Levy Economics Institute of Bard College

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New Strategic Analysis

JOBLESS RECOVERY IS NO RECOVERY: PROSPECTS FOR THE US ECONOMY

DIMITRI B. PAPADIMITRIOU, GREG HANNSGEN, and GENNARO ZEZZA

Strategic Analysis, March 2011

Using the Levy Institute's macro model, President Dimitri B. Papadimitriou and Research Scholars Greg Hannsgen and Gennaro Zezza examine a range of medium-term scenarios for the US economy and identify the challenges ahead. The authors find that the current US economic expansion may continue into 2013, but that satisfactory growth cannot be achieved without a major increase in net export demand. Although domestic monetary and fiscal stimulus measures have helped, deficits will likely remain far below the levels needed to bring about a strong recovery, largely due to congressional objections to further stimulus and a shift in focus to cutting the budget deficit.

Papadimitriou, Hannsgen, and Zezza note that the Great Recession has generated the largest increase in unemployment since 1970 (from 4.4 percent to 10.1 percent). More than seven million jobs have been lost since November 2007, and approximately 19 million jobs would need to be created for employment to return to its prerecession trend (Figure 1). The recent evolution of the US economy has been in line with their previous projections, which implied that the economy would recover but with a high, and slowly declining, unemployment rate.

The authors sketch out three scenarios for economic performance through 2015. Their baseline scenario uses a set of neutral assumptions derived from projections made by the International Monetary Fund and the Congressional Budget Office (CBO), the latter's based on current legislation that implies a declining federal deficit. They find that the main sector balances slowly move toward sustainable levels and are broadly in line with the CBO's GDP projection. This is a "growth recession" scenario, in which unemployment declines to 8.6 percent at the beginning of 2012 before increasing to 9.4 percent in 2015 (Figure 2). The private sector continues to reduce its debt and the external deficit disappears, but unemployment stabilizes at a high level. The simulations show that the current attempt to address the public deficit "problem" by cutting spending will not be successful.

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

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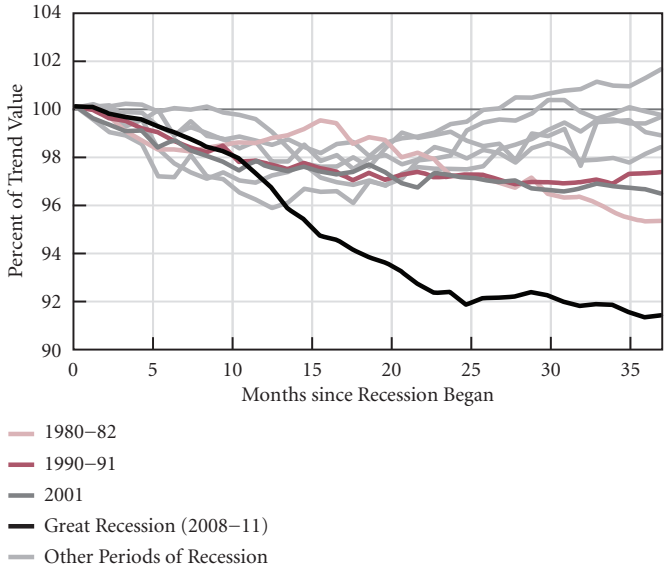
Figure 1 Employment in Recessions (beginning of recession = 100)

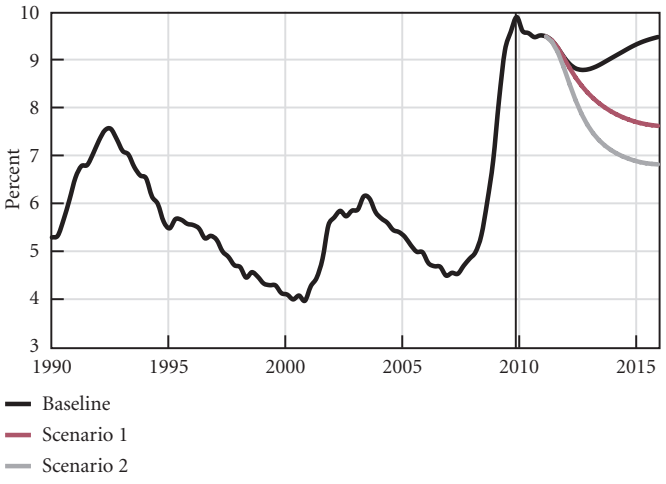


Sources: BLS; authors' calculations

In the "enhanced fiscal stimulus" scenario (Scenario 1), the adjustment to public sector deficits assumed in the baseline is deferred. Government expenditures are assumed to continue to grow, in real terms, at prerecession averages and tax rates are kept at current levels. Under these assumptions, output grows faster, unemployment drops below 8 percent, and the (larger) foreign deficit exceeds 2 percent of GDP. However, the relaxation in fiscal policy would have to be so great that the general government deficit would rise to more than 7.8 percent. The fiscal stimulus would have to be much larger than the one assumed in order to significantly reduce unemployment.

The authors' export-led growth scenario (Scenario 2) examines the effects of devaluing the US dollar against all other currencies (10 percent starting in the second quarter of 2011). The simulations show that the impact on trade would be substantial, with the United States achieving a deficit of 1 percent of GDP. The government deficit would also improve, to 6.7 percent of GDP, because of higher GDP growth and lower unemployment (7 percent). Still, this is insufficient to change the country's path toward stagnating growth.

Figure 2 Unemployment Rate in Three Scenarios



Source: Authors' calculations

One of three strategies can fill the gap in aggregate demand and reduce unemployment: stimulating private investment, increasing net exports, or relaxing the government's fiscal stance. The authors find that a revaluation of the currency of surplus countries (e.g., the euro) may be more effective in closing trade gaps than a general devaluation of the dollar. Thus, a coordinated realignment of currencies or reform of international monetary institutions would be the preferred approach in the long run. However, exchange rate movements are a more likely option in the short term.
www.levyinstitute.org/pubs/sa_mar_11.pdf

New Public Policy Briefs

Will the Recovery Continue? Four Fragile Markets, Four Years Later

GREG HANNSGEN and DIMITRI B. PAPADIMITRIOU
Public Policy Brief No. 118, 2011

With remaining stimulus measures winding down or expiring, and no new stimulus on the political horizon, the question is whether the US economic recovery can sustain itself in the absence of government support. In this brief, Research Scholar

Greg Hannsgen and President Dimitri B. Papadimitriou focus on four broad groups of markets that have shown signs of stress for the last several years: financial markets, markets for household goods and services, commodity markets, and labor markets. The results of their investigation suggest that a premature abandonment of fiscal and monetary stimulus would be both damaging and unnecessary.

Predictions of runaway inflation and rising interest rates putting pressure on capital markets have not come to pass. Interest rates are at historic lows, and several rounds of expansionary policy have resulted in reduced yields on low-risk, short-term securities and lower rates for other types of issues and loans crucial to corporate bottom lines. Core inflation stood at 1.5 percent in January, and based on the yield spread between inflation-indexed and nonindexed Treasury securities, investors are not expecting serious inflationary pressures down the road.

In the household sector, retail sales and personal consumption expenditures sustained positive growth rates from midsummer of 2010 to year's end. Unfortunately, the growth rate of personal consumption turned slightly negative in January, and retail sales were not strong in the first two months of this year. In addition, seasonally adjusted industrial production was flat in February, and real earnings growth has been meager at best since the recovery began. Overall, consumer credit has yet to expand after stagnating in 2007–09.

In Europe, the banking system has been threatened by the sovereign debt crisis, and numerous institutions with large holdings of government bonds are not yet out of the woods. The long-run presence of financial fragility looms large, compared to the supposedly excessive demands for capital generated by high government deficits.

Although the dollar's value against the major foreign currencies still seems to be trending downward, data show that the trade deficit widened by about $6 billion in January, to $46 billion, largely due to increases in the cost of imported oil. In the broader commodities market, the Fed could face the prospect of a serious episode of cost-push inflation if prices climb broadly and sharply.

Unfortunately, the labor market is ill positioned to deal with a double whammy of rising commodity prices and monetary policy tightening. The seasonally adjusted unemployment rate stood at 8.9 percent in February, reflecting only a tiny drop from the January level of 9.0 percent. Unless there is new resolve for effective government action on the jobs front, drastic cuts in much-needed federal, state, and local programs will be the order of the day in the United States as in much of Europe. The bottom line: markets cannot be counted on to solve a long-lasting macroeconomic crisis like ours in the absence of firm monetary stimulus, jobs programs, or other public sector initiatives. *www.levyinstitute.org/pubs/ppb_118.pdf*

The Contradictions of Export-led Growth

THOMAS I. PALLEY

Public Policy Brief No. 119, 2011

The export-led growth paradigm is a development strategy aimed at growing productive capacity by focusing on foreign markets. It rose to prominence in the late 1970s and became part of a new consensus among economists about the benefits of economic openness. According to Thomas I. Palley, changing conditions in both emerging-market (EM) and developed economies have made this paradigm irrelevant.

Palley outlines the stages of the export-led growth paradigm leading to its adoption worldwide, as well as the various critiques of this agenda that have become increasingly prescient. He concludes that we should abandon strategies aimed at attracting export-oriented foreign direct investment (FDI) and institute a new paradigm based on a domestic demand–led growth model. Otherwise, the global economy is likely to experience asymmetric stagnation and increased economic tensions between EM and industrialized economies.

The financial crash and accompanying Great Recession has created a global demand shortage and stagnation in the industrialized economies. Moreover, the positive factors related to export-led growth strategies are likely to prove temporary. There are several structural problems, such as the debt saturation of US consumers and the fact that EM exports are sabotaging the recovery of the industrialized economies.

According to Palley, China is unlikely to become the global engine of growth because its export-growth model is that of an assembler who focuses on supplying consumers in industrialized countries. And because of its size, China is siphoning FDI and demand away from other EM economies. Thus, its entrance onto the global stage has introduced South-South competition to the traditional dynamic of North versus South. In addition,

multinational corporations have created a "race to the bottom" dynamic where developing countries undermine one another to gain competitive advantage. As a result, Palley concludes, no single country or region can act as the global engine of growth, so all countries and regions must pull together.

A domestic demand–led strategy includes building social safety nets, raising and linking wages to productivity growth, increasing public infrastructure investment (as well as public goods such as health care and education), and rebalancing tax structures. In addition, the international economy needs to end undervalued exchange rates and adopt a system of managed rates aimed at avoiding global trade imbalances; implement labor, environmental, and social standards; and limit incentives to attract export-oriented FDI. However, agreement on such rules and standards is unlikely, says Palley, given the political and structural obstacles.

www.levyinstitute.org/pubs/ppb_119.pdf

New Policy Notes

Is the Federal Debt Unsustainable?

JAMES K. GALBRAITH

Policy Note 2011 / 2

According to Senior Scholar James K. Galbraith, the commonly accepted story about why we ought to be worried about the long-term US federal debt is flawed. Concerns about the "unsustainable path" of the federal budget are conceptually confused and depend upon projections that contain significant internal tension.

To begin with, Galbraith argues, a US government default on dollar bonds is impossible because the government controls the currency in which its bonds are issued. The word "bankruptcy" simply does not apply. Galbraith then attempts to clarify what it means for a budget path to be "sustainable" or not. A path that leads to uncontrolled and explosive increases in the ratio of debt to GDP is "unsustainable." By the same definition, anything that can be reproduced year over year is sustainable. What matters is whether or not a path stabilizes. Galbraith notes that the big primary deficit is not the dominant source of "unsustainability" for the United States. Rather, any primary deficit is "unsustainable" so long as interest rates exceed growth rates.

The Congressional Budget Office (CBO) assumes that short-term interest rates will rise to 4.5 percent nominal (2.5 percent real) within five years. This assumption makes its projected debt-to-GDP path "unsustainable" (passing 300 percent by midcentury). Galbraith argues that the CBO's assumption about interest rates is hard to square with its concurrent assumptions of moderate growth and low unemployment and inflation. If we allow an average interest rate on the public debt to remain at 1 percent, then real rates are modestly negative and the debt-to-GDP ratio no longer rises without limit (despite a primary deficit as high as 5 percent of GDP every year, forever). The ratio stabilizes at below 130 percent of GDP—not far above the highest historical value of 122 percent, in 1946. And since it is stable, it is not "unsustainable."

There is no reason, he argues, why a 100 percent–safe borrower that controls its own currency should pay a positive real rate of return on liquid borrowing. A sovereign borrower controls both the short-term rate and the maturity structure of the public debt, so it can issue as much short-term debt at a near-zero rate as it needs to. Changing the CBO's assumption that the United States must offer a real interest rate on the public debt higher than the real growth rate completely alters the long-term dynamic of the public debt. The prudent policy conclusion, therefore, is to *keep the projected interest rate down*. A more plausible worry regarding the debt is inflation, alongside depreciation of the dollar, but neither event constitutes default or is intrinsically "unsustainable."

www.levyinstitute.org/pubs/pn_2_11.pdf

A Modest Proposal for Overcoming the Euro Crisis

YANIS VAROUFAKIS and STUART HOLLAND

Policy Note 2011 / 3

According to Yanis Varoufakis, University of Athens, Greece, and Stuart Holland, University of Coimbra, Portugal, the policies of the eurozone governments—based on triptych loans, austerity, and debt buyouts—are failing both economically and politically. The authors argue that the euro crisis can be dealt with without fiscal transfers, taxpayer-funded bond buybacks, altered treaties, or new institutions. The eurozone needs to reinvigorate its

commitment to a European Economic Recovery Programme (EERP) by learning from the American New Deal; that is, borrowing to invest rather than cutting investments or raising taxes.

The key to what Europe needs today is a "tranche transfer": transferring a share of national debt and borrowing eurobonds held and issued by the European Central Bank (ECB). A tranche transfer of debt up to 60 percent of GDP would reduce the default risk for the most exposed member-states by lowering their debt-servicing costs, and would signal to bond markets that governments have a proactive response to the crisis (rather than remaining victims of credit rating agencies).

The crisis in the eurozone is multidimensional: it includes a sovereign debt crisis, a banking sector crisis, and an underinvestment crisis. The reason European Union (EU) policies are failing is that they address only the sovereign debt crisis; the immediate effect is a worsening of the banking sector and underinvestment crises, as well as debt-to-GDP ratios. The broader crisis is thus replicating itself rather than being resolved. The authors propose four main principles for a more comprehensive solution: (1) the triple crises must be tackled together; (2) shareholders rather than depositors in the banks causing the financial crisis should share in the pain; (3) the need for structural, proactive change to exposed sovereign debt (e.g., a major share of national debt is transferred to the EU and held by the ECB as eurobonds); and (4) such a "tranche transfer" to ECB eurobonds should not count toward the national debt of member-states.

They also propose three main policies. The first would stabilize the sovereign debt crisis using tranche transfers held as ECB bonds—a strategic policy that requires no change to existing treaties. The second would tackle the banking sector crisis by applying rigorous stress tests and recapitalizing by way of the European Financial Stability Fund (i.e., cleansing the banks of questionable public and private paper assets). The third would support the EERP by expanding the role of the European Investment Bank (EIB) and promoting member-state debt accounts with the ECB, thus enabling the EIB to be the driver of a New Deal–modeled recovery.

www.levyinstitute.org/pubs/pn_3_11.pdf

Was Keynes's Monetary Policy, *à Outrance* in the *Treatise*, a Forerunner of ZIRP and QE? Did He Change His Mind in the *General Theory*?

JAN KREGEL

Policy Note 2011 / 4

John Maynard Keynes was considered the true father of the unorthodox monetary policies introduced by the Bank of Japan (zero interest rate policy, or ZIRP) and the Federal Reserve (quantitative easing, or QE). Senior Scholar Jan Kregel evaluates *A Treatise on Money, Vol. II: The Applied Theory of Money* (1930) and *The General Theory of Employment, Interest, and Money* (1936) in terms of Keynes's belief in the power of monetary policy to counter financial crisis. He finds that the optimism displayed in the *Treatise* was misplaced, and that the *General Theory*'s more nuanced position was more appropriate—in particular, Keynes's emphasis on the need to provide an external source of demand through government expenditure. If Keynes had taken into account such factors as the impact of capital loss on the inducement to invest and the propensity to consume, he would have placed even greater emphasis on the role of government spending in bringing about recovery, says Kregel.

It appears that the Bank of Japan experimented with Keynes's recommendation that interest rates be set as low as possible, and that the US Federal Reserve followed his recommendation in full by purchasing long-term securities to bring down the long-term rate of interest and satiate the desire to hold deposits. It also appears as if Keynes's expectation that the public would become willing buyers of government securities upon a sharp reduction in short rates, thereby aiding the policy of lowering the long-term rate, was accurate. What has not been borne out is the expected impact on the rate of investment. Although businesses have increased their borrowing and the spread between corporate junk bonds has fallen to near-historic lows, these funds are not being used to finance new investment. Similarly, banks have accumulated record levels of reserves in their deposit accounts at the Fed, earning the short-term interest rate. Thus, the policy has been successful in influencing the interest rate in the way Keynes predicted, but it has not had the impact on investment that he outlined in the *Treatise*.

A novel feature of the *General Theory* is its emphasis on the conditions of a monetary economy as "one in which changing views about the future are capable of influencing the quantity

of employment and not merely its direction" (i.e., the state of long-term expectations upon which decisions are based and the confidence with which forecasts are made). Keynes modifies his prior belief in the positive impact of lower interest rates on the rate of investment, as well as his position on the ability of the central bank to influence the lending practices of financial institutions through a reduction in interest rates. He also modifies his *Treatise* analysis of the impact of "extraordinary" monetary policy on the long-term rate of interest and his belief in the efficacy of monetary policy to influence the rate of investment.
www.levyinstitute.org/pubs/pn_4_11.pdf

New Working Papers

The Dismal State of Macroeconomics and the Opportunity for a New Beginning

L. RANDALL WRAY
Working Paper No. 652, March 2011

What passed for macroeconomics on the verge of the global financial collapse had nothing to do with reality. As a result, the ensuing crisis exploded the reigning orthodoxy—rational expectations and continuous market clearing, New Classical and real business cycle approaches, neutral money, the New Monetary Consensus, the Taylor rule, the Great Moderation, the efficient markets hypothesis, Ricardian equivalence and other versions of the policy irrelevance doctrine, and claims made by advocates of deregulation and self-regulation. None of these ideas should be taught in any serious economics course, says Senior Scholar L. Randall Wray. It is time to throw out neoclassical theory and update John Maynard Keynes's theory so that it is relevant to the world we now live in.

Keynes revolutionized economic thought in the aftermath of the Great Depression, but his important insights were never incorporated into mainstream macroeconomics. Rather, "synthesizers" borrowed only the less revolutionary aspects of Keynes's theory and integrated them into the old neoclassical approach, which is applicable to an imaginary world (i.e., an economy focused on market exchange based on a barter paradigm) where money and finance do not really matter.

Wray points out that mainstream macro models cannot incorporate the real-world features used by Keynes, such as animal spirits and degree of confidence, market psychology, and liquidity preference. By contrast, Keynes's basic model is easily extended to account for heterogeneous credit ratings, to allow default to affect expectations, and to include "contagions" and other repercussions when a large economic entity defaults on its commitments.

When postwar "Keynesian" economics translated the *General Theory* into algebra, it became too simplistic and specific to be relevant in a complex world. The methodology adopted by orthodoxy was precisely the opposite of Keynes's (general) methodology, which was also institution specific. There were no forces to drive a capitalist (entrepreneurial) economy to the full-employment level of effective demand. The dynamics of full employment engendered an unstable equilibrium that changed expectations in a destabilizing manner.

The heterodox approach based on Keynes and Hyman P. Minsky is skeptical that the private sector can be a reliable engine of growth and that government policy should incorporate a "pump-priming" approach. Rather, policymaking should be more specific, with well-formulated regulations to constrain private firms, and well-targeted government spending. The wholesale abandonment of regulation and supervision of the financial sector proved to be a tremendous mistake, and fundamental reform is required to restore the US economy.

Minsky argued that only the federal government can offer an infinitely elastic demand for workers at a decent wage. Program creation and administration (to provide public services), and worker supervision, could be decentralized to local not-for-profit agencies, community development organizations, and state and local governments. Policymakers should stop worrying about the "affordability" of necessary programs and focus on whether government spending is well targeted. The goal should be to use the government's "purse" to achieve the public purpose, and to budget in order to reduce waste, graft, and corruption.
www.levyinstitute.org/pubs/wp_652.pdf

Financial Keynesianism and Market Instability

L. RANDALL WRAY

Working Paper No. 653, March 2011

Hyman P. Minsky foresaw the development of the current economic and financial crisis based on his "financial Keynesian" approach. He argued that the strongest force in a modern capitalist economy operates toward an unconstrained speculative boom, and that crisis (including debt deflation) is a natural outcome of money manager capitalism—highly leveraged funds seeking maximum returns in an environment that systematically underprices risk.

In spite of recent Keynesian attempts to mitigate the crisis, Senior Scholar L. Randall Wray believes that Minsky would recommend more radical policies, and that true reform is unlikely until the financial system and economy collapse a second time. He recommends a system with enhanced oversight of financial institutions, a structure that promotes stability rather than speculation, and policies that promote rising wages and employment rather than transfer payments.

Minsky understood the true potential of securitization, which contributed to the globalization of finance and to the relative decline in the importance of banks in favor of "markets" and "managed money" (e.g., pension, hedge, and mutual funds) that were not subject to the costs of relationship banking. Banks and thrifts responded by earning fees for loan origination and by moving mortgages off their books in order to escape reserve and capital requirements. The competition between managed money and banking helped to produce the current crisis.

Not enough attention has been given to the role played by pension funds in fueling the asset price boom and bust, says Wray. Although pensions allocated a small proportion of their portfolios toward the commodity indexes, it represented a huge volume relative to the size of the commodity markets and created one of the biggest commodities price bubbles—which collapsed along with everything else.

Wray expects that continuing price deflation in the United States will wipe out an additional several trillion dollars of wealth, so we will need further household debt relief, such as Minsky's proposal in the wake of the savings-and-loan fiasco: an institution, modeled on the Reconstruction Finance Corporation, to purchase and hold mortgages until the real estate sector recovers. Another potential measure is to nationalize Fannie Mae and Freddie Mac, with the Treasury explicitly guaranteeing their debts and ensuring that they operate in the public interest. Moreover, Congress needs to rethink the role played by government-sponsored entities, whereby these entities support rather than compete with private lenders in the home-finance sector.

The biggest policy challenge relates to money manager capitalism. The only way to constrain risky practices is to reregulate and downsize the financial markets. It is in the public interest to maintain the soundness of a portion of the banking, student loan, and home mortgage sectors, including pension and insurance funds. Reform should make it more difficult for banks to participate in the next speculative boom and bust by, for example, ensuring that all liabilities show up on their balance sheets. In addition, commodity price pressures could be relieved by removing all tax advantages for funds purchasing commodities and by drawing down the US Strategic Petroleum Reserve.

www.levyinstitute.org/pubs/wp_653.pdf

Measuring Macroprudential Risk: Financial Fragility Indexes

ÉRIC TYMOIGNE

Working Paper No. 654, March 2011

Research Associate Éric Tymoigne uses the analytical framework of Hyman P. Minsky's financial instability hypothesis to develop an index that captures the growth of financial fragility—the propensity of financial problems to generate a debt-deflation process. Minsky's Ponzi-finance position is taken as a point of departure to construct the index. Tymoigne finds that there should have been much earlier interventions by financial supervisors and regulators when default rates on mortgages were very low, wealth was rising, and banks were highly profitable. He notes that financial market data may not be reliable in capturing the risk of financial instability beforehand, and that we should focus on the growth of financial fragility during periods of economic stability.

The two main datasets that use macroeconomic variables related to funding methods are the Federal Reserve's Flow of Funds and the Bureau of Economic Analysis National Income and Product Accounts. Given that Ponzi finance is the point of

reference, more weight is given to variables that directly reflect refinancing and liquidation pressures (e.g., debt-service ratios, refinancing volume, and the proportion of liquid assets relative to debt). Tymoigne notes that net worth as a variable indicating financial fragility is of limited usefulness. Rather, the detection of Ponzi finance is based on rising net worth, which allows borrowing on the expectation of the availability of refinancing sources or asset liquidation to meet debt-service costs.

At the macroeconomic level, financial fragility increases over time because of compounding and volume effects that cause interest payments to grow exponentially. Tymoigne's index captures these effects and changes in funding methods, including increases in Ponzi finance. The use of Ponzi finance stops when there is a crisis, as refinancing and liquidation risks lead to a debt-deflation process (economic units try to "simplify debts"). Thus, the index indicates the strength of the debt-deflation risk, given the duration and volume of Ponzi finance prior to a crisis. This means that Ponzi financial practices in underwriting procedures occur before they are captured in the actual data, so it is important to understand these procedures (traditional bank supervision is crucial, he says). The index should be used as a regulatory and supervisory tool, but not for fine-tuning.

Tymoigne constructs indexes for three sectors: household; nonfinancial, nonfarm corporate; and financial business. He creates two indexes for the household sector: household funding and home funding. They show that fragility grew rapidly over the past two decades but has declined today as households pay down debts and save, leading to a significant decline in home prices (however, the level of fragility remains high). The most striking aspect of the nonfinancial, nonfarm corporate and financial business indexes is that the latter sector is much more prone to financial fragility—as predicted within the Minskyan framework. The financial business index provides a signal to financial regulators that there is trouble despite appearances based on traditional supervisory and economic indicators, such as low default rates and risk premiums, and high profitability.

www.levyinstitute.org/pubs/wp_654.pdf

A Minskyan Road to Financial Reform

L. RANDALL WRAY

Working Paper No. 655, March 2011

Senior Scholar L. Randall Wray examines Hyman P. Minsky's approach to reforming the economy and the financial system. According to Minsky, the system should create a financial structure conducive to economic development that improves (broadly defined) living standards. Minsky believed that "industry" should dominate "speculation," and that the most dangerous instability in the capitalist economy was the run up to a euphoric boom.

The current crisis represents a failure of the Big Government / neoconservative model that promotes deregulation, limited supervision and oversight, privatization, and consolidation of market power. In addition, monetary and fiscal policy is biased against both full employment and adequate growth to generate rising living standards. Thus, we must return to a more sensible model, with enhanced oversight of financial institutions, a financial structure that encourages stability rather than speculation, and policy that promotes rising wages and employment. The proper role of monetary policy is to stabilize interest rates, to enact direct credit controls to prevent runaway speculation, and to provide supervision. In addition, we need short-term economic stimulus spending plus long-term commitments by the federal government to improve infrastructure, create jobs, and reduce inequality. As argued by Minsky, a private sector–led expansion increases financial fragility as tax revenues rise, the government sector deficit falls, and the current account deficit worsens (especially for a country like the United States that has a high propensity to import).

Minsky preferred a high-consumption society to an economy that grew by encouraging investment, since investment must rely to some degree on external finance, while a sustained investment boom creates euphoria and rising asset prices that increase indebtedness (and therefore fragility). Moreover, when investment represents a rising share of GDP and is supported by policy, there is an inflationary bias, followed by a policy move that suppresses an economic expansion prior to full employment. In Minsky's view, growth promoted by government consumption and public infrastructure investment would improve private sector balance sheets and be financially stabilizing. And

in place of welfare, Minsky advocated an employer-of-last-resort program (see Working Paper no. 652 on p. 7).

The essential functions of a financial system are a safe and sound payment system (e.g., deposit insurance to prevent bank runs, and close regulation and supervision of asset purchases); short-term loans to households and firms (and to state and local governments); a safe and sound housing finance system; a range of financial services, including insurance, brokerage, and retirement savings services; and long-term funding of positions in complex and expensive capital assets. Policy reform should favor small institutions over large ones, as economies of scale in banking are reached at a very small size. Minsky proposed a network of local community development banks that engaged in a wide range of services, while prohibiting all large chartered banks from diversifying across the range of financial services.

Finance has played an outsize role over the past two decades, says Wray. It's time to put global finance back in its proper place as a tool to achieving sustainable development through downsizing and reregulation.
www.levyinstitute.org/pubs/wp_655.pdf

Money in Finance

L. RANDALL WRAY
Working Paper No. 656, March 2011

Senior Scholar L. Randall Wray defines, and distinguishes between, money and finance; addresses alternative ways of financing spending; and examines the role played by financial institutions (e.g., banks) in the provision of finance.

The term "money" is used to designate the money of account (such as the US dollar) and in reference to specific money-denominated assets that fulfill important functions such as medium of exchange, means of payment, and store of value. The development of a wide variety of substitutes for bank demand deposits, including credit and debit cards, makes it difficult to define money with precision. According to Hyman P. Minsky, anyone can create things that can be used as money, but the problem lies in getting these "money things" accepted.

In terms of a hierarchy of "money things," the government's IOUs (central bank notes and reserves, and Treasury coins) are at the top of the pyramid, followed by the deposit liabilities of financial institutions (including banks) with access to the central bank, the short-term liabilities of financial institutions and nonfinancial corporations, and, finally, the short-term liabilities of households and small businesses. Wray notes that liquidity declines further down the pyramid, and that the US dollar has been at the apex of the pyramid since the abandonment of the gold standard. He also notes that economic agents use the liabilities of those above them in the pyramid for payment.

The two universal laws of credit and debit (the two sides of an IOU) are that they are denominated in a unit of account (e.g., the US dollar) and that the issuer of an IOU must accept its own IOU back in payment (often intermediated by banks). A default arises when a debt-issuing economic entity refuses to redeem its own IOU when submitted in payment. All "money things" and "debt things" are IOUs denominated in the money of account, and all things are "redeemable" (accepted in payment of debts held by the issuer).

Aside from a sovereign currency-issuing government that makes payments by issuing its own IOU, there are three options for financing a transaction: income, assets, or debt. All options use "money things" in financing expenditures, and because "money things" are debt, monetary purchases always involve debt. The key insight behind Minsky's financial instability hypothesis is that using external finance in place of internal finance is risky for both borrower and creditor.

Government spends by issuing debt, while taxes cancel government debt. Taxes do not really "finance" government spending—it is actually financed by issuing liabilities. Government deficit spending is the source of net nongovernment sector financial wealth. Furthermore, saving is increased by spending more on investment, which increases income. Wray points out that saving can never be a net source of finance at the aggregate level, since new finance requires new debt. He also points out that banks do not lend central bank reserves, and that providing more reserves will not encourage bank lending (banks need good borrowers). Access to the central bank as lender of reserves (and as lender of last resort) is essential to keeping bank liabilities liquid and to converting them to high-powered money on demand.

Although economists have traditionally focused on a very narrow definition of money (high-powered money plus checkable deposits), all economic agents can be treated as "banks"; that is, taking positions in assets by issuing liabilities. Recent innovations such as the securitization of home mortgages have added layers of complexity, but consumer loans are low on the

money pyramid. Mortgages have served as collateral behind all sorts of securities, to the extent that each dollar of US income serviced five dollars of debts and securities, and unknown amounts of derivatives. As a result, finance's superstructure began to collapse in 2007.

The point is that it is a mistake to focus on banks and narrow definitions of "money supply," says Wray, as all kinds of debts were securitized and most were outside normal banking. Debt ratios have risen over time, and income and output were expected to service an ever-larger financial superstructure. The last time the US economy was financialized to a similar extent was in 1929. This ultimately led to the Great Depression, and to substantial financial reforms and government controls.
www.levyinstitute.org/pubs/wp_656.pdf

What Does Norway Get Out Of Its Oil Fund, if Not More Strategic Infrastructure Investment?

MICHAEL HUDSON
Working Paper No. 657, March 2011

Norway maintains the world's second-largest sovereign wealth fund (more than $500 billion). However, its "oil fund" is mainly invested in European and US stocks and bonds—meaning that foreigners receive most of the royalties and earnings on the country's domestic wealth. It also means that the fund is relying on a renewed rise in financial asset prices that can only be achieved by loading down economies with more debt.

According to Research Associate Michael Hudson, Norwegian financial managers are only interested in the short run, the financial sector has decoupled from tangible capital formation, and the country's oil fund is in jeopardy. Based on the experience of BRIC (Brazil, Russia, India, and China) sovereign wealth funds, Norway should focus on long-term planning for economic development that is in the national interest. Contrary to the tenets of Norwegian policymaking, more public investment minimizes living and business costs—and it is not inflationary.

Norwegian financial managers believe that they are spreading the risk over a wide spectrum of foreign stocks and bonds. But this is not the case in an increasingly risky global environment where money management fees absorb a large share of Norway's modest oil fund returns, prices reflect the supply of credit (contrary to the efficient market hypothesis), and the stock market has become a vehicle to replace equity with debt. Credit creation has reduced Norway's oil fund savings to the level of bank credit that is flooding the global markets in search of investment opportunities. Such debt-leveraged speculation is distorting the world economy by leaving no retained earnings and by threatening to crowd out tangible capital investment.

The financial crises of Iceland, Ireland, and Greece are not anomalies but the result of neoliberal tax ideology and central bank policies that steer savings and credit to inflate real estate and stock market prices rather than expand direct investment in the means of production. The best way for Norway's oil fund to maximize returns related to its liquid savings surplus is full equity ownership in place of borrowing. Norway should use its surplus to invest directly in domestic and regional enterprises that will prosper over the next half-century by modernizing its railway and transport system, expanding its fishing industry, subsidizing its education, reintroducing classical free-market policies that minimize FIRE-sector overhead, and maintaining a low-interest infrastructure. And it may be time to establish a Norwegian Futures Institute, says Hudson.
www.levyinstitute.org/pubs/wp_657.pdf

Keynes after 75 Years: Rethinking Money as a Public Monopoly

L. RANDALL WRAY
Working Paper No. 658, March 2011

Economists and government policymakers fail to recognize that money is a public monopoly. The result of this misunderstanding is unemployment and inflation, says Senior Scholar L. Randall Wray. We need to analyze money and banking from the perspective of regulating a monopoly by setting the "price" and letting the "quantity" float, as exemplified by Hyman P. Minsky's universal employer-of-last-resort program.

Understanding how a monopoly money works would advance public policy formation a great deal, says Wray. And since banks are given the power to issue government money, failure to constrain what they purchase fuels speculative bubbles that are ultimately followed by a crash. The real debate should be over the proper role of government—how it should use the monetary system to achieve the public purpose.

Wray provides an overview of alternative approaches to money and focuses on two main categories: the orthodox approach (money is an efficiency-enhancing innovation of markets) and the Chartalist approach (money is a creature of the state). Three notable economists who openly embraced the importance of money are Karl Marx, Torstein Veblen, and John Maynard Keynes. Their monetary theory of production asserts that money is the *object* of production. If we recognize that the money of account is chosen by the state and that only the state can issue domestic currency, then "money" should be viewed as a public monopoly, says Wray.

Bank money is privately created when a bank buys an asset such as a mortgage, or even securitized toxic waste. We have effectively given banks the power to issue government money (since they have access to the central bank and treasury), and by removing government regulation and supervision, we invite private banks to use the public monetary system to pursue private interests. In turn, unbridled lending for speculative purposes invites excess and rewards fraud, leading to a crash. Private, for-profit institutions can play a role in mobilizing resources for the public purpose, but there is no reason to believe that self-regulated private undertakers will do so (private lending and spending are strongly procyclical).

When a crisis hits, only the government is prepared to offer its liabilities. There are three lines of defense: (1) the central bank lends reserves without limit to financial institutions facing a run on their own liabilities; (2) the central bank purchases illiquid and risky financial assets that the nongovernment sector is trying to unload; and (3) fiscal—the sovereign government spends by issuing currency, which simultaneously satisfies liquidity preference and props up aggregate demand. In spite of recent large-scale interventions and the fact that a sovereign government cannot run out of its own liabilities, many potential problems have been created with respect to incentives, transparency of central bank activities, democratic accountability, and unemployment.

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Minsky Crisis

L. RANDALL WRAY

Working Paper No. 659, March 2011

Hyman P. Minsky's insight that stability is destabilizing underlies his analysis of an economy's transformation from robust to fragile over a long period of time. Similarly, Senior Scholar L. Randall Wray argues that the causes of the current crisis resulted from a slow transformation that actually began in 1951. Thus, the collapse of "money manager capitalism" should be termed the "Minsky half-century" as opposed to a "Minsky moment."

Wray notes that economic crises became more frequent and severe in the postwar period, so that another Great Depression and debt deflation were possible. Policymakers removed New Deal regulations and institutions, and substituted "self-regulation" in place of government oversight. He calls for a return to a more sensible model of global finance, one designed to achieve sustainable development. This model would include enhanced oversight of financial institutions, a structure that promotes stability rather than speculation, a bigger role for government, and a new economic paradigm.

Minsky's basic thesis is that the dynamic forces of the capitalist economy are explosive, and therefore must be contained by institutional ceilings and floors. He analyzed the financial innovations of profit-seeking firms that were designed to subvert New Deal constraints and foresaw the development of securitization (which moves interest rate risk off bank balance sheets while reducing capital requirements), a leading cause of the global financial crash in 2007.

Wray outlines Minsky's financial theory of investment—that success during an economic expansion generates a greater willingness to borrow, commits a rising portion of expected gross profits (gross capital income) to servicing debt, and exposes the firm to greater risk. This leads to Minsky's famous categorization of financial positions as hedge, speculative, or Ponzi units. Moreover, government itself could be both stabilizing and destabilizing, based on its budget allocations during economic booms and slumps. In Minsky's view, Federal Reserve interest rate policy is not a strong stabilizing force. Rather, the central bank should act as lender of last resort, a policy that would stop a bank run and place a floor on asset prices, attenuating the debt deflation process. The combination of a Big

Bank and Big Government helps to prevent a financial crisis from turning into a deep economic downturn.

Wray reviews various policy responses that will help to reformulate global capitalism along Minskyan lines. He suggests a return to a more sensible model, with enhanced oversight of financial institutions and a financial structure that promotes stability rather than speculation. The proper role of monetary policy is to stabilize interest rates, use direct credit controls to prevent runaway speculation, and supervise. An employer-of-last-resort program could provide jobs when they are unavailable in the private sector.

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Financial Markets

JÖRG BIBOW

Working Paper No. 660, March 2011

In mainstream economics, saving finances investment, competitive markets are efficient, and fundamentals anchor well-behaved financial markets. According to Research Associate Jörg Bibow, there is little concern that mainstream economics may provide an altogether flawed depiction of the role of finance in real-world economies. He notes that the financial markets are at the heart of the flaw in neoclassical economics diagnosed by John Maynard Keynes in his *General Theory* (1936).

The *General Theory* focuses on the issue of satisfying "liquidity preference" through financial markets and how this affects full employment. Thus, a crucial public policy matter is how society chooses to deal with fundamental uncertainty and cope with important uninsurable risks. The challenge of monetary policy is to guide financial conditions in a way that is conducive to achieving public policy goals and anchoring the financial markets. Regulation of financial instruments and supervision of financial intermediaries are essential public policy functions. Otherwise, endogenous processes of credit creation and asset-market play may feed bubbles and lead to financial fragility.

In monetary production economies, both the money of account function and the property of money as liquidity par excellence are central to the functioning of the financial system and the economy at large. The importance of money essentially flows from its link between the present and the future. For example, the lure of short-term profit in an industry that literally deals in bridging an uncertain future has produced a history of finance that is scattered with fraud, instability, and crises.

Under Keynesian uncertainty, the idea of uniquely correct asset prices determined by fundamentals is philosophically fallacious, says Bibow. Money and finance condition the real economy—not the other way around. The financial system has command over the money units needed to meet money contracts, and the price at which it does so is the money rate of interest.

www.levyinstitute.org/pubs/wp_660.pdf

Minsky's Money Manager Capitalism and the Global Financial Crisis

L. RANDALL WRAY

Working Paper No. 661, March 2011

Notions that an economic recovery is imminent or under way are not shared by Senior Scholar L. Randall Wray. He believes that we are in round three of a nine round bout, with financial institutions cooking the books in the aftermath of a liquidity crisis and a wave of insolvencies. Round four should begin later this year, he says, when another wave of defaults by borrowers forces institutions to recognize losses. This round could deliver a knockout punch that brings on a full-fledged debt deflation and the failure of most large-scale financial institutions.

Such a knockout punch might provide the impetus for a thorough reformation of the international financial system, says Wray. The only way out of this deep recession is fiscal policy, but it is constrained by deficit hysteria. Radical policy changes no less significant than those adopted under the New Deal will be required to get us out of this mess.

Minsky argued that the New Deal promoted a Big Government / Big Bank model that was highly successful for financial capitalism. Spending during World War II ended the Great Depression and set the stage for a stable economy that included high, countercyclical government deficits, a central bank ready to intervene, low interest rates, and a heavily regulated financial sector. Until the mid-1970s, recessions were mild and crises easily resolved through prompt government response.

Wray outlines four important transitions that led to the current crisis. The first transition was the rise of "managed money," with professional money managers seeking maximum returns, riskier assets, and (fraudulently) overstated earnings. The second transition is that the investment banks went public, allowing top management to profit from rising share prices—the same pump-and-dump short-term incentives that drove the boom in 1929. The third transition is deregulation and self-supervision. This transformation was complete with the collapse of Lehman Brothers, Bear Stearns, and Merrill Lynch, and the granting of commercial banking charters to the two remaining investment banks: Goldman Sachs and Morgan Stanley. Now the riskiest financial institutions are playing with "house money" (i.e., government-insured deposits).

The fourth transition is the rise of fraud as normal business procedure. According to Wray's colleague, William Black, we have a criminogenic environment fueled by control fraud, where top management turns a firm into a weapon of fraud in the interest of enriching itself. But in spite of rampant fraud, there has been almost no investigation and no prosecution of top officials at any of the big banks.

The problem, says Wray, is money manager capitalism, with its focus on short-run returns and uncompromised profit margins. "Finance" has become too big, capturing 40 percent of all corporate profits and 20 percent of the value added to GDP. This compares to 1929, and apparently represents a practical maximum and a turning point at which the economy collapses.

We need to protect jobs, wages, insured deposits, and retirements, says Wray, not financial institutions. We also need a massive fiscal stimulus and a permanently larger fiscal presence to allow growth without relying on private sector debt. In addition, we need to reduce the role of Wall Street and eliminate government subsidies for managed money. It is time to put global finance back in its proper place as a tool for achieving sustainable development.

www.levyinstitute.org/pubs/wp_661.pdf

The Financial Crisis Viewed from the Perspective of the "Social Costs" Theory

L. RANDALL WRAY

Working Paper No. 662, March 2011

Rather than operating "efficiently," the financial sector has been imposing huge costs on the economy. Senior Scholar L. Randall Wray observes that the continuing crisis makes it clear that the efficient markets hypothesis does not work. Wray hopes that the current crisis will lead to a transformation of the economics discipline similar to the creation of Keynesian economics during the Great Depression, and a reorientation of financial institutions toward serving the public purpose.

Wray outlines William K. Kapp's theory of social cost presented in *The Social Costs of Private Enterprise* (1971 [1950]). Kapp's notion is that market competition does not lead to a socially efficient allocation of resources. Instead, competition encourages the pursuit of private profit in a manner that shifts benefits to entrepreneurs and costs to society. Hyman P. Minsky's financial instability hypothesis provides an endogenous, rational explanation of the possible volatile behavior of asset prices that is not self-equilibrating. In particular, financial institutions find it rational to increase leverage, and rising leverage plays a crucial role in the hypothesis.

Wray reviews the transformation of the financial system as fragility rose, and refers to some specific examples of social costs resulting from "innovative" financial practices (e.g., the hedge fund Magnetar and Goldman Sachs's Abacus deals). He notes that finance capital played an uncommonly small role for some decades after World War II. Thereafter, the development of an array of financial institution liabilities circumvented New Deal constraints, as finance responded to profit opportunities and adopted new practices to protect institutions from interest rate risk (e.g., securitization of mortgages, derivatives for hedging, and "off balance sheet" operations to evade reserve and capital restraints). The key mistake leading to the crisis was not the demise of Glass-Steagall but rather the decline of underwriting over a run of good times, when a trader mentality triumphs, says Wray. Thus, calls for a return to Glass-Steagall or forcing banks to put more "skin in the game" are both wrongheaded.

The problem now is that total financial liabilities in the United States amount to about five times GDP (versus three times GDP in 1929). And the trend toward concentration of

income and wealth at the top makes it more difficult to support the weight of the debt. Furthermore, when income flows take a back seat, acceptable capital leverage ratios are much higher. Thus, the extensive and unknown linkages among financial institutions (e.g., layering of debts upon debts) mean that one counterparty failure could bring down the whole house of cards.
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Quality of Match for Statistical Matches Used in the 1995 and 2005 LIMEW Estimates for Great Britain

THOMAS MASTERSON
Working Paper No. 663, March 2011

This paper by Research Scholar Thomas Masterson describes the construction of synthetic datasets to estimate the Levy Institute Measure of Economic Well-Being (LIMEW) in Great Britain. Since no single dataset includes all the required data, Masterson creates a synthetic data file by combining various sources for information about demographics, income, transfers, taxes, time use, and wealth. He finds that the quality of his overall statistical matching is good. Therefore, the LIMEW should be able to adequately portray the distribution of household production and wealth, given the data limitations.

The Office of National Statistics Family Resources Survey (FRS) is used as the basic dataset. The British Household Panel Survey (BHPS) is used for the wealth data. Time-use data for 1995 is derived from the Office of Population Censuses and Surveys Omnibus Survey time-use module, while that for 2005 is derived from the United Kingdom Time Use Survey.

The matching unit for wealth is the household, and the source datasets for the LIMEW estimates are the FRS and BHPS. Missing values in the BHPS data were replaced in two stages: hot-decking for individuals, and multiple imputations with chained equations for households. In order to perform a successful match, the candidate datasets must be well aligned in the strata variables used in the match procedure. The strata variables for the wealth match are homeownership, age, educational attainment, family type, and household income.

The strata variables for the time-use match are sex, parental status, employment status, and marital status, and the matching unit is the individual. In both the 1995 and 2005 LIMEW estimates, Masterson finds that the overall match quality is good respecting the distribution of household production and wealth in Great Britain, given the limitations of the data. (For additional information about measures of economic well-being in Great Britain, see Working Paper no. 667 on page 18.)
www.levyinstitute.org/pubs/wp_663.pdf

Can Portugal Escape Stagnation without Opting Out from the Eurozone?

PEDRO LEAO and ALFONSO PALACIO-VERA
Working Paper No. 664, March 2011

According to Pedro Leao, ISEG, Technical University of Lisbon, Portugal, and Alfonso Palacio-Vera, Universidad Complutense de Madrid, Spain, there is no clear pattern of economic integration among eurozone countries. Peripheral eurozone countries have financed their large current account deficits by increasing their indebtedness vis-à-vis core countries—Germany in particular. According to the authors, Portugal, Greece, and Spain face a decade of economic stagnation and high unemployment. In the absence of institutional reform of the European Monetary Union, Portugal's best way forward is to exit the eurozone.

This paper reviews the literature on intra-eurozone current account imbalances, analyzes the evolution of the Portuguese economy, discusses various economic policy strategies, and proposes institutional changes that may help to correct the macroeconomic imbalances. The authors note that there has been a steady divergence in terms of relative competitiveness, inflation, and current account balances since the launch of the euro in 1999.

Southern eurozone countries ran large current account deficits, whereas northern eurozone countries ran large current account surpluses. Productivity in the south drifted below that in the north, and most of the increase in investment in the south went into nontradable sectors. Inflation in the south rose relative to the north so competitiveness declined.

Portugal entered the eurozone with an overappreciated real exchange rate and a current account deficit of 8.5 percent of GDP at full employment. Since then, the Portuguese economy has experienced four adverse trends: (1) a decline in the surplus of remittances; (2) an increase in the energy deficit; (3) a growing external debt service; and (4) greater direct competition from

China and the European Economic Community. The combined effect increased the current account deficit and pushed the real effective exchange rate further above its initial equilibrium level.

Economic policy alternatives available to Portugal include an increase in the private saving rate, an increase in public saving, and a boost to net exports. The first two alternatives would lower output and increase unemployment. The third, however, would boost domestic output and lead to smaller private sector and budget deficits, and lower unemployment.

An upsurge in net exports can only be achieved through cutbacks in unit production costs. But Portuguese workers are reluctant to accept lower nominal wages, and any decline in wages (and prices) could adversely affect domestic consumption and investment. Moreover, the decline in nominal wages in an individual eurozone economy does not lead to an increase in the GDP of the eurozone as a whole, but merely redistributes a given level of output between eurozone economies.

The authors suggest two solutions: imposing a ceiling on the current account imbalances (either deficits or surpluses) of individual eurozone countries, and raising the inflation target of the European Central Bank (ECB). Restrictive fiscal policy in the south, coupled with expansionary fiscal policy in the north, could curb the present current account imbalances without depressing output and employment. Unfortunately, this solution is unlikely to be adopted, say Leao and Palacio-Vera, because Germany has recently limited federal government budget deficits to no more than 0.35 percent of GDP from 2016 on. The second solution is also unlikely, since the ECB determines the quantitative definition of price stability enshrined in the Treaty of Lisbon and will probably not revise its inflation target upward to "grease the wheels" of labor markets in the troubled eurozone economies.

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Causes of Financial Instability: Don't Forget Finance

DIRK J. BEZEMER

Working Paper No. 665, April 2011

One reason that dynamic stochastic general equilibrium (DSGE) models fail to model the macroeconomy is that finance is treated inadequately. Dirk J. Bezemer, University of Groningen, explores the methodological shift toward agent-based models, where complex behavior and sudden transitions arise from the economy's financial structure (as reflected in its balance sheets) and heterogeneous interacting agents.

The author develops a simple balance-sheet model to demonstrate that nonlinear behavior, and sudden transition may arise from the economy's balance-sheet structure in the absence of microfoundations. He explores two types of leverage and finds that an economic system survives crises in the equity scenario but not in the securitization scenario. A promising avenue of future research is combining flow-of-funds and agent-based models.

Bezemer notes that general equilibrium models dominated macroeconomics after the demise of Keynesianism in the late 1970s, but they exclude the possibility of financial instability. In principle, DSGE models cannot incorporate the financial sector and credit creation, so they cannot anticipate a credit crisis. He points out that the current crisis was anticipated by scores of nonorthodox economists, including Wynne Godley and his collaborators at the Levy Institute. Godley's predictions were based on a flow-of-funds framework that was built upon theorists (such as John Maynard Keynes and Hyman P. Minsky) who considered true finance-induced macroeconomic instability. This strand of theorists locates the economy's instability not only in its financial structure but also in the behavior of its agents.

There are two organizing principles that explain how finance induces instability: a balance-sheet approach to the economic system, and distinction between money and other types of credit. Bezemer notes that the growth of lending to the nonfinancial sector is subject to the growth of aggregate economic activity (GDP). Moreover, flows of "free" credit issued by US banks (i.e., the FIRE sector) have risen fivefold in proportion to the US economy since the 1950s. Thus, the bulk of the economy's financial flows (what Minsky termed "managed money") are left out of DSGE models. And the key to understanding finance-induced instability is leverage. Each postwar US business cycle started with a higher level of leverage.

The crucial point in Minsky's work is that financial instability arises from the structure of financial capitalism, not from variations in its financial parameters. Thus, sophisticated financial markets mean financial fragility and instability, which arise from the structure of leverage (the key element of capitalist finance), not interest rate movements.

Bezemer creates a simple four-variable, five-parameter model that retains the necessary features of stock-flow consistency (Godley) and nominal values for assets and debt that are among the financial causes of cycles and crises (Minsky). His model properties also generate endogenous cycles and cycle instability due to increasing leverage. Simulations of the model show that the timing and severity of instability depend on the nature of securitization. In the short run, securitization-led growth is very profitable, but financially unsustainable.
www.levyinstitute.org/pubs/wp_665.pdf

Hegemonic Currencies during the Crisis: The Dollar versus the Euro in a Cartalist Perspective

DAVID FIELDS and MATÍAS VERNENGO
Working Paper No. 666, April 2011

David Fields and Matías Vernengo, University of Utah, conclude that the dollar will remain the lingua franca of the international monetary system for a very long period (neither the euro nor the renminbi is a credible challenger). The dollar has served as the risk-free asset since the rise of global capitalism, and its resilience stems from the fact that, for the first time, a hegemonic currency is fully the creature of the dominant international state and divorced from gold.

According to the conventional or Metallist view, confidence is essential, so it is necessary to reduce political power from directly controlling the money supply. It infers that a separation of monetary and fiscal policies is the trademark of good policymaking. The hegemon must maintain a credible macroeconomic stance to avoid a run on its currency and the possibility of default.

In the Cartalist (Chartalist) approach, the key to a currency's standing (as a secure asset) is the role of economic and political power—the hegemonic country sets the global social, political, and economic conditions. Today, the power of the state is more important than the confidence of the markets. In this context, the monetary functions are intrinsically connected with the fiscal matters of the state. Money derives its properties from the state's guarantee, and the monetary authority ensures the creditworthiness of the state by maintaining its fiscal solvency. The power to coerce other countries is central for monetary hegemony. For example, the hegemonic country can provide credit on an international basis to expand global demand. The national state is always creditworthy in its own domestic currency and default is impossible, since the central bank can always buy government bonds and monetize the debt.

The hegemon in previous international monetary systems was not only a source of global stability, acting as a lender of last resort, but also the crucial source of global demand. These features have intensified since the collapse of Bretton Woods and the dollar's ascendance as the first world fiat money. There is no balance-of-payments constraint for the hegemonic country, and the principles of functional finance apply on a global basis. In this case, the United States is the global debtor that (1) provides a default risk-free asset to facilitate global accumulation and (2) can stimulate global effective demand. This situation would only be inflationary and lead to a run on the dollar if there were currency substitution on a massive scale. But it would require a credible alternative to the dollar.

According to Fields and Vernengo, the data do not provide an obvious scenario in which the euro would overtake the dollar as the main international currency. The reserve position of the dollar has not changed much, the use of the dollar in international trade transactions remains very high, and the dollar remains the leading transaction currency in the foreign exchange markets. Furthermore, European banks have been heavily exposed to the financial crisis, there has been a lack of coherent fiscal framework in the eurozone, and the European Central Bank has been unwilling to act as lender of last resort and expand effective demand at the regional level.

The essential feature of the key currency is that there is no possibility of default. The reason the dollar will remain the key currency is because the United States does not incur debt in other currencies, while the institutions that manage macroeconomic policy guarantee that a default in dollars cannot take place (and leading commodities are priced in dollars). This allows the United States to incur international debt without any reasonable limit.
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The Levy Institute Measure of Economic Well-Being, Great Britain, 1995 and 2005

SELÇUK EREN, THOMAS MASTERSON, EDWARD N. WOLFF, and AJIT ZACHARIAS

Working Paper No. 667, April 2011

Research Scholars Selçuk Eren and Thomas Masterson, and Senior Scholars Edward N. Wolff and Ajit Zacharias compare the Levy Institute Measure of Economic Well-Being (LIMEW) with two official measures of economic well-being in Great Britain. The authors find that the level and distribution of well-being in Great Britain differ considerably between the measures.

The unit of analysis for the LIMEW is the household. The measure is constructed as the sum of base income, income from wealth, net government expenditures (both cash and noncash transfers, and public consumption), and household production.

The basic sample for the 1995 and 2005 LIMEW estimates are the public-use files of the Family Resources Survey published by the Department for Work and Pensions of the National Centre for Social Research and the Office for National Statistics. The source data for household wealth are provided by the British Household Panel Survey published by the University of Essex. The source data for time spent on household production are taken from the 1995 Office of Population Censuses and Surveys Omnibus Survey and the 2000 United Kingdom Time Use Survey. The matching unit for the time-use match is the individual. Other data sources include the Public Expenditure Statistical Analyses published by HM Treasury and the Annual Abstract of Statistics published by the Office for National Statistics.

The two official measures of economic well-being in Great Britain are the Redistribution of Income (ROI) analysis from the Office for National Statistics and the Households Below Average Income (HBAI) annual report from the Department for Work and Pensions. The LIMEW includes additional types of public consumption, such as public transportation (in addition to education and housing), as well as the value of household production.

The LIMEW and official measures differ considerably in their assessment of economic well-being in Great Britain. The LIMEW suggests that the government played a greater role in promoting middle class well-being, and that the elderly are better off because of the advantages of wealth ownership. In addition, the LIMEW's lower Gini coefficient stems from the equalizing effects of public consumption, health expenditures, and household production. The authors also find that there was a notable decrease in the redistributive effect of net government expenditures between 1995 and 2005. Income from wealth in the LIMEW is almost three times the reported property income in the HBAI and ROI measures. In addition, base money income accounted for most growth in the official measures and only half the growth in the LIMEW, where more than one-quarter of the growth is explained by the increase in the value of household production. Overall economic inequality declined in the 1995–2005 period according to the LIMEW but increased according to the official measures.

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The Freedom Budget at 45: Functional Finance and Full Employment

MATHEW FORSTATER

Working Paper No. 668, May 2011

This year marks the 45th anniversary of the Freedom Budget—a policy program developed by A. Philip Randolph and Bayard Rustin in association with New Deal Keynesian economists that proposed full employment and a job guarantee. The main components were the government acting as an employer of last resort, and public works.

This paper by Research Associate Mathew Forstater proposes a "New Freedom Budget" for full employment. According to Forstater, a primary roadblock to true full employment policy is public perception of the cost and its impact on the government budget and national debt. He compares three paradigms for understanding government budget deficits and the national debt: the deficit hawk, deficit dove, and functional finance perspectives.

Hawks align themselves with the basic neoclassical view that deficits and debt are negative for the economy and society. They believe that the market economy has a built-in tendency toward full employment of resources, including labor, and that savings determine investment through variations in the interest rate (e.g., a loanable funds model). In their view, deficits cause inflation and high interest rates, and crowd out private spending.

The deficit dove perspective follows the basic Keynesian view of the operation of a macroeconomy. Unemployment and excess capacity are normal features of a modern capitalist economy, and investment determines savings through changes in income. One should examine the "full employment deficit" because much of the deficit is due to unemployment. Thus, the "true" deficit is the real value of the full employment deficit on the current account, net of government debt purchases and state and local transfers. Doves argue that the budget should be balanced over the business cycle rather than one year, debt does not burden future generations because it creates assets, and deficits do not cause high interest rates.

The functional finance perspective was originally formulated by Abba Lerner in 1943. According to this view, managing the government budget requires a Chartalist or state money system (i.e., a flexible exchange rate). The federal government is the monopoly issuer of the currency (e.g., the United States); taxation creates a demand for, and gives value to, an unbacked currency; the purpose of government bond sales is to drain excess reserves created by deficit spending (and maintain positive short-term, or overnight, interest rates); printing money independent of fiscal operations has no effect on the economy; deficits generate savings; and the national debt does not burden future generations.

Forstater determines that economies operating with a fiat currency should manage their budget according to the principles of functional finance. A public-service employment program based on functional finance could guarantee full employment, he says, and provide a framework for humanistic social policy.

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Race, Power, and the Subprime/Foreclosure Crisis: A Mesoanalysis

GARY A. DYMSKI, JESUS HERNANDEZ, and LISA MOHANTY
Working Paper No. 669, May 2011

This paper outlines the difference between two approaches used to explain the subprime/foreclosure crisis: the inclusion of race by many social scientists and the exclusion of race by most economists. The first overlooks market mechanisms; the second, the effects of market mechanisms on households and communities.

Gary A. Dymski, University of California, Riverside; Jesus Hernandez, University of California, Davis; and Lisa Mohanty, Trident University International, show how subprime lending arose from a coevolutionary process involving banking strategy, minority communities, and financial markets. They find that competition did not reduce the proportion of minority (exploitative) loans. They also find a strong link to racial inequality through the systemic market power of lenders. Such power will lead to a reversal of fortune in wealth accumulation that will take decades to undo, the authors say, and have substantial implications for gender inequality.

This paper attempts to recenter the political economy of the subprime crisis by identifying the missing links between racial inequality and market mechanisms; that is, focusing on the social construction of the institutional mechanisms used to create and distribute subprime loans, and on the mechanisms that govern foreclosure processes.

The authors show that minorities were systematically disadvantaged in mortgage markets for reasons unrelated to racial/ethnic differences in creditworthiness. The pervasive effects of racial inequality in multiple markets, combined with ineffective regulation, created incentives for banks to maximize short-term profits by pushing subprime lending in minority communities. High information costs led profit-maximizing banks to use race as a form of informational shorthand.

Economic analyses of the subprime crisis overlooked racial discrimination, redlining (the systematic denial of home mortgages to urban areas with high proportions of minority residents), and predatory lending. Their attention centered on the bad behavior of participants, inadequate government regulation of market relations, or unwanted government interference. They failed to identify racial inequality or exploitation as a cause of the subprime crisis because economists consider predatory racial behavior and the systematic vulnerability of loan applicants to be outside the boundaries of their analysis.

The authors outline several key points contributing to their analysis: (1) subprime loans in minority neighborhoods were already growing rapidly in the 1990s; (2) subprime lending continued to grow in "subprime zip codes" even as income levels declined in the 2002–05 period; (3) subprime lending accounted for 43 percent of the increase in homeownership by blacks and 33 percent of the growth in ownership within minority neighborhoods during the 1990s (a pattern that continued through

the 2007 subprime crisis); and (4) mortgage-payment pressures led to foreclosure problems in minority neighborhoods well before the housing bubble peaked in late 2006.
www.levyinstitute.org/pubs/wp_669.pdf

The Product Space: What Does It Say About the Opportunities for Growth and Structural Transformation of Sub-Saharan Africa?

ARNELYN ABDON and JESUS FELIPE
Working Paper No. 670, May 2011

Arnelyn Abdon, Asian Development Bank, Manila, Philippines, and Research Associate Jesus Felipe evaluate Sub-Saharan Africa (SSA) in the context of structural transformation ("product space"), and find that the majority of SSA countries are in a "low-product" trap that makes the process of transformation difficult. Exports are not sophisticated, and they are poorly connected in the product space.

The product space is a network representation of all products exported globally. It is based on two ideas: the ability of a country to export a new product depends on its ability to export similar products, and commodities requiring similar capabilities are more likely to be exported together. Products in the periphery are less sophisticated and have a lower income elasticity of demand for exports than those in the core (implying that products do not have the same consequences for economic development).

Since 1962, the number of products exported from SSA countries with revealed comparative advantage (RCA) has increased, but the increase represents almost exclusively "nearby" products in the garment sector and other peripheral products, rather than core products that are more sophisticated and connected. The export structure of resource-rich SSA countries barely changed, while the landlocked countries exported some new products in the periphery but not in the core. In contrast, coastal SSA countries, on aggregate, acquired RCA in a number of new nonperipheral products (e.g., the garments sector) and have successfully ventured into some core products. However, this is mainly attributed to South Africa.

Complexity is another measure of product sophistication. It is associated with the set of capabilities required by a product. The authors find that more than half of SSA exports (excluding South Africa) are among the least complex products. As a result, 29 of 38 SSA countries are in a "low-product" trap, and only two countries (Seychelles and Sierra Leone) are relatively well positioned.

The authors are adamant that governments must implement policies and provide public inputs that will incentivize the private sector to invest in new and more sophisticated activities, in order to jump-start and sustain growth. The real turning point will materialize when countries become less reliant on natural resource exports by upgrading and diversifying their export baskets.
www.levyinstitute.org/pubs/wp_670.pdf

Public Job-creation Programs: The Economic Benefits of Investing in Social Care: Case Studies in South Africa and the United States

RANIA ANTONOPOULOS and KIJONG KIM
Working Paper No. 671, May 2011

Senior Scholar Rania Antonopoulos and Research Scholar Kijong Kim analyze the employment and distribution effects of expanding the domain of social care services in South Africa and the United States. Using input-output analysis, social accounting matrices, and microsimulation techniques, the authors compare the effects of investments in either physical infrastructure or community-based social care. The results of the simulation suggest that we would get more bang for the buck, from the standpoint of employment, by investing in the care sector—all while aiding those least able to weather the current economic storms.

South Africa's Expanded Public Works Programme (EPWP) provides labor-intensive projects for unskilled, unemployed, poor individuals. This (public) program invests in three main sectors: physical infrastructure, the environment, and social services, which focuses on home- and community-based care, as well as early childhood development. The authors run a policy simulation in which the final demand for social care services in 2000 is increased by approximately 1 percent of GDP. The simulation shows that most of the direct unskilled jobs are allocated to ultrapoor households living in the ex-homelands (rural tribal regions) and that 95 percent of jobs are allocated to unskilled workers. The authors also find that an additional job

is created for every three jobs created by expanding social care, and that job creation for women is greater than that for men across both skilled and unskilled categories. By comparison, investing in infrastructure construction generates slightly more than half the number of (direct and indirect) EPWP jobs. The simulation also shows that spending on social care produces more GDP growth (0.8 percent) than that for infrastructure investment (0.68 percent).

Turning to the United States, the authors find that investing in the social care sector ($50 billion) generates slightly more than twice the number of jobs (1.2 million) than investing in the infrastructure-construction sector, and 8 of 10 new jobs are within the care sector. In addition, more than 90 percent of the jobs created in the social care sector go to women, while more than 80 percent of the jobs created in the construction sector go to men. Moreover, social care investment generates significantly more jobs for workers with less than a high school diploma.
www.levyinstitute.org/pubs/wp_671.pdf

Income Distribution in a Monetary Economy: A Ricardo-Keynes Synthesis

NAZIM KADRI EKINCI
Working Paper No. 672, May 2011

According to Nazim Kadri Ekinci, Dicle University, Diyarbakir, Turkey, the Kaldorian (Post Keynesian) approach to income distribution misses important aspects of both Ricardian and Keynesian theory. Moreover, all classical approaches to distribution theory neglect the monetary nature of capitalist economies.

The author's central proposition is that, in the absence of uncertainty, money and capital become indistinguishable and are perfect substitutes in a monetary economy, and no useful distinction can be drawn between profit and interest. Using one-sector and two-sector models, he illustrates how the amortization equation may be solved for the price level, given the money wage rate and the interest rate structure. The two-sector extension illustrates how the solution based on closing the circuit of fixed capital may be applied in general. Money as an investment fund is truly the "widow's cruse" of modern times, he says.

Capital as a fund can only exist as money, giving rise to two circuits: the direct circuit of money, and the circuit of money as fixed capital. If there is no uncertainty in closing the circuits, equilibrium results when there is nothing to be gained by shifting a dollar from the direct circuit to the other circuit. It follows that the imputation for fixed capital must be the capital recovery cost obtained from the direct circuit of money, adjusted for the normal rate of profit. Although the capital recovery cost is not the same across industries, the marginal efficiencies of all assets (adjusted for differences in normal profit rates) are equal, and there is no incentive to shift capital in or out of any sector.

When prices replenish (amortize) the cruse over a time period shorter than the useful life of the capital assets, the economy continues to grow, as the capital assets accumulate pure rent. What appears to be "profitable" in the case of older capital assets is in fact a reflection of their rent-earning potential, and the price of these assets is simply the present value of their rent earning potential. Moreover, as shown by John Maynard Keynes, money as an investment fund determines the rate at which the accumulated stock can be utilized through the multiplier. This is a fragile process, since money can be hoarded to the extent that the cruse is not replenished in full, leading to slower economic growth.
www.levyinstitute.org/pubs/wp_672.pdf

Effective Demand in the Recent Evolution of the US Economy

JULIO LÓPEZ-GALLARDO and LUIS REYES-ORTIZ
Working Paper No. 673, June 2011

The dominant view among mainstream economists explaining the evolution of capitalist economies is based on so-called "dynamic stochastic general equilibrium models," which refute the claim that monetary policy has a lasting influence on output and employment. The recent crisis, however, has compelled authorities to sustain demand with expansionary policies, including deficit spending. Thus, there has been a return to evaluating the role of effective demand and the teachings of John Maynard Keynes and Michal Kalecki.

Using the principle of effective demand, Julio López-Gallardo, Universidad Nacional Autónoma de México, and Luis

Reyes-Ortiz, Université Paris 1, Panthéon-Sorbonne, study the evolution of the US economy before the crisis. Using econometric procedures, they test the significance of money and the interest rate, as well as the opinions of Keynes and Kalecki. They also test the role of fiscal policy. The authors find that monetary conditions affect demand and output in both the short and long runs, thus contradicting the conventional view.

The findings support Keynes's hypotheses that larger credit availability has a positive impact on demand, and that higher interest rates tend to depress demand. They also confirm Kalecki's hypotheses that government expenditure financed via taxes on profits has a positive effect on demand and output, and that a shift from profits to wages expands demand. The findings corroborate that government expenditure raises effective demand, and support Kalecki's hypothesis about the impact of taxing profits in order to finance that expenditure. The shift from wages to profits in the US economy (a "wage-led" regime) has caused a short-term fall in effective demand, and has also discouraged demand and output in the long run. Thus, the main intuitions of Keynes and Kalecki were essentially correct.

Using a vector auto regression (VAR) specification and system-based cointegration methods, the authors estimate an error correction model and a cointegrated structural VAR to carry out an impulse-response analysis. The quarterly data sample is for the period 1980–2008.

The results suggest that the main channels through which Keynes thought monetary developments affect the macroeconomy have played a significant role in the recent evolution of the US economy. The availability of loans, combined with low interest rates, explains much of the growth in the United States prior to the crisis. The results also confirm the argument that growing household indebtedness compensated for the negative effects of the economy's shift from wages to profits, and contributed to sustaining effective demand.

www.levyinstitute.org/pubs/wp_673.pdf

Institutional Prerequisites of Financial Fragility within Minsky's Financial Instability Hypothesis: A Proposal in Terms of "Institutional Fragility"

CHRISTINE SINAPI

Working Paper No. 674, July 2011

Institutional mechanisms play a key role in the works of Hyman P. Minsky; in particular, his financial instability hypothesis (FIH). According to Christine Sinapi, Burgundy School of Business, Dijon, France, the institutional foundations of the FIH are inadequately addressed in the literature. She outlines three main limitations: (1) the absence of a clear definition of institutions; (2) the absence of a global approach to the institutional mechanisms underlying the FIH; and (3) the intuitive character of Minsky's institutional framework.

Sinapi proposes a definition of institutional forms of financial systems consistent with the Minskyan approach, summarizes Minsky's main institutional mechanisms and integrates them within the endogenous dynamic described by the FIH, and interprets the results in light of the relevance and modernity of his intuitions. She finds that Minsky's institutional approach is grounded in the works of the American Institutionalists (in particular, John R. Commons). She also finds that the institutional processes driving the FIH in the presence of "institutional fragility" initiate the endogenous clockwork that leads to crisis. Another finding is that the institutional mechanisms intuited by Minsky are partially justified in recent discussions of asymmetric information, cognitive bias, and procyclical risk taking.

The study emphasizes the relevance and modernity of the FIH, and provides a robust theoretical framework for the FIH—including its prediction that financial fragility increases over protracted periods of stability and growth. Moreover, the study suggests complementary ways to examine the causes of the current international financial crisis, and provides the groundwork for analyzing international financial governance.

The author endeavors to define the role of institutions within the FIH in order to establish a clear framework. One function relates to cure, which involves public intervention during a crisis in the form of a lender of last resort (Big Bank) and the socialization of investment (Big Government). The aim is to restart the economy and influence agent expectations in order to halt self-sustaining, debt-deflation mechanisms. Another function is preventive, whereby institutions act on the destabilizing

forces of financial systems (i.e., the process of financial fragility underlying the FIH). The endogenous character of the renewal of crisis episodes appears to depend on the actions of the institutional system in place, observes Sinapi.

Two complementary processes of institutions are behind financial fragility: the internal dynamics of capitalist economies, and the system of interventions and regulations. The first process corresponds to "spontaneous" mechanisms and to the action of informal institutional forms. The combination of risk incentives and the relaxation of prudential usage in good times is an inherent (endogenous) force of the capitalist system. The second corresponds to "intentional" mechanisms and to the action of formal institutional forms. An institutional system can be effective only if it is constantly adjusting to the development of the financial system and innovation.

www.levyinstitute.org/pubs/wp_674.pdf

The Rise and Fall of Export-led Growth

THOMAS I. PALLEY

Working Paper No. 675, July 2011

This Working Paper formed the basis for Public Policy Brief no. 119 (see pp. 4–5)

www.levyinstitute.org/pubs/wp_675.pdf

Quality of Match for Statistical Matches Used in the 1989 and 2000 LIMEW Estimates for France

THOMAS MASTERSON

Working Paper No. 676, July 2011

This paper by Research Scholar Thomas Masterson describes the construction of synthetic datasets to estimate the LIMEW for France. Since no single dataset includes all the required data, Masterson creates a synthetic data file by combining various sources for information about demographics, income, transfers, taxes, time use, and wealth. He finds that the quality of his overall statistical matching is good. Therefore, the LIMEW should be able to adequately portray the distribution of household production and wealth, given the data limitations.

The base dataset is the Enquête Budget de Famille, which contains good information on demographics, income, transfers, and taxes for a regionally representative sample of French households. Wealth data for 1989 come from the 1992 Enquête sur les Actifs Financiers, while that for 2000 comes from the 2004 Enquête Patrimoine. Time-use data come from the 1985 and 1999 Enquête Emploi du Temps (EDT). All of these datasets were carried out by the Institute National de la Statistique et des Études Économique. Missing values were replaced using the method of multiple imputation with chained equations.

The paper details four statistical matches: wealth and time-use matches for both 1989 and 2000. Masterson describes the source datasets and compares their demographic characteristics prior to reviewing the quality of each statistical match. In order to perform a successful match, the candidate datasets must be well aligned in the strata variables used in the match procedure. In terms of the wealth match, the strata variables are homeownership, age of the household head, educational achievement of the household head, family type, and household income. The strata variables for the time-use match are sex, parental status, employment status, marital status, and spouse's employment status. While the wealth-matching unit is the household, the time-use-matching unit is the individual.

This work was carried out for a project supported by the Alfred P. Sloan Foundation to produce international comparisons of economic well-being.

www.levyinstitute.org/pubs/wp_676.pdf

The Global Crisis and the Remedial Actions: A Nonmainstream Perspective

SUNANDA SEN

Working Paper No. 677, July 2011

The mainstream perspective on the meltdown of the global economy is based on the theory and policy prescriptions of the efficient market hypothesis. Research Associate Sunanda Sen contests this perspective by focusing on market uncertainty. She finds that policies to mend the financial system have not addressed two major issues: speculative investments in the market for financial assets, and higher returns on such investments relative to those backed by real assets.

A boom in the financial sector creates little opportunity for expansion in the real economy, where growth tends to be

demand constrained and marked by underconsumption. Thus, higher growth rates in the real sector require an expansionary strategy of public policy that includes employment creation. In addition, there is a need to curb short-term speculation and contain volatility in the financial markets.

The disruptions in the financial sector and underperformance in the real sector are related to the framework of neoliberal growth models. The efficient market hypothesis postulates full information and rational agents in the capital markets, so the mainstream literature dispenses with the notion of uncertainty. The author offers an alternative interpretation of the deepening slump in real activities based on the theoretical foundations of the post-Keynesian structuralist framework (stagnation due to underconsumption) and Hyman P. Minsky's financial instability hypothesis.

Sen outlines the structural transformations in the global economy that have led to chronic underconsumption (e.g., deregulation, securitization, and leverage in the financial sector). She finds that the global economy was subject to a lopsided pattern of expansion, where growth in the real sector fell behind unprecedented growth in the financial sector. The efficient market paradigm failed to deliver growth as promised.

Responses to mitigate the crisis included a series of regulatory proposals. Regulators of the Dodd-Frank Wall Street Reform and Consumer Protection Act, however, completely ignored Minsky's insight into the need to shift investment from capital-intensive production to job creation, which ensures both stability and an equitable income distribution. Meanwhile, there was a government policy shift in terms of an expansionary strategy where monetary policy (e.g., tax hikes and expenditure cuts in Europe) is favored over fiscal deficits. Efforts to rejuvenate ailing economies had rather limited results because they did not remedy the structural weaknesses of the system—shortsightedness and speculation in the financial markets.

www.levyinstitute.org/pubs/wp_677.pdf

What Ended the Great Depression? Reevaluating the Role of Fiscal Policy

NATHAN PERRY and MATÍAS VERNENGO

Working Paper No. 678, July 2011

Conventional wisdom suggests that the Great Depression was caused by restrictive monetary and fiscal policies. According to Christina D. Romer (1992), monetary expansion based on gold inflows (associated with political instability in Europe) was central to economic recovery from the Depression, while fiscal policy and the employment-creation policies of the New Deal were secondary.

Nathan Perry, Mesa State College, and Matías Vernengo, University of Utah, analyze Romer's evidence and determine that the effects of the New Deal were misrepresented in the literature, and that fiscal policy was central to economic recovery. Incorrectly emphasizing the effects of monetary policy promotes the anti–New Deal agenda of the conservative movement, the authors say.

Based on Romer's fiscal multiplier analysis, fiscal policy was insufficient to bring the US economy back from the brink of disaster. The authors believe that any results derived from Romer's formula to assess the relative influence of monetary and fiscal policies on the level of activity (changes in output) are flawed. Her calculations presume that the money supply caused changes in the rate of interest and these changes, in turn, led to an increase in investment and consumption. The money supply, however, is only one influence on the rate of interest. Two other important variables are the discount rate (determined by the Fed) and open market operations, including quantitative easing. Hence, Romer's equation tends to confound the effects of money on income. Besides the conceptual issues in Romer's multipliers, the authors took issue with the calculation of "narrow" multipliers derived for different time periods, since these do not represent "broad" multipliers or the impact of government spending and monetary policy during the entire period of the Depression and World War II.

The authors proceed to derive a simple supermultiplier measure in order to quantify the direct impact of the government and external sectors—two main elements of autonomous spending during the recovery. They also apply a structural vector autoregression model to capture the endogeneity between government spending and GDP, and to measure the fiscal and

foreign trade multipliers. In addition, a basic instrumental variable approach is used to calculate the fiscal multiplier, where defense spending represents an instrumental variable of government spending.

Perry and Vernengo find that the fiscal multipliers are larger than assumed by conventional wisdom, and that monetary policy is a subsidiary policy needed to sustain the fiscal expansion. Moreover, the effectiveness of fiscal expansionism is confirmed when estimating the impact of the federal government's fiscal policy on employment, including the job creation programs of the New Deal.
www.levyinstitute.org/pubs/wp_678.pdf

The Levy Institute Measure of Economic Well-Being, France, 1989 and 2000

THOMAS MASTERSON, AJIT ZACHARIAS, SELÇUK EREN, and EDWARD N. WOLFF
Working Paper No. 679, July 2011

Research Scholars Thomas Masterson and Selçuk Eren, and Senior Scholars Ajit Zacharias and Edward N. Wolff, construct and compare the LIMEW and disposable income (DI) measures for France in terms of the overall population, as well as several subpopulation and income groups. They find that the LIMEW reveals a starkly different picture of the change in inequality over the 1989–2000 period—that is, no change, whereas conventional analyses conclude that inequality has declined. This result is crucially dependent on the fact that DI does not adequately reflect the advantages of wealth ownership.

The authors also find sharp differences in terms of the redistributive effects of government social expenditures and taxation. On balance, these effects have an inequality-reducing effect in DI but an inequality-enhancing effect in LIMEW. The main reason is the lower redistributive impact of taxes in the LIMEW measure, which includes household production and nonhome wealth components that are not subject to taxation. In contrast to the standard DI measure, the LIMEW indicates that the government played a smaller role in promoting middle-class well-being (i.e., the third quintile). Moreover, the economic well-being of families headed by single females worsened much more, and that of elderly households relative to nonelderly households improved more, than indicated by DI. In addition, the economic well-being of households headed by college graduates did not outstrip that of less-educated household heads.

For the overall French population, the major difference between the DI and LIMEW measures consists of the relative contributions to growth in terms of income from wealth and base money income. The latter component is the principle driver of growth in DI, while both components play major roles in the LIMEW. The deterioration in the relative economic well-being of single females between 1989 and 2000 is driven by their disadvantage in terms of income from wealth and the unfavorable shift in government transfers. The improvement in the well-being of the elderly is mostly a result of expanding government transfers and income from wealth that offset the gap in base income. The gaps in base income, income from wealth, and household production between college graduates and those with less education are offset, to some extent, by net government expenditures (after taxes).Using the LIMEW and DI measures, the gain in economic well-being between 1989 and 2000 for the average French household is 15 percent and 20 percent, respectively.

France is characterized as a country that experienced declining inequality over the 1990s. This view is based on conventional analyses that neglect the role of wealth in shaping economic inequality. However, the share of income from wealth in overall well-being increased sharply over the 1989–2000 period, especially for those on the top rungs of the LIMEW distribution, and this offset the lower contributions of base income and net government expenditures. The LIMEW takes wealth into account, and it shows practically no change in inequality.
www.levyinstitute.org/pubs/wp_679.pdf

The Levy Institute Measure of Economic Well-Being: Estimates for Canada, 1999 and 2005

ANDREW SHARPE, ALEXANDER MURRAY, BENJAMIN EVANS, and ELSPETH HAZELL
Working Paper No. 680, July 2011

This report from the Centre for the Study of Living Standards estimates the LIMEW for a representative sample of Canadian households in 1999 and 2005. The authors strive to make their analysis compatible with the 2000 and 2004 LIMEW estimates for the United States as presented by Levy scholars in Working

Paper no. 556 (2009). They find only modest growth in the average LIMEW among Canadian households because substantial growth in the base income and income from wealth components was offset by a decline in household production. They also find that the median LIMEW for Canada was approximately 9 percent lower than that for the United States, and that inequality increased slightly over the period.

The authors note that economists have not reached a consensus for valuing household production, so they compromise by using a modified general-replacement-cost approach, as outlined in Working Paper no. 556. They also note an interest in the distributional effect of the Canadian national health care system, given that its structure is different from the US system. In order to make Canada's LIMEW compatible with the US LIMEW, a large portion of government expenditure on health is included in government noncash transfers.

The mean value of the LIMEW is shown to increase 1.08 percent per year during the 1999–2005 period. The benefits of government transfers and public consumption were largely offset by taxes. Moreover, significant growth in base income and income from nonhome wealth was offset by a decline in household production, which accounts for part of the US advantage in economic well-being.

Additional findings include a shift from larger to smaller households, higher growth rates in the top two quintiles, and a greater share of income from wealth relative to total LIMEW at the top of the distribution. In contrast, net government expenditure represents 18–19 percent of total LIMEW in the bottom quintile, while the top quintile is a net loser. This suggests that the fiscal system, on balance, is progressive. The inequality measures show that economic well-being is more equally distributed in Canada than in the United States.

Although the tax and transfer system closes the gap, the elderly remain worse off than every other age group. This result highlights the importance of using a comprehensive measure, and of using government transfers to level economic well-being across groups. A counterintuitive result is that household production contributes a larger share of total well-being at the top of the LIMEW distribution than at the bottom.

It is clear from the alternative LIMEW estimates that more standard measures of income such as base income and aftertax income substantially underestimate the growth in inequality between 1999 and 2005. In addition, alternative methods of valuing household production demonstrate not only lower inequality relative to the standard LIMEW and other income measures, but also more growth in inequality over the time period. *www.levyinstitute.org/pubs/wp_680.pdf*

INSTITUTE NEWS

20th Annual Hyman P. Minsky Conference

Financial Reform and the Real Economy

April 13–15, 2011

Ford Foundation, New York City

A Conference Organized by the Levy Economics Institute of Bard College with Support from the Ford Foundation

The 20th Annual Minsky Conference—with 300 participants, the Institute's largest conference to date—addressed the ongoing effects of the global financial crisis on the real economy, and examined proposed and recently enacted policy responses. Moreover, the European, Latin American, and Asian responses to the crisis were compared, and proposals for reforming the international financial architecture were reviewed. Central bank exit strategies, both national and international, were also considered. In addition to Federal Reserve Bank Presidents Charles Evans and Charles Plosser, Gary Gensler of the CFTC, and former PIMCO managing director Paul McCulley, keynote speakers included Sheila Bair, then head of the FDIC; the FCIC's Phil Angelides; Paul Tucker, Bank of England; Argentine central bank president Mercedes Marco Del Pont; Asia specialist Stephen Roach, Morgan Stanley; and Brookings scholar Martin Mayer.

For more information, visit www.levyinstitute.org.

The Wynne Godley Memorial Conference

Contributions in Stock-flow Modeling

May 25–26, 2011

Levy Economics Institute of Bard College

Blithewood, Annandale-on-Hudson, N.Y.

The late Levy Distinguished Scholar Wynne Godley's work focused on the strategic prospects for the US, UK, and world economies, and the use of accounting macroeconomic models to reveal structural imbalances. This conference provided scholars profoundly influenced by his work the opportunity to celebrate his contributions to the field of economics. Topics included fiscal policy and stock-flow consistent models; unsustainable processes and the role of the dollar in fostering global imbalances; stability and convergence programs; trade and current account imbalances and international currencies; financial integration, intrazone credit, and stabilization in a monetary union; debt-deflation traps within small open economies; and the UK and US private expenditure function. A full list of participants is available at www.levyinstitute.org.

The Hyman P. Minsky Summer Seminar

June 18–26, 2011

Levy Economics Institute of Bard College

Blithewood, Annandale-on-Hudson, N.Y.

The Levy Institute held its second annual Minsky Summer Seminar in June, with 48 students from 14 countries attending. Organized by the Institute with support from the Ford Foundation, the Seminar provided a rigorous discussion of both the theoretical and applied aspects of Minsky's economics, with an examination of meaningful prescriptive policies relevant to the current economic and financial crisis. For more information, visit www.levyinstitute.org.

New Research Associate

Jesus Felipe has joined the Levy Institute as a research associate working primarily in the State of the US and World Economies program. The lead economist in the Central and West Asia department of the Asian Development Bank, Manila, Philippines, Felipe works on issues relating to long-run growth in Asia, productivity, and technological progress. He has held academic positions at the Hong Kong University of Science and Technology and the Georgia Institute of Technology, Atlanta, and is a research associate at the Cambridge Centre for Economic & Public Policy and the Center for Full Employment and Price Stability, among other institutions. Felipe is co-author and co-editor of *Labor Markets in Asia: Issues and Perspectives* (Palgrave Macmillan, 2006), named a noteworthy book in industrial relations and labor economics by Princeton University. He is the author of *Inclusive Growth, Full Employment, and Structural Change: Implications and Policies for Developing Asia* (Anthem Press, 2009) and the forthcoming *Aggregate Production Function and the Measurement of Technical Change: A Critique and Evaluation*. His work has also appeared in the *Cambridge Journal of Economics*, *Journal of Comparative Economics*, *Eastern Economic Journal*, *Journal of Income Distribution*, *International Review of Applied Economics*, *Journal of Development Studies*, and *Oxford Development Studies*. He also serves on the editorial board of the journal *Metroeconomica*.

Felipe holds an undergraduate degree in economics from the Universidad Autonoma de Madrid, master's degrees from the International University of Japan and the University of Pennsylvania, and a Ph.D. in regional studies from UPenn.

New Senior Editor and Policy Fellow

Michael Stephens has joined the Institute as senior editor and policy fellow, with primary responsibility for the *Report* and the Institute's blog, Multiplier Effect (www.multiplier-effect.org).

Stephens holds a BA from McGill University and will receive his Ph.D. from the University of Chicago. His dissertation, titled "The Limits of Work," is an examination of arguments surrounding policies addressing work-life balance. Most recently, he was a consultant for Georgetown University's "Workplace Flexibility 2010" project, which concerns the creation of a national social insurance program supporting time off for health and caregiving purposes.

PUBLICATIONS AND PRESENTATIONS

Publications and Presentations by Levy Institute Scholars

PHILIP ARESTIS *Senior Scholar*

Publications: "European Integration and the Euro Project" (with M. C. Sawyer), in J. Michie, ed., *The Handbook of Globalisation*, 2nd ed., Edward Elgar Publishing, 2011; "Keynesian Economics and the New Consensus in Macroeconomics" and "European Economic and Monetary Union Policies from a Keynesian Perspective," in E. Hein and E. Stockhammer, eds., *A Modern Guide to Keynesian Macroeconomics and Economic Policies*, Edward Elgar Publishing; *New Economics as Mainstream Economics* (edited with M. C. Sawyer), Palgrave Macmillan; *The Financial Crisis: Origins and Implications* (edited with R. Sobreira and J. L. Oreiro), Palgrave Macmillan; "A New Paradigm for Macroeconomic Policy" (with M. C. Sawyer), *International Journal of Public Policy*, Special Issue on Economic Policy: In Search of an Alternative Paradigm, P. Arestis and O. Onaran, Guest Editors, Vol. 7, Nos. 1/2/3 (2011); "Inflation Targeting in Brazil" (with L. Fernando de Paula and F. Ferrari-Filho), *International Review of Applied Economics*, Vol. 25, No. 2 (March); "The Design Faults of the Economic and Monetary Union" (with M. C. Sawyer), *Journal of Contemporary European Studies*, Vol. 19, No. 1 (March); "The Persistence of Inequality?" (with R. Martin and P. Tyler) and "Inequality Adjusted Growth Rates in Latin America" (with A. Angeriz and S. P. Chakravarty), *Cambridge Journal of Regions, Economy and Society*, Vol. 4, No. 1 (March); "Moral Hazard Requires Targeting Wealth" (with E. Karakitsos), Brazilian Keynesian Association, Short Papers, March 11; "The Economic Policies of the Political Economy of the Australian Patriot and Cambridge Economist," *Intervention: European Journal of Economics and Economic Policies*, Vol. 8, No. 1 (Spring); "Fiscal Policy is Still an Effective Instrument of Macroeconomic Policy," *Panoeconomicus*, Vol. 58, No. 2 (June); "Time to Say Farewell to the Euro?" (with M. C. Sawyer), *WSI Mitteilungen*, Vol. 64, No. 6 (June).

Presentations: "The EMU and Euro Future," conference on "Competitiveness of the Cyprus Economy after Adopting the Euro," Cyprus Labour Institute (INEK-PEO), Nicosia, Cyprus, March 29–30, 2011; interview regarding the future of the euro, Cypriot state radio and television (RIK) and Sigma TV, Cyprus, March 30; "The 'New Economics' and Policies for Financial Stability" (with M. C. Sawyer), conference on "Economic Policies of the New Thinking in Economics," St Catharine's College, Cambridge, England, April 14; "New Consensus Macroeconomics: A Critical Assessment," "Distinguished Lectures" series, Centre for Planning and Economic Research (KEPE), Athens, Greece, May 5; "Estimating Monetary Policy Preferences of the ECB" (with M. Karoglou and K. Mouratidis), 15th Annual Conference of the Department of Economics, University of Crete, Greece, May 26–28; "New Consensus Macroeconomics: A Critical Assessment," staff seminar, Economics Division, Nottingham Trent University, England, June 8; "Moving from Inflation Targeting to Incomes Policy" (with M. C. Sawyer) and "Identity Economics Meets Financialisation: Gender and Race Stratification in the US Labour Market" (with A. Charles and G. Fontana), "Conference in Honour of G. C. Harcourt: The Future of Capitalism," Robinson College, Cambridge, England, June 25–26; "Modelling Accumulation: An Empirical Application of the Acceleration Principle Under Uncertainty" (with O. Dejuán and A. R Conzález), "Keynesian Economics and the New Consensus Macroeconomics," "The US Dimension of the Euro Area Debt Crisis" (with E. Karakitsos), and "Can the Euro Survive after the European Crisis? (with M. C. Sawyer), 8th International Conference on Developments in Economic Theory and Policy, Bilbao, Spain, June 29–July 1.

JAMES K. GALBRAITH *Senior Scholar*

Publications: "Early Retirement as a Fix for Unemployment," *The American Prospect*, February 17, 2011; "Why Not Keynes?" *The American Conservative*, June 8; "Hawk Nation: A Guide to the Catastrophic Debt Ceiling Debate," *The Huffington Post*, July 7; "Unless It's Reformed, Europe's Project Is Doomed," *Deutsche Welle*, July 8.

Presentations: "The Final Death and Next Life of Maynard Keynes," 5th "Dijon" Post-Keynesian Conference, Copenhagen, Denmark, May 13, 2011; "Is There a European Crisis," conference on "Challenges of Europe: Growth and Competitiveness—Reversing the Trends," organized by the University of Split Faculty of Economics, Bol, Croatia, May 26.

JAN KREGEL *Senior Scholar and Program Director*

Publications: "Sraffa, Keynes e la scuola anglo-italiana di Cambridge: Quel flusso continuo e fecondo," *L'Indice*, No. 2 (2011); "Uscire dalla crisi finanziaria statunitense: La politica domina l'economia nella Nuova Economia Politica," *Moneta e Credito*, Vol. 64, No. 253; "Resolving the US Financial Crisis: Politics Dominates Economics in the New Political Economy," *PSL Quarterly Review*, Vol. 64, No. 256 (March); "Evolution versus Equilibrium: Remarks upon Receipt of the Veblen-Commons Award," *Journal of Economic Issues*, Vol. 45, No. 2 (June).

Presentations: "A Schumpeter/Evolutionary Economics?" Building Bridges: Keynes-Minsky/Macrofinance Meeting, Ford Foundation, New York, February 3, 2011; "Homogeneity and Complexity in Economic Theory," Seminar in Economic Methodology, New School University, New York, February 24; "Was Keynes's Monetary Policy, *à Outrance* in the *Treatise*, a Forerunnner of ZIRP and QE? Did He Change His Mind in the *General Theory*?" 7th International Keynes Conference (IKCS), "Whither the Capitalistic World? Dialogue in 'Keynes's Spirits,'" Sophia University, Tokyo, Japan, March 1–3; "The Multicurrency System, including Internationalization of the Renminbi," conference on "Reforming the Global Monetary System," School of Finance, Central University of Finance and Economics, Beijing, China, March 18–19; "Putting It Together: Financial Institutions, Innovation, and Development in Brazil and India," conference on "Financial Institutions for Innovation and Development: The Cases of Brazil and India," organized by the Multidisciplinary Institute for Development and Strategies (MINDS), Rio de Janeiro, Brazil, March 22–23; "How Did Financial Regulation Influence Brazil's Response to the 2008 Financial Crisis?" workshop on "Financial Stability and Financial Governance in Brazil—Assessing the Landscape and Drawing Policy Implications," Structuralist Development Macroeconomics Center, The São Paulo School of Economics at the Getulio Vargas Foundation, São Paulo, Brazil, March 24–25; "Implications of the Single Currency on Sovereign Risk," conference on "European Financial Systems: In and Out of the Crisis," Faculty of Economics, University of Siena, Italy, April 1–2; "Regulaciónes financieras y macroeconomía en América Latina," seminar organized by CEDES, CEFID-AR, and CCC, Buenos Aires, Argentina, May 13; "How to Be More Effective in Communicating the Importance of Financial Issues and Concepts to Non-experts," conference on "Financial Liberalization and Global Governance: The Role of International Entities," organized by IBASE and the Ford Foundation, New York, May 17–18; "Diversity and Uniformity in Economic Theory as an Explanation of the Recent Economic Crisis," J. Fagg Foster Memorial Lecture, University of Denver, Colo., May 20; "Regulation of Proprietary Derivatives Trading," conference on "Where to Direct Proposals and Action to Make Financial Reforms More Effective," Paolo Sylos Labini Foundation, Rome, Italy, June 1–2; "Economic and Political Subsidiarity," roundtable on "Rethinking Governance after the Global Economic Crisis," International Association of Schools and Institutes of Administration Annual Conference, Rome, June 15; "The Case for Global Collective Action in Financial Regulation," workshop on "A Global Architecture for Effective Financial Regulation," Global Economic Governance Programme, University College, Oxford, England, June 30.

DIMITRI B. PAPADIMITRIOU *President*

Publications: "The International Economic Crisis: The U.S. and Its International Rivals," in A. Vlachou, N. Theocarakis, and D. Milonakis, eds., *Economic Crisis and Greece*, Gutenberg, 2011; "To Restore Jobs, U.S. Has to Ramp Up Exports," *Los Angeles Times*, May 13; "Diagnosing New Inflation Symptoms," *New Geography*, May 26.

Presentations: Speaker, workshop on "Towards Harmonization of Time Use Surveys at the Global Level with Special Reference to Developing Countries," organized by CFDA/UNIFEM, New Delhi, India, April 6–8, 2011; interview regarding California's weak job growth and whether it may be holding back the overall US recovery with Chris Palmeri, *Bloomberg News*, April 12; interview regarding the market's estimates around the FOMC meeting with Ivan David Ryngelblum, Agência Leia, April 20; interview regarding the state of the Greek economy, policies of the current administration, and EU macroeconomics with C. J. Polychroniou, *Episilon (Eleftherotypia Sunday Magazine)*, May 8; interview regarding the US unemployment rate with Marina Trombin, Agência Leia, May 30; interview regarding *Will the Recovery Continue? Four Fragile Markets, Four Years Later* (Levy Institute Public Policy Brief no. 118) with Moe Ansari, *Market Wrap*, June 6; interview regarding the US economic recovery with Wanger Arrais, Agência Leia, June 13; interview regarding Minsky and the role of the economist in society

with Dan Monaco, *The Straddler*, June 25; interview with Jessica King regarding the controversy surrounding negotiations on the US debt ceiling, *Financial Times*, July 6; interview with Andy Robinson regarding the eurozone crisis, *La Vanguardia*, July 17; speaker, conference on "From the Breakdown of the Bretton Woods System to a New Era of Macro Prudential Oversight?" organized by the Reinventing Bretton Woods Committee and the Central Reserve Bank of Peru (BCRP), Cusco, Peru, July 18–19; interview regarding the US economic recovery and potential changes in the Fed interest rate with Marília Ávila, Agência Leia, August 5; interview regarding the spreading debt crisis in the eurozone and China's reaction to the shakeup in global markets with Mike Wereschagin, *Pittsburgh Tribune-Review*, August 11.

EDWARD N. WOLFF *Senior Scholar*

Publications: "Recent Trends in Household Wealth in the U.S.: Rising Debt and the Middle Class Squeeze" and "The Distribution of Wealth in the United States from 1983 to 2004: Inequality and Polarization" (with C. D'Ambrosio and D. Fiaschi), in J. M. Gonzales, ed., *Economics of Wealth in the 21st Century*, Nova Science Publishers, 2011; "Level and Distribution of Global Household Wealth" (with J. Davies, S. Sandström, and A. Shorrocks), *The Economic Journal*, Vol. 121, No. 551 (March).
Presentation: "US 2010 Conference: America after the First Decade of the New Century," "The Asset Price Meltdown and the Wealth of the Middle Class," Russell Sage Foundation, New York, May 12–13.

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