, Countermeasures, and Prospects

BERNARD SHULL

Working Paper No. 601, June 2010

During the financial crisis, U.S. government intervention forestalled the failure of the largest financial firms. The persistence of "too big to fail" policies such as forbearance and bailouts in the face of supervisory and regulatory reforms, and mitigating systemic threats, raises questions about the motives of authorities.

Bernard Shull, Hunter College, CUNY, evaluates the underlying motives and concludes that structural reforms to contain the problems of too-big-to-fail should limit further increases in concentration among the largest financial companies. He suggests restricting specific activities, revising bank merger policy, and, perhaps, divestiture.

The author notes that legislative and regulatory modifications have failed to contain too-big-to-fail policies over the last four decades. For example, the Federal Deposit Insurance Corporation (FDIC) provided "open bank assistance" based on its determination that a bank was essential to its community, and in spite of its awareness that assistance had harmful side effects (e.g., the erosion of market discipline). Moreover, the Federal Reserve acted as a lender of last resort to failing banks. The quintessential too-big-to-fail case occurred in 1984 when the banking agencies coordinated support for Continental Illinois National Bank, which faced a bank run in the wake of rumors about bad loans.

Concern about the insolvency of savings-and-loan institutions and commercial banks in the 1980s and early 1990s led to the passage of the Financial Institutions Reform, Recovery, and Enforcement Act (1989) and the FDIC Improvement Act (1991) strengthening supervision and regulation, with the aim of limiting forbearance and bailouts. However, banks whose failure posed a systemic threat were exempted from certain restrictions, and the Acts' lack of success was clear when the hedge fund Long-Term Capital Management was not closed immediately in 1998 out of concern for the solvency of other large financial institutions.

The explicit justification by bank regulators (and Congress) for the bailout of large financial firms was to preclude systemic threats (under the belief that these firms served a public interest). The symbiotic bank-government relationship and the motivation for regulatory forbearance and bailouts have deep historic roots. If the motivation is to forestall systemic threats, then measures that constrain risk, require more rigorous supervision, and prevent bank failures are in order, says Shull. The principal cause of banking problems, however, has been macroeconomic processes (i.e., recurring shocks and financial instability should be expected). If the systemic threat is exaggerated, then supervisory and regulatory reform will be ineffective. Further, regulatory authorities should be penalized, discretion should be restricted, and incentives should be altered.

All of these reforms, however, are futile if the survival of the largest financial companies is deemed to be in the public interest. In this case, the remedy is structural. Recent proposals have favored breaking up the largest companies (judicious divestitures such as AT&T's in 1983), restoring commercial banking to a status consistent with the Glass-Steagall Act, or enacting the Volcker rule, which would prohibit proprietary trading or investing in hedge funds and private equity funds. Activity and merger restrictions help, says Shull, but they will not solve the problem entirely. (Neither these restrictions nor more radical breakups of the large financial companies should

result in any significant loss in economic efficiency. There is a consensus among economists that economies of scale disappear well below the size of the largest banks.)

Bank merger policy, which has incorporated antitrust standards for almost a half century, has ignored too-big-to-fail issues. Policy should be revised to require the federal bank regulatory agencies to consider these issues. There are a number of proposals that would mitigate the too-big-to-fail problem: (1) requiring a more complete analysis of mergers by the Fed and other banking agencies; (2) amending the Riegle-Neal Act to further restrain state and national deposit limits; (3) restricting negotiated divestitures; (4) imposing higher capital requirements and deposit insurance premiums on large banks; and (5) requiring annual Congressional reports (and public hearings) on banking and financial structure by federal banking agencies and the Justice Department that are comparable to the Fed's monetary reports.

www.levyinstitute.org/pubs/wp_601.pdf

Fiscal Responsibility: What Exactly Does It Mean?

JAN KREGEL

Working Paper No. 602, June 2010

The U.S. deficit and debt are currently in the midrange of postwar experience. Nevertheless, popular opinion is divided about the merits of the government's stimulus policies, which have provided a floor under the potential collapse of income and employment.

Senior Scholar Jan Kregel discusses fiscal responsibility in light of the failure to recognize the need for additional stimulus measures. He observes that there is no clear rule on the impact of (government) spending on employment in conditions of balance sheet disequilibrium. The best policies would have affected balance sheets and the flow of funds so that household mortgage liabilities could have been written down at the same time as the banks' housing assets, and households could have had a minimum credit position by means of a government-guaranteed employment program. These measures would have cost less than the stimulus package, says Kregel. Moreover, it would be irresponsible for the government to reduce its outstanding indebtedness when households, firms, and institutions are attempting to increase their savings.

The author notes that modern economics treats the role of government as an afterthought when analyzing the behavior of the private sector in a free-market economy. There is no reference to the decision-making process of government or the foreign sector, even though government (the sovereign) and foreign trade existed long before there was a private property–based market economy. Moreover, the U.S. Constitution presumes that the federal government, acting through a democratically elected Congress, is an economic actor (through taxing and borrowing).

The assumption that government should act like a household (i.e., operating a fiscal policy that generates a budget surplus) is false, says Kregel, and a clear contradiction of the classical role of government in ensuring that private vices produce public benefits. Also false is the notion that restitution of the debt will burden "future generations" because future consumption will be determined by future national income, irrespective of the inherited debt. Thus, prudent household management should not be an example for "good" government.

In a consistent flow-of-funds accounting framework, household savings correspond to firm losses; that is, household virtue leads to firm bankruptcy, loss of employment and household income, and a decreased ability to save (Bernard Mandeville's law of unintended consequences). In a market-based economy, firms can only exist if they make profits so they must save, which implies that households must spend (by borrowing) and will be unable to repay their debts. An escape from this catch-22 caused by unintended consequences is to introduce autonomous investment.

If households save more than firms invest, there is excess capacity and a cutback in future investment and employment. The unintended consequences of the decision to save are lower incomes and savings, leading to an unsustainable expansion and inflation, or a collapse of output and employment with no natural limit. The market is not capable of coordinating saving and investment decisions, and there is an aggregate constraint on individual actions.

Government fiscal policy, however, is not bound by pure market principles and budget constraints, and thus can support private sector decisions that lead to public good. For example, a responsible government could deficit spend when the private sector is frugal. Government can influence the budget constraint or the size of credits for both households

and firms by creating a sufficiently large debit in its flow-of-funds account. However, there is no strict connection between government deficits and employment, and no guarantee that this action will affect the level of employment, which depends on the level of technology and the balance sheets of households and firms (e.g., unemployment continued to rise despite the nearly $800 billion stimulus package).

Current economic conditions can be characterized as a flow-of-funds disequilibrium where both households and firms intend to increase their savings to meet declining credits. According to the law of accounting, not all components of the private sector can simultaneously increase credits in order to repair the insolvency of their balance sheets. This result can only arise if the government creates a debit position through a deficit equal to the increase in private sector credits.
www.levyinstitute.org/pubs/wp_602.pdf

Three Futures for Postcrisis Banking in the Americas: The Financial Trilemma and the Wall Street Complex

GARY A. DYMSKI
Working Paper No. 604, June 2010

Banking systems in the Americas have been in crisis periodically during the last 30 years. Now is an opportune moment to reshape these systems, says Gary A. Dymski, University of California, Riverside. Doing so, however, will involve overcoming three major barriers: (1) the lack of an alternative vision for a functioning financial system; (2) the financial-regulation trilemma, whereby the banking system's ability to be more socially productive and economically functional is limited by regional economic compacts such as the North American Free Trade Association and the World Trade Organization, and by multinational banks operating within domestic markets; and (3) the operational and regulatory disparities between Wall Street and community banks in the United States.

In the mid-1960s, the functions of banking shifted from acknowledging the uniqueness of national economies to adopting the core concepts of the efficient market hypothesis. This hypothesis is premised on a one-size-fits-all approach and the elimination of regulatory barriers, and is embedded in the financial models of the World Bank and the International Monetary Fund. Economists believed that crises stemmed from asymmetric information that violated efficient market allocations, so policy responses included privatizing public banks, eliminating state planning agencies and development banks, and opening up markets to foreign entry. Although there is now some skepticism about the efficient market hypothesis, analysts have not embraced an alternative, despite success stories such as the National Bank for Economic and Social Development in Brazil (and the role it has played in the broader functioning of national finance). Rather, the focus has been on how to improve regulations, not designing an alternative financial system.

Most financial systems are subject to a bank-regulation trilemma due to hierarchical global rules about financial regulation. The trilemma dictates that either monetary policy or exchange rate stability must be sacrificed when there is a financial crisis, so developing countries have attempted to gain control by building foreign reserves. However, national banking regulations and enforcement are constrained by regional compacts and by foreign megabanks, which are in turn constrained by the Basel system as well as their home-based banking authorities. Thus, a (developing) country cannot simultaneously be part of an integrated regional compact, have a large share of its market controlled by foreign megabanks, and be free to make its own financial rules and regulations. In effect, countries outside the global financial centers must replace risk regulation with risk compensation.

By contrast, the United States has its own dilemma, between its megabanks and its community banks. A decentralized (state) system has permitted excessive risk taking, resulting in a regulatory policy that favors mergers as a means of encouraging banking efficiency and limiting risk. Even large banks were not immune to mergers, with only six domestic megabanks remaining in December 2009. These megabanks were preserved by the Troubled Asset Relief Program, which was consistent with the broader design of U.S. (too-big-to-fail) banking policy initiated three decades earlier.

There is a clear contrast between mega- and community banks in terms of the extent of risk taking related to off-balance-sheet activities. Banks with less than $1 billion in assets have virtually no derivatives exposure or loan securitization on their balance sheets, but larger banks have incurred a steadily rising proportion of these items on their balance

sheets. While small bank business models (profits) depend on local economies and small businesses, megabank models depend on global finance that includes fee-based activity, securitization, and off-balance-sheet positions. The dilemma is that there is a mismatch between social functionality and subsidy. Other countries face a similar dilemma whenever they give "special treatment" to megabanks, domestic or foreign, especially in times of crisis.

The constraints outlined above have narrowed the future of financial reform. Dymski sets out three different, but not necessarily mutually exclusive, futures: (1) Latin America becomes the site of a struggle for global megabank supremacy (and the future of the dollar) with the establishment of branch networks to woo the consumer and business financial services markets; (2) Latin America becomes the site of global competition for scarce resources and income (with an emphasis on cross-border flows of capital and credit); and (3) a new financial structure based on social and economic functions is adopted in order to serve the needs of national and regional development. The third alternative would require modifying regional-compact rules that establish rights of market access for nondomestic financial firms.

www.levyinstitute.org/pubs/wp_604.pdf

Detecting Ponzi Finance: An Evolutionary Approach to the Measure of Financial Fragility

ÉRIC TYMOIGNE

Working Paper No. 605, June 2010

According to Research Associate Éric Tymoigne, the full definition of hedge, speculative, and Ponzi finance includes the structure of both balance-sheet and off-balance-sheet positions. In this working paper, he shows that it is possible to detect financial fragility using macroeconomic data. He finds that the quality rather than the quantity of leverage plays a central role in the growth of financial fragility, and that quality is unrelated to capital equity or profitability. Ponzi finance involves collateral-based lending, so reform leading to financial stability requires a return to sound underwriting practices based on income.

Tymoigne outlines an approach to detect Ponzi finance using Hyman P. Minsky's evolutionary framework of financial fragility (i.e., a crisis is endogenous to an economic system rather than the result of exogenous shocks). He develops an index of Ponzi finance for the U.S. residential housing sector and finds two periods characterized by Ponzi processes: 1989–90 and 1999–2007. (Because of data limitations, he believes that his index actually underestimates financial fragility.) He concludes that Ponzi processes can be detected well in advance of a crisis, when bank balance sheets look strong, the net worth of households and businesses is rising, and unemployment is declining.

Tymoigne provides a detailed outline of the static and evolutionary approaches that attempt to conceptualize financial instability and fragility, leading to different definitions of both. Until the 1990s, there was little interest in studying financial crises because standard mainstream models suggested that money and finance are neutral, and financial markets, efficient. Initial attempts to account for financial fragility in macroeconomic models focused on exogenous factors such as the interrelationship of financial decisions and the probability of financial crisis. There was no explanation of how an economy enters a crisis besides bad luck or shocks, and it was believed that episodes of financial instability were rare and random events.

Fragility and instability are not the same thing, says Tymoigne. Financial instability refers to the propensity of financial fragility to affect the economic process, and it materializes in terms of a debt deflation process. Thus, the goal is to preempt instability by constraining the growth of fragility. Since the (static) models do not account for the underlying problems and processes, policy responses arrive too late to avoid a crisis. Economists should worry when GDP is growing steadily on a noninflationary path, profits are strong, and loan delinquency rates are low. Thus, a more productive analysis would focus on the growth of fragility during periods of economic stability. The goal is to identify the worsening of financial and funding quality (not quantity) early on in order to take preemptive measures.

This circumstance is clearly illustrated by the last U.S. housing boom, when Ponzi finance dominated both prime and subprime mortgage lending. Detecting fragility would have limited the impact of the business cycle on the deterioration of funding positions (and vice versa). Financial institutions should have been prevented from providing mortgages to

noncreditworthy customers and from refinancing creditworthy borrowers into low-quality mortgages. Moreover, home equity loans should have been constrained to ensure that household income kept pace with home prices.

In the evolutionary view of financial fragility, the possibility of crisis is endogenous to the system, so the focus is detecting fragility during periods of economic stability rather than financial crisis. Which variables to check will depend on the monetary regime as well as the economic sector of interest, and it is best to look at how these variables behave simultaneously (e.g., a rising debt-to-income ratio does not necessarily mean that an economic unit is more fragile, and traditional liquidity ratios can be misleading). There should be more emphasis on cash-flow analysis (including the financial and nonfinancial industries, as well as the household and government sectors) in order to assess funding structures, liquidity needs, and alternative funding sources (as advocated by Minsky in 1975). It is also important to differentiate between sovereign and nonsovereign monetary regimes when analyzing financial fragility.

Ponzi underwriting practices may occur before they are revealed in actual data about refinancing, debt levels, and other variables. These practices are based on expectations of refinancing or liquidation rather than on expectations of operating net cash inflows. In order to detect these processes, which are in part collateral driven, it is important to check if there is a strong interaction between an asset and a specific debt within a sector's balance sheet. It is also important to be aware that some forms of Ponzi finance are more dangerous than others, and that nominal values are crucial when analyzing financial fragility.

Cash-flow levels determine the financial positions of an economic unit. Two central features of Ponzi finance related to cash flows are a growing need for refinancing and shrinking liquidity buffers. These features, together with a rising cash-flow ratio, are better indicators of Ponzi finance than other approaches that attempt to determine the degree of financial instability and fragility.

www.levyinstitute.org/pubs/wp_605.pdf

Program: Gender Equality and the Economy

Determining Gender Equity in Fiscal Federalism: Analytical Issues and Empirical Evidence from India

LEKHA S. CHAKRABORTY

Working Paper No. 590, March 2010

India was the first country to institutionalize gender budgeting within its Ministry of Finance. Research Associate Lekha S. Chakraborty focuses on incorporating gender-sensitive fiscal policies at the local level against the backdrop of fiscal federalism and the Thirteenth Finance Commission of India. This approach to financial devolution would help to identify unique spatial gender needs that depart from one-size-fits-all budgeting policies. Ideally, the transfer system for gender equity should include a judicious mix of purposes that is both general and specific.

The author recommends that fiscal transfers be calculated on a per capita basis with relative adjustments for regional poverty (i.e., "backwardness"). Moreover, states with adverse juvenile sex ratios should be penalized, she says, given the magnitude of "missing girls" in India. The best approach is to integrate gender concerns into the local budgetary process, ensure transparency and accountability through better governance, and enhance women's participation and "voice" so that they have more power to influence public expenditures.

Fiscal decentralization is deemed to be good for economic efficiency and equity based on the premise that local governments are more efficient in providing public services. One risk, however, is the dominance of elite groups within jurisdictions and their control over public expenditures. Since there is empirical evidence that corruption is muted and public goods and services are enhanced when women participate in the governance structure, it may be timely to consider asymmetric federalism (based on unequal powers and relationships between units) in the context of incorporating gender into fiscal policies. Moreover, says Chakraborty, information symmetry is an important factor in maintaining transparency, reducing transaction costs, and holding subnational governments accountable.

Chakraborty outlines some key initiatives on gender-sensitive fiscal policy within India, One of these, a study by the National Institute of Public Finance and Policy, showed the positive effect of public education and health spending on the Gender Development Index. The study also showed that decentralized gender-budgeting policies lead to social multiplier effects related to the care economy. However, local government (third-tier) mandates are often poorly funded, as expenditures constitute only 2.2 percent of GDP, while revenues constitute a mere 0.5 percent of GDP.

The criteria of fiscal devolution by the Central Finance Commission include population, geographical area, distance from highest per capita income, index of deprivation, and revenue effort. There are also state finance commissions that recommend transfers to local bodies from the states' coffers. Population is the predominant criterion, but this measure can be inconsistent with promoting fiscal equalization or balanced regional development since it ignores income disparities between states. The Twelfth Finance Commission, for example, incorporated indices of deprivation, including the percentage of households fetching water or living without sanitation facilities. Public investment in infrastructure related to water supply and sanitation can have positive social externalities in terms of educating girls or improving the health and well-being of households.

In the past, studies have shown that rich states have received more per capita fiscal transfers than poor states. Fiscal equalization grants can redress spatial inequalities in providing merit or quasi-public goods (e.g., education and health), which have differential impacts on gender. The question of whether gender criteria need to be incorporated within otherwise unconditional fiscal transfers is moot, says Chakraborty.

In light of the precipitous decline in the sex ratio for children, especially in some prosperous states, the author concludes that fiscal transfers should not be unconditional. She suggests a simple method that would attach some weight for the female population in the tax devolution formula of the finance commissions, in the allocation of central assistance for state plans, and in need-based equalization transfers. Thus, the transfer system can and should play a role in upholding the right to life for females in India.

Chakraborty notes that there is growing recognition that fiscal policy can redress intrahousehold inequalities in terms of the division of labor by reducing the amount of time women spend in unpaid work, since time poverty affects income poverty.

www.levyinstitute.org/pubs/wp_590.pdf

The Economic and Financial Crises in CEE and CIS: Gender Perspectives and Policy Choices

FATMA GÜL ÜNAL, MIRJANA DOKMANOVIC, and RAFIS ABAZOV

Working Paper No. 598, May 2010

What began as a monetary and financial crisis rapidly became a global human development and human rights crisis. Research Associate Fatma Gül Ünal, Mirjana Dokmanovic, and Rafis Abazov, Columbia University, review the countries in Central and Eastern Europe (CEE), and in the Commonwealth of Independent States (CIS)—economies that have been seriously impacted by the crisis. They find that governments with similar macroeconomic fundamentals and (limited) fiscal space have adopted policy mixes with differential impacts on vulnerable groups of people, such as women and the poor.

The authors emphasize that fiscal policies must target the lower-middle class, which has been most affected by the global downturn. They also recommend that poverty should be addressed through both short-term programs (e.g., cash transfers and child allowances) and long-term programs (e.g., public/private cooperation in employment generation and social protection systems), and that women should be involved in developing policy. Moreover, data should enable the design of gender-differentiated policies, while economic stimulus packages should prioritize job creation through employment guarantee programs in both the private and public sectors.

The authors note that the highest contraction of GDP in 2009 took place in the CIS countries (minus 6.7 percent), followed by Japan (minus 5.4 percent) and CEE countries (minus 5.0 percent). The World Bank estimates that almost 40 percent of the 480 million people in the CEE/CIS region are poor or vulnerable—a number that is expected to rise along with unemployment. The global crisis has had a dramatic effect on the region's economic output because of its dependence on

international trade, foreign direct investment, and remittances—and a rebound in response to growth abroad will be delayed for many years. Moreover, economic downturns affect women more than men because of their limited access to social benefits and employment in such (hard-hit) sectors as agriculture and export-oriented industries.

The key macroeconomic indicators show that poverty in CEE/CIS countries does not discriminate by size, income per capita, or geographical location. Adopting a purchasing power parity of U.S. $4 per day as the poverty and vulnerability threshold, the authors categorize the countries by poverty rate. Countries with a lower level of poverty have a lower share of agricultural employment, while unemployment declines with lower poverty rates. Women are engaged more than men in (low-paying) informal employment, which has little job security or social protection, and in unpaid work. Moreover, privatization of sectors such as education and health care has a negative impact on women's paid labor compensation, while increasing women's unpaid work burden. Meanwhile, there is a persistent gender pay gap in all countries in the CEE/CIS region.

Countries in the extreme-poverty group (60 percent or higher) have become highly dependent on outmigration to stabilize their labor markets (particularly among women) and to provide remittances that add substantially to currency reserves. The majority living in poverty are rural, retired, and the "working" poor, who are found in all sectors. Although most countries are adopting measures to protect the poor and other vulnerable groups, some measures in response to International Monetary Fund (IMF) conditions appear to increase poverty and inequality. A significant difference between the high-poverty group (40 to 60 percent) and the extreme-poverty group is the prevalence of poverty among female-headed households and more pronounced differences in rural/urban poverty. Education should be a target of expanded public spending because most of the poor have only a basic education.

Five countries in the medium-poverty group (15 to 40 percent) are European Union (EU) members, while two countries are prospective members. Only the three Baltic countries had negative real GDP growth rates in 2008 (following a period of spectacular growth), and IMF estimates show double-digit contraction in these countries in 2009. Some analysts attribute this dramatic reversal to the nature of the transition to a market economy: financial liberalization, financial fragility (foreign investment and unsustainable current account deficits), pegged exchange rates, and the IMF's procyclical recipe of government spending cuts.

According to macroeconomic indicators, all of the countries in the low-poverty group (less than 15 percent) are financially sound. Three countries are EU members, while the fourth is a prospective member. Poverty is often associated with people who are socially excluded, such as the Roma people in the Czech and Slovak Republics. The countries in this group have higher spending on health and education, and relatively positive health outcomes.

Gender equality and women's empowerment are essential to achieving equitable and effective development, and to foster a vibrant economy, say the authors. Anticrisis policy responses, stimulus packages, and other measures should account for differentiated impacts based on gender. Furthermore, expansionary fiscal policy should be countercyclical, progressive tax systems should compensate for gender biases, minimum wage regulations should be part of the policy mix, public spending should support gender-sensitive investments in infrastructure, joint initiatives between countries should protect the rights of migrant workers, and financial sector reform should ensure that small producers can access credit from formal institutions.

www.levyinstitute.org/pubs/wp_598.pdf

Time and Poverty from a Developing Country Perspective

RANIA ANTONOPOULOS and EMEL MEMIS

Working Paper No. 600, May 2010

Poverty thresholds and deprivation measures do not incorporate the availability and distribution of time across and within households. According to Research Scholar Rania Antonopoulos and Research Associate Emel Memis, time availability affects living standards. But this notion has been overlooked in traditional poverty measures, and it has not been studied in the context of developing countries. Traditional measures do not capture the time-use dimensions of both paid and unpaid work, nor some of the income-poor and time-deprived households. Due to the close association of the unpaid work burden and

poverty, the authors find that a nonsubstitutable amount of unpaid work time (e.g., water and fuel collection) can be as binding as paid work time, while hindering participation in paid work.

The authors conduct a literature review of time-adjusted poverty thresholds with a focus on the pioneering work of Clair Vickery (1977) and that of Andrew S. Harvey and Arun K. Mukhopadhyay (2007). Since these threshold measures were built on assumptions germane to advanced countries, the authors develop a modified analytical framework for developing countries, with a focus on South Africa. For example, one cannot assume in the context of a developing country that people are free to reduce their paid work hours and solve their time-poverty problems.

Time-poverty and poverty measures have been blind with respect to the time dimension of poverty, inequalities among people, and the allocation of time as a limited resource, say the authors. In developing countries, there are several unpaid work activities where market substitutes or state provisioning options do not exist. The authors therefore question the assumption of perfectly substitutable unpaid work activities that has been adopted in previous studies. They explain the difference between time deprivation and time poverty, and note that people with equal time deprivation may not be equal in terms of time poverty.

South Africa's first time-use survey was implemented in 2000 and consisted of a sample of 8,327 households. The authors use a subsample of 6,387 households (with one to three adults) and group them based on location and poverty status. The majority of households live in formal urban areas (51 percent), followed by informal urban areas (11 percent). Slightly more than half of the country's total population lives in poverty, and the unemployment rate (including the economically inactive) is 30 percent. Nearly half of those who are income-poor reside in the ex-homeland areas.

Using the Harvey-Mukhopadhyay measure for individuals of working age (15 to 66), the median levels of leisure, sleep, and care time add up to 14.5 hours a day. Thus, the time available for total work is 9.5 hours. The authors calculate the average minimum for unpaid work in order to derive the time deficit/surplus for South Africa. The results show that 18 percent of the population faces a time deficit, which implies that households need more money income to substitute for the unpaid work time they lack. Single-adult households are more likely to be time poor.

The authors set up a new time-adjusted poverty threshold by adding the monetized value of the time deficit to the traditional poverty threshold for households with a time deficit. They show that there could be some people (in developing countries) who are not included among the time-poor group despite being time deprived. Combining households' time-deprivation status with their income-poverty status, they find that people who are both income poor and time deprived are likely to be female, African, living in the ex-homelands, elderly, living in single-adult households, or having at least two children.

Almost 10 percent of the South African population is living under income poverty in combination with being time deprived. The authors find that the unaccounted-for households that belong in this group (i.e., those who appear time wealthy but are actually time deprived) spend almost twice as much time on unpaid work as the average household.

www.levyinstitute.org/pubs/wp_600.pdf

Program: Employment Policy and Labor Markets

Economic Policy for the Real World

CHARLES J. WHALEN

Policy Note 2010 / 1

Since the 1990s, contingent work has been on the rise, pension and health-care benefits have continued to erode, and job "offshoring" remains persistent. Experienced workers who lose their jobs suffer an average income loss of 20 percent upon reemployment.

According to Charles J. Whalen, Utica College and Cornell University, the United States is facing not simply a cyclical or an employment crisis, but rather a standard-of-living-and-economic-opportunity crisis—that is, the latest phase in a decades-long "silent depression."

Any policy response must recognize that we are dealing with a deep-seated structural problem that is rooted in the

evolution of economic development, says Whalen. His agenda includes another fiscal stimulus with a major assistance package for state and local governments, more relief for the unemployed and people facing home foreclosures, and financial-sector and fiscal reform. In terms of reforming the financial sector, legislation should include tougher and broader supervision, contain innovations that threaten financial stability, and address the "too big to fail" problem. Fiscal reform should include stronger automatic stabilizers such as enabling the government to serve as employer of last resort, and innovation policy with a commitment to technological development and associated education.

An important area of concern is working families. Policymakers should foster economic opportunities, address resource depletion and environmental sustainability, keep aggregate demand high, and strive to generate a hot labor market. In addition, reform should strengthen retirement security, such as reducing the eligibility for Medicare to age 55 (as suggested by Senior Scholar James K. Galbraith), encouraging a return to defined-benefit pension plans, and elevating worker and labor standards according to international agreements.
www.levyinstitute.org/pubs/pn_1_10.pdf

Program: Immigration, Ethnicity, and Social Structure

Racial Preferences in a Small Urban Housing Market: A Spatial Econometric Analysis of Microneighborhoods in Kingston, New York

SANJAYA DESILVA, ANH PHAM, and MICHAEL SMITH
Working Paper No. 599, May 2010

The divergence of U.S. housing prices across neighborhoods has been associated with race. However, there is a race-amenity correlation with historical links to prejudice, discrimination, and state-sanctioned segregation. The goal of this paper by Research Associate Sanjaya DeSilva, Anh Pham, University of California, San Diego, and Michael Smith, Boston College, is to study the consequences rather than the causes of this correlation. They test for the presence of racial preferences in the small urban housing market of Kingston, New York, and find that price discounts in black neighborhoods and the spatial dispersion of black and white households are caused by the demand for amenities, not by racial prejudice. From a policy perspective, the study underscores the need to improve the quality of amenities in black neighborhoods.

The authors use a unique dataset comprising city records of home sales, block group–level data from the U.S. Census Bureau, and spatial location data from GeoLytics, Inc. Contrary to previous studies, households represent a relatively homogeneous housing stock that shares the same labor market, school district, cultural amenities, and transportation infrastructure. By narrowing the scope to price differences across microneighborhoods in a small city, the authors are able to minimize estimation problems from unobserved neighborhood heterogeneity. To further reduce omitted-variable bias from the correlation of racial composition and amenities, GIS-based control variables measure the distance between each household and the exogenous amenities.

The authors' primary methodological contribution is the use of spatial econometric methods to account for the spatial dependence of unobserved neighborhood characteristics. Their dataset has two additional advantages: the ability to disentangle race effects from income and amenity effects, and the ability to overcome problems related to the interpretation of hedonic model coefficients as the capitalization of racial preferences in the housing market. The hedonic pricing model is appropriate for the purposes of the study because the dataset is associated with a relatively racially integrated city and the correlation between race and neighborhood amenities is relatively low.

A key result of the authors' analysis is that the finding based on ordinary least square (OLS) regressions—racial preferences in hedonic pricing models in the presence of spatially correlated unobserved heterogeneity—is incorrect. In fact, their spatial error model rejects the OLS conclusion that racial preferences are capitalized in the housing market. The negative effect of black neighborhoods' having price discounts was eliminated when census tract–level fixed effects were introduced into the model. Racial price discounts are much smaller and statistically insignificant for most thresholds.

The goal of policymakers should not necessarily be racial integration but rather the elimination of amenity and price

differences that have persisted along racial lines, say the authors—a self-perpetuating cycle that cannot be broken without a concerted investment in schools, parks, libraries, and community policing within inner-city black neighborhoods.
www.levyinstitute.org/pubs/wp_599.pdf

Program: Economic Policy for the 21st Century

Explorations in Theory and Empirical Analysis

Infinite-variance, Alpha-stable Shocks in Monetary SVAR

GREG HANNSGEN

Working Paper No. 596, May 2010

Macroeconomists have used structural vector autoregressions (SVARs) to quantify the economic effects of monetary policy shocks. Research Scholar Greg Hannsgen extends Working Paper No. 546 in an attempt to find out whether one or more innovations (i.e., shocks or error terms) in a monetary SVAR have infinite unconditional variance. Using a monetary VAR that broadly represents the monetary SVAR literature, he finds evidence supporting the hypothesis that for one or more equations, the error term has an alpha-stable, infinite-variance distribution. This means that the unconditional distribution of each such error term in the reduced form of the VAR is so thick tailed that it possesses no finite variance. The alpha-stable family of distributions can be informally defined as the collection of all limiting distributions for normalized sums of independently and identically distributed shocks; of this family, only the normal distribution possesses a finite variance.

This paper provides a background on alpha-stable distributions; presents a standard SVAR model, arguing that infinite-variance reduced-form shocks preclude most standard structural interpretations of VARs; discusses the literature on alpha-stable distributions, macro SVARs, and their interconnections; discusses Hannsgen's six-variable monetary SVAR, including the data, specification, results, and residuals; reports estimates of the characteristic exponent of the error term in each equation of the VAR for both the full sample and two subsamples; and assesses the fit of the estimated alpha-stable distributions. The author notes that few studies have considered the possibility that VAR residuals or shocks of any kind might have infinite-variance distributions. And it is probable that no study has examined in detail the evidence for and implications of infinite variance in the error terms of an SVAR. Hannsgen does this by fitting alpha-stable distributions to reduced-form VAR residuals in raw and GARCH-filtered form, and by reporting estimated stable-distribution parameters along with variance-stabilized P-P plots.

Hannsgen's VAR appears to lead to impulse response functions that are typical in the monetary VAR literature. The innovations, however, have thick-tailed and skewed distributions, and tests indicate weak (G)ARCH effects. While the paper's main concern is the unconditional moments in the covariance matrix V of the reduced-form shocks, it also attempts to separate the respective influences of time-varying dispersion and thick-tailed shocks in light of recent VAR studies that emphasize heteroskedasticity.

By examining residuals from his monetary VAR, the author finds evidence suggesting that all of the variances in V are infinite. He also finds evidence that a better model than SVAR for some macro data might combine time-varying dispersion with stable, non-Gaussian shocks. And since the empirical generality of the findings is not yet known, Hannsgen suggests that one should be cautious when using SVARs.
www.levyinstitute.org/pubs/wp_596.pdf

INSTITUTE NEWS

The Hyman P. Minsky Summer Seminar and Conference

June 19–29, 2010
Levy Economics Institute of Bard College
Blithewood, Annandale-on-Hudson, N.Y.
The Levy Institute held its first Minsky Summer Seminar and Conference under the leadership of President Dimitri B. Papadimitriou and Senior Scholars Jan Kregel and L. Randall Wray. More than 50 scholars worldwide attended the week-long seminar, while more than 100 participants attended the three-day international conference that immediately followed.

The seminar provided a rigorous and intensive 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 instructors included well-known economists concentrating on and expanding Minsky's work. The conference provided a forum for the presentation and discussion of various Minskyan themes: financial fragility; reconstituting the financial structure; modern money, money endogeneity, and functional finance; asset bubbles; employment of last resort and macroeconomic stability; stock-flow consistent modeling and policy simulations; and the Levy Institute's macroeconomic models.

Upcoming Event

The 2011 Hyman P. Minsky Summer Seminar

The second annual Minsky Summer Seminar will be held at Blithewood, the Institute's main research and conference facility in Annandale-on-Hudson, N.Y., from June 18 to 26, 2011. Applications may be made to Susan Howard at the Levy Institute (howard@levy.org), and should include a current curriculum vitae. Admission will include provision of room and board on the Bard College campus, and a limited number of small travel reimbursements will be available to participants.

The deadline for applications is March 31, 2011. For further information, visit www.levyinstitute.org.

New Research Associate

Sunanda Sen has joined the Levy Institute as a research associate in the Monetary Policy and Financial Structure program. Sen is a national fellow of the Indian Council of Social Science Research and a visiting professor at the Institute for Studies in Industrial Development, Delhi; Jamia Millia Islamia University, Delhi; and the Institute of Development Studies Kolkata, among other institutions. She previously taught for nearly three decades at the Centre for Economic Studies and Planning, Jawaharlal Nehru University, Delhi. In 1994, she held the Joan Robinson Memorial Lectureship at Cambridge University, and she is a life fellow of Clare Hall, Cambridge.

Sen's current research relates to global finance, money, development, labor, economic history, and gender studies. Her published works include the books *Unfreedom and Waged Work: Labour in India's Manufacturing Industry* (with B. Dasgupta), 2009; *Globalisation and Development*, 2007; *Global Finance at Risk: On Real Stagnation and Instability*, 2003; and *Trade and Dependence: Essays on the Indian Economy*, 2000.

Sen holds a Ph.D. from the University of Calcutta, India.

PUBLICATIONS AND PRESENTATIONS

Publications and Presentations by Levy Institute Scholars

PHILIP ARESTIS *Senior Scholar*

Publications: *The Post "Great Recession" US Economy: Implications for Financial Markets and the Economy* (with E. Karakitsos), Palgrave Macmillan, 2010; ed. (with M. C. Sawyer), *21st Century Keynesianism*, Palgrave Macmillan; "21st Century Keynesian Economic Policies" (with M. C. Sawyer), in P. Arestis and M. C. Sawyer, eds., *21st Century Keynesianism*, Palgrave Macmillan; "Capital Account Liberalisation and Poverty: How Close Is the Link?" (with A. Caner), *Cambridge Journal of Economics*, Vol. 34, No. 2 (March); "Financial Globalisation and Crisis, Institutional Transformation and Equity" (with A. Singh), *Cambridge Journal of Economics*, Vol. 34, No. 2

(March); "The Mediterranean Countries Are Being Condemned to High and Rising Unemployment" (with M. Sawyer), in "Beyond the Public Debt Crisis: The European Union at a Crossroads," special issue, *Re-public*.

Presentations: "Origins of the August 2007 Financial Crisis," public lecture sponsored by the School of Economics and Business Studies, Complutense University, Madrid, Spain, April 8; "Economic Policies to Tackle 'The Great Recession,'" public lecture sponsored by the Hispanic-British Foundation, Madrid, May 11; "Economic Policies for the Post-crisis Era," public lecture sponsored by the Barclays Foundation, Madrid Stock Exchange, May 12; "Estimating Monetary Policy Preferences of the ECB" (with M. Karoglou and K. Mouratides), conference on "Macro and Financial Economics," organized by the Brunel Macroeconomic Research Centre and Quantitative and Qualitative Analysis in Social Sciences, Brunel University, London, England, May 27, and the 17th Annual Meeting of the Multinational Finance Society, Melia Barcelona, Barcelona, Spain, June 27–30; "The Current Crisis and Economic Policy Implications," conference on "Beyond the Headlines—The Political Economy of the Crisis," organized by the Political Economy Research Group, Kingston University, London, June 15, and conference on "Financial and Economic Crisis: The Return to Stability," organized by the Scholars' Association of the Alexander S. Onassis Public Benefit Foundation, Athens, Greece, June 21; "The Economic Policies of the Political Economy of the Australian Patriot and Cambridge Economist," "Economic Policies of the 'New Economics,'" and "Time to Say Goodbye to the Euro?" (with M. Sawyer), 7th International Conference on Developments in Economic Theory and Policy, Institutions and European Integration, Bilbao, Spain, July 1–2.

JAMES K. GALBRAITH *Senior Scholar*

Publications: "Pay Inequality in the Turkish Manufacturing Sector by Statistical Regions: 1980–2001" (with A. Y. Elveren), UTIP Working Paper No. 59, March 4, 2010; "In Defense of Deficits," *The Nation*, March 22; "Twelve Things the World Should Toss Out: The Congressional Budget Office," *The Washington Post*, May 6; "Don't Fear the Debt," *The New York Times*, May 12; "A Financial Crisis, Not a Deficit Crisis," *Campaign for America's Future*, June 30; "Why the Fiscal Commission Does Not Serve the American People," *The Huffington Post,* June 30; "Tremble, Banks, Tremble," *The New Republic*, July 19.

Presentations: panelist, "Wealth, Empire and the Future of America: An Exploration of the Deep Politics of War," New York Open Center, New York, N.Y., March 13, 2010; panelist, "Rebuilding America: How to Do It and How to Pay for It," EPS Bernard Schwartz Symposium on "Jobs, Investment, and Energy: Meeting President Obama's Challenge," sponsored by Economists for Peace and Security, Washington, D.C., March 23; "Macro Economic Issues & Monetary Policy Implications," The Health Management Academy Treasurers Forum, Irving, Texas, April 6; "Inequality and Economic and Political Change: A Comparative Perspective," Inaugural Conference, Institute for New Economic Thinking, Kings College, Cambridge, UK, April 10; "The Predator State and the Great Crisis," Clifford and Virginia Durr Memorial Lecture, Auburn University, Montgomery, Alabama, April 17; panelist, "Future Crises in the World Economy and Geopolitical Consequences," CISS Second Annual Symposium: "The Geopolitical Implications of the Financial Crisis," Center for International Security Studies, Princeton University, Princeton, New Jersey, May 13–14; "The New Normal: Doing Less with Less," 18th Biennial Forum of Government Auditors: "Transparency in Government: Lighting the Way Forward," San Antonio, Texas, May 18–20; "The Great Crisis and the American Response," 57th Conference of the German-American Studies Association, Humboldt University, Berlin, Germany, May 27; "The Imperative of a Green New Deal," Institute for Interdisciplinary Social Research, Friedrich Schiller University of Jena, Jena, Germany, June 4; "The Great Crisis and the American Response," Athens Economics University, Athens, Greece, June 8; commentary on "The Slump, the Recovery and the New Normal" by E. S. Phelps, conference on "Challenges of the Global Crisis to Macroeconomic Theory and International Finance," Helsinki, Finland, June 11; "The Necessary Future of Social Democracy," Bruno Kreisky Forum, Vienna, Austria, June 14; testimony on the financial crisis, and especially the role of fraud, before the Commission de Finances, Sénat de la Republique Française, Paris, France, June 18; panelist, "The Links between the Real Economy, Fiscal Sustainability, and Financial Markets: Has Enough Been Done?" conference on "What Social Democratic Solutions Can We Have to the Current Economic Situation?"

Foundation for European Progressive Studies, Lisbon, Portugal, July 9–10.

JAN KREGEL *Senior Scholar and Program Director*
Publications: "A New Triffin Paradox for the Global Economy," in A. Birolo et al., eds., *Production, Distribution, and Trade: Alternative Perspectives, Essays in Honour of Sergio Parrinello,* Routledge, 2010; "Can a Return to Glass-Steagall Provide Financial Stability in the U.S. Financial System?" *PSL Quarterly Review*, Vol. 63, No. 252 (March).
Presentations: "Mercados financieros y especialización en el comercio internacional: El caso de los productos básicos," Encuentro Internacional de Economistas: Globalización y Problemas del Desarrollo, Havana, Cuba, March 2; "Regulating the Size of Financial Institutions," X IIEc-UNAM Seminario de Economía Fiscal y Financiera: "Banca global: Regulación y cambio institucional para el desarrollo," Mexico City, Mexico, March 16–18; "Modernisation of the Russian Economy: Financing Innovation and Modernisation of the Russian Economy," Expert–Other Canon Conference, Gonville and Caius College, Cambridge, UK, March 28–30; "Financiamiento y políticas de desarrollo: Elementos para una regulación más eficaz del sistema financiero argentine: The Minsky Alternative to Financial Reform in Finance Development," Buenos Aires, Argentina, April 5; "Why Bailouts Aren't Working and Why a New Financial System Is Needed," Caribbean Business Executive Seminar: "The Future of the Financial Services Industry after the Crisis," Port of Spain, Trinidad and Tobago, April 30; "The Architecture of the International Monetary (Non-)System: What Is Unsustainable? What Is Missing?" "Initiative Triffin 21: Towards a World Reserve Currency," Triffin International Foundation, Turin, Italy, May 13–15; "Financing Growth with Financial Stability and the New Developmentalism," Fundaçao Getulio Vargas, Sao Paulo School of Economics (EESP), Sao Paulo, Brazil, May 24–25; "Urgent Policy Responses and Congressional Proposals for Reform of the U.S. Financial System," Commission de Finances, Sénat de la Republique Française, Paris, France, June 17; "Financial Liberalization and Global Governance: Taking Stock of the Role of International Entities," IBASE–Ford Foundation Conference, Ipanema, Brazil, July 5–6.

ELLEN CONDLIFFE LAGEMANN *Senior Scholar and Program Director*
Publication: *Preparing Teachers: Building Evidence for Sound Policy*, final report of the National Research Council's Committee on the Study of Teacher Preparation Programs (E. C. Lagemann, chair), National Academies Press, 2010.

THOMAS MASTERSON *Research Scholar*
Publication: ed. (with E. Kawano and J. Teller-Elsberg), *Solidarity Economy I: Building Alternatives for People and Planet*, Center for Popular Economics, 2010.
Presentations: "Trends in American Living Standards and Inequality, 1959–2007" workshop on "Income Inequality: A New Threat to Globalizing Economies," organized by Kyoto Sangyo University and Nagoya University, Kyoto, Japan, April 10; "The United States in a Global Economy," symposium on "Income Inequality: A New Threat to Globalizing Economies," organized by Kyoto Sangyo University and Nagoya University, Kyoto, Japan, April 12.

DIMITRI B. PAPADIMITRIOU *President*
Publications: "Promoting Economic Growth and Development through an Employment of Last Resort Policy," *Bulletin of Political Economy*, Vol. 3, No. 2 (December 2009); joined the editorial advisory board of the *Journal of Economic Analysis*, 2010; "A New 'New Deal' for Job Creation" (in Greek), *Kathimerini*, January 24; "Holiday from the Eurozone Would Bankrupt Greece," *Financial Times*, February 19; "How the Wall Street Investment Banks Sank Greece" (in Greek), *Kathimerini*, March 7; "The Future of the Euro: Europe's Threat and Pity," *Kathimerini*, May 2; "The European Mega Loan Fund Is No Panacea," *Kathimerini*, May 16; "Greek Debt Restructuring Unavoidable," *Kathimerini*, June 6; "Spending Cuts and Tax Increase Will Not Decrease the Budget Deficit," *Kathimerini*, June 27; "The Faulty Structure of the Eurozone," *Kathimerini*, July 11.
Presentations: Interview regarding socially responsible investing in lieu of the market crash of early 2008 with Jesse Ordansky, *Chronogram*, March 16; interview, Sky TV, Greece, March 22; interview regarding the consumer price index in relation to cost-of-living trends with Sarah Bradshaw, *Poughkeepsie Journal*, March 31; interview regarding the powers of the European Central Bank with Ron Fink, CFOZone,

May 7; interview regarding the proposal to restructure the financial system with Sewell Chan, *The New York Times*, June 4; interview regarding government spending as the best way to boost job growth with Stuart Varney, *Varney and Company*, Fox News, July 27.

JOEL PERLMANN *Senior Scholar and Program Director*
Publication: "Secularists and Those of No Religion: It's the Sociology, Stupid (Not the Theology)," *Contemporary Jewry*, Vol. 30, No. 1 (June 2010).

EDWARD N. WOLFF *Senior Scholar*
Publications: "Review of *Transmitting Inequality: Wealth and the American Family* by Yuval Elmelech," *Journal of Contemporary Sociology,* Vol. 39, No. 2 (2010); "Rising Profitability and the Middle Class Squeeze," *Science & Society,* Vol. 74, No. 3 (July).
Presentations: "Rising Profitability and the Middle Class Squeeze," NYU Colloquium on the Economic Crisis, February 24, and New School for Social Research Student Economics Conference, March 5; "Spillovers, Linkages, and Productivity Growth in the U.S. Economy, 1947 to 2007," CESIS Workshop on Innovation and Productivity, Vienna University of Economics and Business, Vienna, Austria, April 6–8.

GENNARO ZEZZA *Research Scholar*
Presentations: "Income Distribution and Borrowing: A 'New Cambridge' Model for the U.S. Economy," seminar, Universite Paris XIII, Villetaneuse, France, April 16, 2010; "Getting Out of the Recession? Strategies for Sustainable Growth," conference on "The Global Crisis, Policy Failures, and the Road to Prosperity," Lugano, Switzerland, April 20; "Tracking the U.S. Economy with a Post-Keynesian Model," Seminari di Economia della Sapienza, Rome, Italy, May 27.

Recent Levy Institute Publications

PUBLIC POLICY BRIEFS

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DIMITRI B. PAPADIMITRIOU and GREG HANNSGEN
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JAMES K. GALBRAITH
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YEVA NERSISYAN and L. RANDALL WRAY
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WORKING PAPERS

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