



# Summary

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The Levy Economics Institute of Bard College, founded in 1986, is a nonprofit, nonpartisan research organization devoted to public service. Through scholarship and economic research it generates viable, effective public policy responses to important economic issues that profoundly affect the quality of life in the United States and abroad.

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

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## LETTER FROM THE PRESIDENT

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### To our readers:

This issue begins with the 18th Annual Hyman P. Minsky Conference, under the State of the U.S. and World Economies program. The conference, supported by the Ford Foundation and held at their New York City headquarters in April, focused on meeting the challenges of financial crisis, and included current economic forecasts, an analysis of macro policy proposals by the Obama administration, and suggestions for the institutional shape of the future financial system.

In a strategic analysis by Research Scholar Greg Hannsgen and me, we outline how increased deficits and their impact on private sector balance sheets will help stabilize the U.S. economy. In a working paper, Marshall Auerback maintains that the role of the state needs to be reemphasized in order to save the global economy. In another working paper, Research Associate Claudio H. Dos Santos and Antonio Carlos Macedo e Silva illustrate how “Minskyan crises” can be evaluated within small stock flow–consistent constructs. In a third working paper, Research Scholar Gennaro Zezza uses the Levy Institute’s macroeconomic model of financial balances to demonstrate that government expenditures should play a role in sustaining aggregate demand.

In a strategic analysis under the Monetary Policy and Financial Structure program, Senior Scholar James K. Galbraith suggests measures to counter the fact that credit cannot flow when there are no creditworthy borrowers or profitable projects. In a public policy brief, Senior Scholar Jan Kregel finds an absence of New Deal measures in the current government rescue packages. In four policy notes, Senior Scholar Philip Arestis and Elias Karakitsos recommend that central banks target the net wealth of the personal sector; Karakitsos finds that modifying the “good-bank” model would ensure economic recovery; Jan Toporowski suggests lending to foreign governments in the event of lending withdrawals by the private sector; and Kregel focuses on the need to reform the international financial system. Two working papers by Kregel consider matters relating to regulating the U.S. financial system and managing the impact of volatility in international capital markets.

Under the Distribution of Income and Wealth program, a special report and related working paper by Senior Scholar

Ajit Zacharias and Research Scholars Thomas Masterson and Kijong Kim assess the American Recovery and Reinvestment Act, and find need for a comprehensive employment strategy that goes well beyond the current legislation. According to a LIMEW report by Zacharias, Masterson, and Senior Scholar Edward N. Wolff, U.S. inequality was higher in 2004 than in 1959. In a working paper, Zacharias and Vamsi Vakulabharanam analyze the relationship between wealth inequality and caste divisions in India.

In a public policy brief under the Gender Equality and the Economy program, Research Scholar Rania Antonopoulos projects the macroeconomic consequences of scaling up South Africa’s Expanded Public Works Programme. In a working paper, she encourages countries to engage in pro-poor, gender-aware macroeconomic strategies such as the state’s role as employer of last resort (ELR). In a second working paper, Antonopoulos and Research Analyst Taun Toay examine the macro implications of HIV/AIDS on women’s time-tax burdens.

The Employment Policy and Labor Markets program begins with an international conference on employment guarantee policies that was held in June in collaboration with the United Nations Development Programme. In two policy notes, Martin Shubik warns against the ad hoc emergency approach to financial crisis and proposes a permanent Federal Employment Reserve Authority as a much needed buffer. In a working paper, Sergio Destefanis and Giuseppe Mastromatteo find that coordinated bargaining in the OECD enhances labor market performance. In another working paper, Senior Scholar L. Randall Wray outlines the social and economic importance of full employment, and advocates a government ELR program.

Under the Immigration, Ethnicity, and Social Structure program, Research Associates Sanjaya DeSilva and Yuval Elmelech study the spatial determinants of racial and ethnic differences in homeownership.

Under the Economic Policy for the 21st Century program, a policy note by Shubik proposes a prize for finding the most egregious loophole in new legislation. In two working papers, Giuseppe Fontana concludes that fiscal policy could be relevant to the New Consensus Macroeconomic model, while Arestis is critical of the model from a Keynesian perspective.

As always, I welcome your comments and suggestions.

Dimitri B. Papadimitriou, *President*

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

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### 18th Annual Hyman P. Minsky Conference Meeting the Challenges of Financial Crisis

The Levy Economics Institute, with support from the Ford Foundation, held its annual Hyman P. Minsky conference at the Ford Foundation headquarters in New York City on April 16–17. This year’s conference focused on current conditions and forecasts; macro policy proposals by the Obama administration and others; the rehabilitation of mortgage financing; financial market reregulation; proposals to limit foreclosures and modify servicing agreements; regulation of alternative financial products; the institutional shape of the future financial system; and international responses to the crisis.

Instability in the financial system was at the core of Minsky’s work. A capitalist system’s dynamics have an inherent tendency to foster fragility since stability encourages risky behavior, which develops into a crisis; that is, stability is destabilizing. Minsky predicted the explosion of home mortgage securitization in 1987 that led to the subprime meltdown in 2007, validating his theories and leading to the “Minsky moment.” Minsky’s solution for avoiding sharp economic downturns during financial crises was a Big Government to maintain income and profit flows, and a Big Bank with a lender-of-last-resort function in order to inject liquidity into the financial system. Minsky’s theories and solutions toward mitigating financial instability were at the heart of the participants’ explanations for and resolutions to the current recession.

Presenters were top policymakers, economists, and analysts from government, industry, and academia who offered their insights into and policy guidelines for the extraordinary challenges posed by the global financial crisis.

For the complete text of the speakers’ presentations and a summary of the various sessions, visit the News & Events section at [www.levy.org](http://www.levy.org).

## Strategic Analysis

### Recent Rise in Federal Government and Federal Reserve Liabilities: Antidote to a Speculative Hangover

DIMITRI B. PAPADIMITRIOU and GREG HANNSGEN

April 2009

Recent Federal Reserve (Fed) flow-of-funds data show a sharp rise in federal government and Fed liabilities. President Dimitri B. Papadimitriou and Research Scholar Greg Hannsgen examine the holders of these new liabilities and outline the likely effects of these debts on the U.S. economy. They dispel concerns that the surge in government liabilities (especially money) will cause a large increase in inflation, and focus on the badly needed improvement of private sector balance sheets, which will take some time to rebuild. And since default on debts that are backed by the full faith and credit of the United States is virtually impossible, these assets are safe (many U.S. sectors, as well as China, have been buying Treasuries). Moreover, increased deficits and their impact on balance sheets will eventually help stabilize the U.S. economy.

The Fed’s liabilities mostly comprise currency in circulation and member bank reserves, and these liabilities will be augmented by its purchase of longer-term Treasury bonds this spring. They are not, however, at an unprecedented level.

Prices are unlikely to rise at this time because of weak demand for goods and services, combined with the unlikelihood that bank lending will increase significantly in a recessionary environment. Moreover, households have become risk averse by building up a reserve of safe assets (similar to events during and following World War II).

The jump in money and government bonds is a life raft for sectors with shrinking portfolios. Domestic money market mutual funds, life insurance companies, and funding corporations have been buying Treasury debt. Furthermore, households, nonfinancial businesses, and funding corporations have been buying money market mutual fund shares. Many new government bonds are flowing to sectors where they are needed to stabilize net worth.

*For the complete text, go to [www.levy.org/pubs/sa\\_apr\\_09\\_2.pdf](http://www.levy.org/pubs/sa_apr_09_2.pdf).*

## The Return of the State: The New Investment Paradigm

MARSHALL AUERBACK

Working Paper No. 561, May 2009

In a globalized world whose economic policymaking was dominated by a philosophy encapsulated in the Washington Consensus, “small government” was supposed to be good. However, according to Marshall Auerback, RAB Capital PLC, the role of the state needs to be reemphasized in order to save the U.S. as well as the global economy. The private/public sector balance has to shift and the neoliberal economic model has to be modified. Auerback notes the reemergence of state-driven capitalism (a “back to the future” investment paradigm), where many governments are enacting massive economic stimulus packages and taking a central role in promoting economic growth strategies. The Washington Consensus will ultimately be perceived as a historical anomaly, he says.

There are indications that the private sector is beginning to adapt to a new paradigm (modeled on the Sematech consortium) in which the state plays an important collaborative role, such as in the automobile industry. Among other recommendations, Auerback suggests that we employ the current quasi-nationalized financial structure to build up the coalitions needed to support broader public objectives, thus helping to implement industrial policy for the revitalization of America’s manufacturing base.

The ultimate repudiation of the prevailing economic paradigm occurred when former Federal Reserve Chairman Alan Greenspan conceded that the private sector was unable to manage risk in a largely deregulated environment. Limited government caused rising inequality and a decline in median wages over the course of a generation, leading to the rampant neglect of public goods that are vital to citizens’ welfare and a prosperous economy. When the consequences of the existing paradigm hit the United States directly, governments worldwide enacted massive economic stimulus plans and played a more centralized role in promoting economic growth strategies (i.e., state-driven capitalism).

The author points out that the most successful trading countries in Asia did not reach their current status by adopting neoliberal trade policies. Rather, they had far-reaching state intervention to promote economic growth. Moreover,

almost all of the developed countries went through stages of industrial assistance policy prior to declaring that free trade was in the national interest. Furthermore, “transitional” countries (those moving from communism to capitalism) that adopted gradual liberalization and privatization in the 1990s were much more successful economically (e.g., China versus Russia).

The inflexible, theocratic manner in which a market fundamentalist agenda was imposed throughout the developing world has done little to improve aggregate economic performance, says Auerback. Yet, perversely, declining per capita growth data only served to reinforce the Washington Consensus and the need for market liberalization. (Industrial policy was dismissed at regular meetings of the G7 finance ministers.) It is now abundantly clear that a U.S. “growth strategy” predicated simply on militarism and unrestrained credit (in East Asia) contains the seeds of its own destruction.

According to Auerback, Washington itself never fully bought into the alleged Washington Consensus. Rather, the U.S. tax system promoted rent seeking and speculation on credit to ride the wave of asset-price inflation without adding to industrial capacity. Meanwhile, tax cuts caused the national debt to soar, and interest rates were lowered to stabilize asset prices.

Auerback reviews the history of public works in the United States and the impact of the New Deal, which created the foundation for American prosperity in the 20th century and contributed to the dominance of the U.S. economy prior to the onset of neoliberal economics. He finds that the Washington Consensus has denied other countries the opportunity of following the same development strategy. He calls for a recoupling of saving and tangible capital formation, and the restoration of the pre-1980 mixed economy that achieved broad growth and prosperity. We must abandon the exclusive mentality that has favored the private sector and afflicted American policy for the past quarter century, and recognize the need for effective financial reregulation to break what James K. Galbraith terms the “culture of predation.” What is required, says Auerback, is a vision of a new growth path for the United States.

*For the complete text, go to [www.levy.org/pubs/wp\\_561.pdf](http://www.levy.org/pubs/wp_561.pdf).*

## Revisiting (and Connecting) Marglin-Bhaduri and Minsky: An SFC Look at Financialization and Profit-led Growth

CLAUDIO H. DOS SANTOS and

ANTONIO CARLOS MACEDO E SILVA

Working Paper No. 567, June 2009

The stock flow–consistent (SFC) approach provides a general framework that allows the integration of important threads of heterodox macroeconomics that have tried to analyze the financialization of modern capitalist economies. However, the urge for realism has fostered the development of very large models and relatively complex computer simulations. Moreover, these short-period models are often used to shed light on long-period phenomena.

Research Associate Claudio H. Dos Santos and Antonio Carlos Macedo e Silva, University of Campinas, Brazil, believe that small SFC constructs can avoid the shortcomings of large models while addressing the concerns of heterodox economists and providing valuable (and possibly unconventional) insights into longer-period or dynamic phenomena. The key to Post Keynesian, structuralist, and heterodox dynamic analyses is using an approach that looks closely at the dynamics of both the size and composition of sectoral balance sheets, as advocated by Levy Distinguished Scholar Wynne Godley.

Heterodox approaches are interested in structural (i.e., enduring) transformations in the way capitalist economies evolve in time and space. History is extremely important because of ongoing changes in the dynamic properties and long-run tendencies of the capitalist system. Two seminal papers by Stephen Marglin and Amit Bhaduri (1990) focused on change over time and are integral to the “neo-Kaleckian” literature. A main objective of these papers was to understand why cooperative capitalism was replaced by conflict in the 1970s. The historical concern is also at the heart of the “French” regulation school, where some recent authors have concluded that contemporary post–Bretton Woods capitalism is a finance-led economy.

Another set of related literature has tried to formalize the insights of Hyman P. Minsky, whose main objective was to understand the dynamics of interrelated capitalist portfolios (and fluctuations in income and employment) in a development phase characterized by Big Government and the Big

Bank. Given the upsurge in financial crises in the last 30 years, say the authors, it is no wonder that Minskyan insights into financial fragility are illuminating for people using the heterodox approaches. While the neo-Kaleckian and formal Minskyan models are similar in nature, they are limited in scope because they may be misleading to long-run concerns. Furthermore, central aspects of the creation and distribution of financial power in capitalist economies are missing in the formal Minskyan literature.

The focus of SFC models is the evolution of sectoral balance sheets through time. The quintessential insight is that the evolution of balance sheets is entirely determined by the assumptions made about short-period flow behavior and the portfolio choices of the various sectors. However, both the steady state and the dynamic trajectory of the system are bound to change with every sectoral change in the set of hypotheses and parameters (assumptions). The authors believe that it is useful to know if an SFC system is converging or diverging from any given steady state (which depends on many variables) because it allows an approximation of the economy’s dynamic process. They also believe that the insights from a simplified structure can illuminate more complex analyses.

The authors revisit the highly simplified and stylized SFC model created by Dos Santos and Research Scholar Gennaro Zezza (2008). This closed-economy model assumes that an economy consists of households, firms, banks, and government. Dos Santos and Macedo e Silva present the most important behavioral assumptions in the model and discuss their implications to its long-period steady state. Despite its simplicity, the model allows the examination of the features of financialization (e.g., credit and stock-market booms and a rise in interest rates). In the model’s steady state (and in all other SFC models), it is true by definition that assumed stocks and flows will grow at the same rate (and that the net wealth of sectors will grow at the same rate as the stock of capital). The authors focus on the implications of these equilibrium conditions and analyze the long-period steady state, without recourse to complex and time-consuming computer simulations.

The authors discuss how “Minskyan crises” can be conceptualized and evaluated within the framework of the Dos Santos/Zezza model. They determine that a typical crisis associated with firms’ increasing financial fragility only happens when rentiers’ wealth and firms’ loans are growing faster than

capital and government debt is growing more slowly than capital. They also find that crises can arise even if there are no particularly controversial nonlinear hypotheses about the economy's investment function. These findings significantly alter the insights and conclusions of Marglin and Bhaduri.

The authors determine that the SFC approach can uncover unknown (longer-period or dynamic) phenomena, and that SFC dynamic analyses can be useful if they (1) imply that the economy is approaching one of the thresholds (i.e., something will have to change soon); (2) imply that the economy is approaching a sustainable steady state; and (3) there is no reason to believe that the parameters of the system will change dramatically in the medium term (say, four to eight years).

*For the complete text, go to [www.levy.org/pubs/wp\\_567.pdf](http://www.levy.org/pubs/wp_567.pdf).*

## **Fiscal Policy and the Economics of Financial Balances**

GENNARO ZEZZA

Working Paper No. 569, June 2009

The Levy Institute's macroeconometric model has proven to be a useful tool to track the evolution of the U.S. economy in the medium term. The model has shown that the growth path, which has been characterized by the accumulation of large and growing debts, was unbalanced and ultimately unsustainable. Projections of a recession eventually materialized.

Research Scholar Gennaro Zezza outlines how the model's approach is based on the financial balances of the private, public, and foreign sectors. He sheds light on how the dynamics of financial balances can be applied as a guide to the prospects of an economy, and how fiscal policy relates to the imbalances and economic growth. In his view, the current financial and economic crisis is not a consequence of financial industry and policy failures but rather the inevitable consequence of an unbalanced growth process that started in the 1980s (when the savings rate of the personal sector declined and the distribution of income shifted systemically in favor of the rich).

The author outlines how the stock market bubble played a major role in the "New Economy" period (1995–2000) and why a housing market bubble followed. He notes that most of the unsustainable processes outlined by Levy Distinguished Scholar Wynne Godley in 1999 remained after these bubbles

burst, with the exception of budget and monetary policy. While some commentators argue that the current crisis is based on the easing of monetary policy, this explanation does not take into account that household (and foreign) debt had started to rise well before monetary easing, observes Zezza. Moreover, one of the problems of the current recession is that fiscal policy is required at a time when the government is already running a deficit.

In Zezza's view, the long period of sustained growth in the United States was fueled by "excessive" private domestic expenditures that were financed by increasing injections of credit. His view contrasts with that of the mainstream (before the bubbles burst), which holds that growth in domestic expenditure was not excessive but rather due to rational expectations on future income growth.

Using the social accounting matrix approach, Zezza investigates the mechanics linking borrowing and expenditure to growth and financial balances. The model's crucial equation relates private expenditure to disposable income and net financial assets of the private sector (measured in real terms). The income-to-asset ratio of the private sector is affected by capital gains on homes and equity, as well as borrowing (i.e., an increase in either the real price of equities, the real price of homes, or borrowing will increase expenditures over income and wealth). The rest of the model is more conventional and follows the Keynesian and Post Keynesian tradition (e.g., trade depends on income and relative prices, and trade prices react to the exchange rate as well as to domestic and foreign prices).

The author finds that the savings rate for the personal sector has declined steadily since 1985, and, concomitantly, the share of residential investment financed by borrowing has increased; the value of new mortgages has exceeded the value of residential investment in the 2000s (which is characteristic of a speculative bubble); and the magnitude of the drop in borrowing in the current crisis has been unprecedented. A comparable picture arises for the nonfinancial corporate sector (e.g., the increase in business borrowing was not matched by an increase in investment and was instead used to acquire financial assets). Fiscal policy partly offset the rise in domestic demand until the 2001 recession, then turned expansionary in order to counter the drop in domestic demand.

Godley and associates adopted the sector balances approach as the basis for a model of the U.K. economy in the 1970s. This



approach—termed the “New Cambridge” hypothesis—was unconventional at the time because it merged households and businesses, and analyzed the private sector as a whole. The hypothesis was that the net acquisition of financial balances for the private sector was stable relative to GDP, and any shock to this assets-to-income ratio would be corrected rather quickly. It implied the creation of “twin deficits,” where any imbalance in the foreign account is matched by an imbalance in the government account. A crisis that called for expansionary fiscal policy along Keynesian lines meant the adoption of measures to counter the implied widening of the current account imbalance (e.g., exchange rate devaluation or protectionism). Although this hypothesis was eventually abandoned, it was resurrected by Godley at The Levy Economics Institute.

Inspection of financial balances is useful to quickly evaluate whether a deficit is “excessive” (i.e., the underlying stock of debt is unsustainable). Since private sector debt is more prone to trigger a crisis, says Zezza, it is better to substitute private debt with public debt through fiscal expansion. He examines the effects of expenditure and transfer shocks to government outlays and compares the results with a baseline projection. He finds that the Levy Institute model respects the New Cambridge hypothesis, but only in the medium term. And since any fiscal expansion will result in a wider external deficit, fiscal policy alone will not solve (and could worsen) the problem of global financial imbalances.

Zezza concludes that government expenditures can and should play a role in sustaining aggregate demand when either the private or the foreign sector is shrinking. Fiscal policy, however, will generate larger external deficits in the medium term, and these deficits should be countered through additional policy intervention.

*For the complete text, go to [www.levy.org/pubs/wp\\_569.pdf](http://www.levy.org/pubs/wp_569.pdf).*

## Program: Monetary Policy and Financial Structure

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### A “People First” Strategy: Credit Cannot Flow When There Are No Creditworthy Borrowers or Profitable Projects

JAMES K. GALBRAITH

April 2009

We are in the shadow of catastrophe and at the beginning of a long, profound, painful, and irreversible process of change, says Senior Scholar James K. Galbraith. We need to come to grips with the crisis, fast, but two ingrained habits are leading to our failure to do so: the assumption that economies will eventually return to normal on their own, and the belief that recovery runs through the banks rather than around them.

Forecasts are wrong because they do not take account of the massive pay-down of household debt resulting from the collapse of the banks. Credit cannot flow when there are no creditworthy borrowers and no profitable projects. Banks have failed, and the inability (or refusal) to recognize this is a pre-script for wild speculation and control fraud, compounding taxpayer losses.

Galbraith suggests the following measures, all of which are needed now: make economic forecasts realistic, audit banks more honestly, introduce effective financial regulation, keep people in their homes, and increase public retirement benefits. Fiscal expansion programs should be geared to the actual scale of the crisis, not limited by the arbitrary thought that it will be shallow and short. Competent regulators should take charge of troubled banks, install new management, and obtain an honest audit. Financial regulation should abolish tax havens and other forms of regulation evasion. There is a critical need to limit the oversupply and collapsing values of housing, and to mitigate the effects of foreclosure. Moreover, says Galbraith, the crisis is dealing a major blow to the private wealth of the elderly, so this is surely the moment to increase public retirement benefits.

*For the complete text, go to [www.levy.org/pubs/sa\\_apr\\_09.pdf](http://www.levy.org/pubs/sa_apr_09.pdf).*

## **It's That "Vision" Thing: Why the Bailouts Aren't Working, and Why a New Financial System Is Needed**

JAN KREGEL

Public Policy Brief No. 100, 2009

The Federal Reserve has been praised for its response to the current financial crisis because it introduced a zero interest rate policy more rapidly than the Bank of Japan, during the Japanese crisis of the 1990s, and embraced massive "quantitative easing." However, despite vast capital injections, the banking system is not lending in support of the private sector.

Senior Scholar Jan Kregel compares the current situation with the Great Depression and the Japanese crisis. The similarity lies in a reliance on monetary and exchange rate policy to reflate asset prices and restore normal functioning of the financial system. The "liquidity trap" idea was used to explain the Bank of Japan's decision to introduce a zero interest rate policy after efforts to boost lending through massive increases in bank reserves failed. Nevertheless, the banks continued to accumulate reserves without further lending. Kregel notes that the Japanese equity and real estate market bubble of the late 1980s is eerily similar to the recent bubble in the United States.

Contrary to current perceptions, Irving Fisher, not John Maynard Keynes, dictated New Deal policy. Keynesian-style deficit spending was adopted only in an emergency after tax increases (which look disturbingly like those discussed by the Obama administration) produced an economic downturn. Ultimately, the Roosevelt administration attempted to use every means to reflate prices and incomes to precrisis levels, so that debtors could meet their commitments. The government encouraged price reflation through monetary expansion, suspended the gold standard and devalued the dollar, raised prices and wages in agriculture and manufacturing, and provided legislative support for firms to act as a cartel and set prices.

Kregel finds an absence of New Deal measures and institutions in the current rescue packages. The lessons of the Great Depression suggest that any successful policy requires fundamental structural reform, an understanding of how the financial system failed, and the introduction of a new financial structure (in a short space of time) that is designed to correct these failures. In the absence of eligible borrowers, the only impact of lower interest rates is lower household and bank

incomes. And as yet, there are no proposed measures to support bank earnings.

The basic problem is that the financial system has significantly reduced its liquidity cushions and virtually eliminated liquidity. Moreover, the crisis has destroyed the lending mechanism based on leveraged securitization for the private sector without there being another mechanism to take its place. Kregel believes that increasing household and business incomes is the best way to cover losses and resolve the liquidity problem. The current crisis could have been avoided if increased household consumption had been financed through wage increases, and if financial institutions had used their earnings to augment bank capital rather than bonuses.

A fundamental change in financial structure through a series of regulatory measures and new regulatory institutions is a key element missing from current policy. The problem is not that the banks are not lending; it is that they are lending only to the Fed. The "modernized" financial structure created in 1999 has broken down, and resurrecting this structure would only lay the groundwork for the next crisis. A clear road map for a new financial system is more important than a replacement mechanism that removes impaired assets from bank balance sheets.

Kregel provides an account of why the financial system failed, and points out that the current economic slump would have been short-lived if price readjustments had been restricted to the buyers of liabilities associated with securitized mortgage entities and the underlying subprime borrowers. Policies should ensure that increased productivity is reflected in increased real wages for households, and that financial system earnings are directed more toward capital than labor. The current system has failed because it was built on an incentive system that did just the opposite.

*For the complete text, go to [www.levy.org/pubs/ppb\\_100.pdf](http://www.levy.org/pubs/ppb_100.pdf).*

## **What Role for Central Banks in View of the Current Crisis?**

PHILIP ARESTIS and ELIAS KARAKITSOS

Policy Note 2009/2

Central bankers must act when markets are dysfunctional. Rather than bailing out speculators, careless investors, and banks, a new policy initiative by Senior Scholar Philip Arestis and

Elias Karakitsos, Guildhall Asset Management and the Centre for Economic and Public Policy, University of Cambridge, recommends that central banks widen their scope and target the net wealth of the personal sector. A net wealth target would not impede the free functioning of the financial system. It would also help to control liquidity and avoid future crises, without interfering with the financial engineering of banks.

Net wealth is defined as financial and tangible assets less personal sector liabilities, including mortgage debt and consumer credit. It is an ideal variable to monitor (and control) bubbles because it is at the heart of the transmission mechanism between asset prices and debt, and consumption.

The actions of a central bank that relies solely on inflation may destabilize a leveraged economy. Increasing leverage means that monetary policy would likely lead to prolonged crisis and possibly to instability, because the economy responds to changes in profitability faster than changes in interest rates. In an asset-led business cycle, a central bank is well advised to have two targets—inflation and the output gap—since the volatility of the output gap is greater than the volatility of inflation. In a highly leveraged economy like the United States that is experiencing a credit crisis, monetary policy should also include mild wealth targeting in order to stabilize the economy around potential output.

The experience of many countries shows that successful control of CPI (consumer price index) inflation does not guarantee control of asset price inflation. The standard argument against asset price targeting is that it interferes with the free functioning of financial markets, as well as the economy as a whole, and is outside the realm of central banks. The way to avoid these problems, say the authors, is to monitor and target the implications of asset prices for consumer spending patterns (i.e., the net worth of the private sector). The Fed should maintain a target ratio of net wealth to disposable income in the range of 4.3 to 5.3, similar to its implicit target of 1 to 2 percent for core PCE (personal consumption expenditure) inflation. The target range could be revised to account for demographics and to anchor expectations of asset price inflation, and monetary policy should maintain this particular threshold. This action would not only allow asset price booms but also prevent bubbles (and their huge adverse economic consequences), and help to regulate financial engineering.

*For the complete text, go to [www.levy.org/pubs/pn\\_2\\_09.pdf](http://www.levy.org/pubs/pn_2_09.pdf).*

## **An Assessment of the Credit Crisis Solutions**

ELIAS KARAKITSOS

Policy Note 2009/3

Fiscal policy on its own will not resolve the current recession unless the credit crisis is resolved and credit flows to business and households return to normal. Elias Karakitsos, Guildhall Asset Management and the Centre for Economic and Public Policy, University of Cambridge, assesses the various schemes to alleviate the credit crisis in terms of the “business as usual” and “good bank” models. He finds that banks are more concerned about credit risk than liquidity risk and hence are worried about the insolvency of the entire financial system. In the business-as-usual model, the government, as lender of last resort, runs the risk of becoming insolvent. Moreover, the problem has been misdiagnosed as liquidity risk by policymakers. The good-bank solution also runs the risk of making governments insolvent and turning an already severe recession into a depression worse than that in the 1930s.

Karakitsos believes that the good-bank model can be salvaged, with one modification: separating the cross-holdings of the personal sector from those of the financial sector, thus containing the damage. The government either guarantees a large proportion of the personal sector’s assets or assumes the first loss in case the old banks fail. In this way, the economy is shielded from falling into depression, and recovery is ultimately ensured.

In terms of the credit crisis, there are two views: (1) the depressed assets of the financial sector are undervalued but will become fairly valued when the recession ends (thanks to measures adopted by policymakers); and (2) the assets are worthless and the banks are insolvent, so current measures are inappropriate. Wall Street and the global banking community prefer the first view, which requires a government bailout that either guarantees the assets or liabilities of the banks, or provides insurance for the bad and toxic assets; places the bad and toxic assets in a “bad bank” that is capitalized by public and private money; or temporarily nationalizes the banks. The banks would not bear the cost of their actions and would continue to do business as usual. The losses from the bad and toxic assets, however, may be too big to bear, even for governments (e.g., the cost of a bailout using taxpayer money in the United States may exceed by trillions the original estimate of \$700 billion, and may not prevent the bankruptcy of financial institutions).

The alternative to the business-as-usual model is to create a good bank from the ashes of each old bank. The new bank is capitalized by public and private money, and the government guarantees the bank's new loans. The old bank effectively becomes an asset management company of the bad and toxic assets, with liabilities consisting of unsecured debt and preferred and common stock. The advantages of the good-bank model are that credit flows to the economy return to normal, moral hazard is minimized, and most costs are directed toward those responsible for the crisis. A major drawback is that the potential losses from allowing the old financial system to go bankrupt could be large enough to sink the entire economy.

Karakitsos addresses the insolvency issue by decomposing risk into interest rate risk, liquidity risk, and credit (or counterparty) risk. The total risk is captured in the three-month London Interbank Offered Rate (LIBOR), while interest rate risk is measured in terms of the three-month overnight indexed swap (OIS). The spread between LIBOR and OIS for corresponding maturities is a measure of liquidity and credit risk. A fundamental difference between the Great Depression and the current credit crisis is that the former was due to liquidity risk (the remedy was to increase the money supply), while the current crisis is due mainly to credit risk. The wrong diagnosis had led policymakers to apply the wrong medicine, so the losses of financial institutions may surprise on the upside.

*For the complete text, go to [www.levy.org/pubs/pn\\_3\\_09.pdf](http://www.levy.org/pubs/pn_3_09.pdf).*

## **“Enforced Indebtedness” and Capital Adequacy Requirements**

JAN TOPOROWSKI  
Policy Note 2009/7

The present system of capital adequacy regulation for banks forces nonfinancial companies into debt (“enforced indebtedness”), and proposals to increase capital requirements during an economic boom (“dynamic provisioning”) simply accelerates the boom's collapse. According to Jan Toporowski, Universities of London and Amsterdam, a much more viable alternative is lending to governments in the event of lending withdrawals by the private sector, alongside lending to foreign private-sector borrowers.

There is uncertainty about the riskiness of assets, says Toporowski, and the strategy of securing bank stability by enforcing capital adequacy is based on a fallacy of composition. The presumption that individual banks can determine their liabilities without affecting the liabilities of other banks and firms in the economy is false because of a balance sheet constraint (i.e., one company's liability is another company's asset), and the fact that there is no guarantee that company assets will generate sufficient incomes to pay for the liabilities.

In practice, banks cannot meet their capital requirements without affecting the availability of capital for other economic enterprises. A regulatory requirement to increase bank capital reduces the amount of capital available to nonfinancial firms, so that these firms are obliged to raise capital through the issue of debt instruments; thus, “forcing” companies into debt. This enforced indebtedness is a crucial factor behind a reduction of investment in fixed capital that precipitates a financial crisis and recession. The “crowding out” of the nonfinancial business sector's demand for capital also raises the cost of capital, as banks are willing to pay whatever price it takes to satisfy the capital regulatory requirement (as reflected in the rising yields on corporate equity issues since 2000).

Another way that banks accommodate demands for higher capital ratios is by securitization; that is, packaging bank loans as bonds and selling those bonds to other financial intermediaries. Such sales also reduce the pool of capital for nonfinancial firms and force companies into debt. Moreover, the establishment of bank holding companies that are financed mostly with debt instruments (e.g., bonds) is a highly speculative form of financing that gives rise to a “layering” of capital within the financial system (i.e., banks holding other banks' capital in their asset portfolios), with potential adverse effects. The reduction of capital available to nonfinancial firms reduces productive investment, edging the economy toward a lower growth trajectory.

Toporowski raises three objections to dynamic provisioning: (1) it is difficult to enforce higher ratios if the boom is prolonged and defaults appear to be reduced; (2) banks would drain the available pool of equity capital and indebted companies even more rapidly than under a system of fixed capital ratios; and (3) it may not be necessary for banks with a diversified portfolio of international assets to increase their capital ratios. A more effective form of dynamic provisioning would

require companies (and households with mortgages) to increase their equity capital as a boom proceeds.

In an internationally integrated financial system, banks and economies would be much more effectively stabilized if cross-border lending to the private sector were matched by a commitment to lend (in the domestic currency of the bank) to the government of the country in which that private sector is based, in the event that lending in that country were reduced. The government bonds issued to foreign banks should be long term in order to avoid repayment pressures on issuing governments in the midst of a crisis. In this way, capital outflows would be matched by new capital inflows to governments and provide an endogenous stabilizing mechanism.

*For the complete text, go to [www.levy.org/pubs/pn\\_7\\_09.pdf](http://www.levy.org/pubs/pn_7_09.pdf).*

### **Some Simple Observations on the Reform of the International Monetary System**

JAN KREGEL

Policy Note 2009/8

The global dimensions of the current financial crisis have drawn attention to the need for reform of the international financial system forged in 1944 at Bretton Woods. Most of the attention has focused on the role of the U.S. dollar and the need to find a substitute.

According to Senior Scholar Jan Kregel, discussions have ignored the basic criticisms of the functioning of the existing monetary system. The problem of the instability of the international reserve currency's purchasing power is less a question of the asset that serves as that currency and more a question of the operation of the international adjustment mechanism. Is the mechanism automatic or coordinated? Is it sufficiently compatible with global aggregate demand to provide full employment and support the national development strategies of developing countries?

Kregel reviews the gold exchange standard, which was based on an international system of free exchange of goods, services, and capital. He finds that the stability of the purchasing power of gold savings was a result of the operation of the international adjustment mechanism rather than some quality or value inherent in gold itself.

John Maynard Keynes criticized the international gold-standard system because the mechanism for addressing imbalances was normally not through arbitrage to eliminate price differentials but rather through (asymmetric) adjustments in the level of activity; particularly, employment. To resolve the problem of asymmetric adjustment, Keynes recommended the creation of an international clearing union with temporary payment imbalances settled by means of a notional unit of account that could not be traded in private markets. The critical point is that member governments would agree to implement coordinated symmetric adjustment policies with policy actions taken by both deficit and surplus countries in order to maintain global demand at a constant level. This would allow countries to pursue national policies of full employment if they chose.

Robert Triffin critiqued the adoption of the U.S. dollar in place of gold at Bretton Woods. Any national currency playing the role of international reserve currency and fixed in terms of gold would lead to the erosion of global confidence in its value (as a result of asymmetric adjustments, as noted by Keynes), with the exception of the issuing country. If a currency were linked to gold, its outstanding issue would soon exceed the gold supply, leading to an inability to meet the commitment to fix the exchange value of the currency in gold (which occurred in the 1960s). The stability of the purchasing power of the international currency is inherently linked to the operation of an adjustment mechanism that eliminates international imbalances, either automatically or through a coordinated policy mechanism.

The demand for reform of the international financial system has not focused on the current system's inability to support global full employment, observes Kregel. Rather, it concerns the dollar's loss of purchasing power in foreign markets and its substitution by an international reserve currency that is not a national currency (e.g., special drawing rights, or SDRs). However, a basket of national currencies cannot resolve the problem. He notes that an automatic adjustment process based on a reduction in domestic income and employment, or in the exchange rate, would preserve the value of accumulated reserves from external surpluses.

In its preliminary report, issued in May 2009, the Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System concluded that the international system

suffers from an inherent tendency toward deficient aggregate demand and a lack of official international liquidity. Thus, the first steps in the reform process must offset the balance sheet losses caused by the collapse of asset values, and provide both an alternative source of demand to replace the U.S. consumer and an alternative source of finance to offset the deleveraging of financial institutions. This can be done through traditional, countercyclical deficit expenditure policies that are implemented on a global scale. Stimulus policies for most developing countries, however, are difficult because additional liquidity is required in order to finance their deficit expenditures.

This leads to the necessity of an alternative financial facility. One method of financing such a facility is through an additional SDR allocation to provide liquidity for developing countries, similar to the “link” proposal by the U.N. Conference on Trade and Development in 1964, and for emerging market countries that may be adversely affected by the rapid contraction in international flows (a recommendation in line with the original objective of SDRs).

It is clear that the introduction of SDRs or another global currency cannot resolve the problem of the adjustment mechanism’s operation. One problem is that some countries may choose to adopt a development policy based on net exports, a pursuit that would require a distortion of prices, exchange rates, or the global distribution of demand. Another problem concerns private capital flows, which have been shown capable of creating substantial distortions to the international adjustment mechanism. A coordinated international policy is required not only to distribute surpluses and deficits, but also to assign an appropriate allocation of the costs of distribution, provide the required liquidity to finance them, and manage capital flows.

*For the complete text, go to [www.levy.org/pubs/pn\\_8\\_09.pdf](http://www.levy.org/pubs/pn_8_09.pdf).*

## **Background Considerations to a Regulation of the U.S. Financial System: Third Time a Charm? Or Strike Three?**

JAN KREGEL

Working Paper No. 557, March 2009

Legislator and regulator responses to previous financial crises in the United States have not led to sustainable financial stability. Senior Scholar Jan Kregel reviews the history of U.S. finan-

cial regulation and finds that prudential regulation no longer has a direct impact on system liquidity, thus eliminating the traditional transmission mechanism for monetary policy. The disappointing performance of the bank holding company model and segmented banking system means a return to the discussion of universal banks (like the one used in Germany) as a preferable model for regulation.

The objectives of prudential regulation have been to ensure the redemption value of private bankers’ circulating promissory notes and the dominance of national over state bank notes, and extended regulation to (state) bank deposits. Before the creation of the Federal Reserve, the distinct functions of banks (i.e., commercial banking, trust and insurance, corporate underwriting, and brokering) were united under investment banking and not conducive to competition. The main criticism was that the control of bank deposits (other people’s money) was the source of power, leading to exorbitant profits for the multifunctional investment banks. Moreover, national banks faced an increasing competitive disadvantage relative to the state charter banks, which operated without restriction in the securities markets.

After the creation of the Federal Reserve System and securities regulations by state governments (in the form of “blue sky” laws), the role of the bank as the central financial institution, deposit taker, and lender of short-term funds for commercial purposes was restored. Prudential supervision at this time ensured the convertibility of private bank deposits into Fed bank notes. Since the national banks were limited to commercial banking activities, their profitability suffered and there was a decline in the quantity and liquidity of “commercial” bank assets, while “free” banking in many states led to widespread overbanking.

The Pepper-McFadden Act (1927) expanded national bank activities while sidestepping federal regulations by organizing independent securities affiliates with state charters. The Glass-Steagall Act (1933) restored the separation of commercial and investment banking in order to provide prudential regulation of banks and to guarantee the value of public deposits in terms of Fed notes. It became clear that prudential regulation had to be framed to ensure the profitability of financial institutions, and this concern became the major policy tool, replacing the role of bank reserves. Another objective of New Deal legislation was to protect individuals from fraud

and malfeasance associated with the activities of the state-regulated securities affiliates of national banks. Regulation of non-deposit takers followed the tradition of the blue-sky law: regulatory authority was based on the particular assets of each financial institution. Legislators were more concerned with protecting the individuals investing in securities than regulating the firms who traded and sold securities. The major organizing principle of the Securities and Exchange Commission (SEC) was transparency rather than prudential regulation.

The regulatory regime that emerged from the New Deal legislation was not based on an analysis of the advantages of product- or function-based regulation versus institution-based regulation. The United States emerged with a dual, segmented, individual unit banking system. There was no recognition of any need to distinguish between functional and institutional regulation, since both were identical. The regulatory response restored profitability by expanding the kinds of capital services offered by the commercial banks (and reducing regulations) in order to generate alternative sources of income. Official attempts to save the savings-and-loan banks from competition (e.g., deregulation) bankrupted the whole industry, and allowed the origination and securitization of mortgages by investment banks. Thus, the 1980s and '90s repeated prior solutions to falling commercial bank profitability in the form of the Financial Modernization Act, which restored the commixture of commercial and investment banking and created new capital market institutions such as hedge funds and private equity funds—all without appropriate regulation. As a result, there is no longer any precise relation between financial institutions and functions, so the first decision is whether reregulation should be based on institutions or on functions and products.

Another implication of the breakdown between institutions and the functions accompanying financial innovation is that regulated banks are no longer the primary source of system liquidity, nor are they the major transmission mechanism of monetary policy. In the present system, liquidity comes primarily from the organized derivative markets: a “margin” multiplier has replaced the deposit “multiplier.” Prudential regulation no longer has a direct impact on system liquidity. The problem is not securitization but the process of creating securitized assets and distributing them across the institutional investor base. Thus, in the current context, there seems to be a clear benefit to pursuing product rather than institutional regulation.

The United States must decide between a segmented or a unified banking system. Germany, for example, rejected the separation of commercial and investment banks in the late 1930s and maintained universal banking, without financial crisis. The banks' balance sheets are split into short-term commercial banking activities requiring maturity matching and capital market activities requiring long-term maturity matching. This is equivalent to extending bank regulations for the commercial banks to the investment banks, while recognizing that these regulations must differ.

*For the complete text, go to [www.levy.org/pubs/wp\\_557.pdf](http://www.levy.org/pubs/wp_557.pdf).*

## **Managing the Impact of Volatility in International Capital Markets in an Uncertain World**

JAN KREGEL

Working Paper No. 558, April 2009

International financial flows transmit financial instability and are the source of unsustainable external debt. Senior Scholar Jan Kregel analyzes proposals to increase stability and manage volatility from the point of view of Hyman P. Minsky's financial instability hypothesis (i.e., hedge, speculative, and Ponzi financing). He reviews the post-World War II international trade and financial systems and finds that its institutions have caused volatility. Risk, rather than cash flow, is now the homogeneous commodity traded in the financial markets that has reduced diversity and led to instability of the global financial system. In essence, the United States is in a deficit, Ponzi-style financial position.

Peace and economic prosperity require increased government control and policies to manage both domestic credit systems and private and international capital markets. Kregel reviews the purpose and dismantling of the New Deal banking legislation and the Bretton Woods system, John Maynard Keynes's “bancor” proposal for an international clearing union, the role of the International Monetary Fund (IMF) and flexible exchange rates, the Brady Plan, and policies of the Washington Consensus. He notes that when the international financial system replaced gold with the dollar, private financial institutions in the United States became the center of international intermediation and the suppliers of international liquidity.

Under the Bretton Woods system, countries were encouraged to maintain hedge financial profiles, with balanced external payments and reserves sufficient to act as a margin of safety against fluctuations in net export earnings. This system carried a deflationary bias, since all countries could not have hedge-financing profiles unless there was an external source of liquid reserves (i.e., a lender of last resort). Countries with a speculative profile due to unforeseen internal or external shocks could be rectified by changes in internal (domestic absorption) policies.

After the collapse of Bretton Woods, financial flows were no longer controlled (in the interests of market stability) but directed toward achieving the efficient international allocation of capital. The rise in lending to developing countries, followed by a sharp reversal of U.S. interest rates and appreciation of the dollar, converted hedge/speculative financial profiles into Ponzi financing schemes with negative net present values. Debtors sought to attract funds by opening up their internal markets and deregulating their capital accounts (i.e., Washington Consensus policies), and raising funds directly by issuing dollar-denominated Brady bonds.

Hedge financing at the international level means ensuring that net export earnings are more than sufficient to cover debt-servicing needs in every future period. Net export earnings for developing countries, however, are usually highly volatile. An important means of avoiding a Ponzi profile is providing liquidity and ensuring that external shocks do not have an asymmetric impact on cash flows and debt payment commitments, in addition to managing balance sheets so that earnings are matched more closely with commitments. Therefore, emerging market borrowers introduced innovative financial instruments to smooth the time profile of future payment commitments. Since the costs of these hedging instruments increase when times are good (rather than bad), the financing profile is stable.

All proposals to stabilize the international financial system have two important deficiencies: (1) it is not possible for every country to attain a hedge or even a speculative profile; and (2) such proposals limit any advancement in global welfare (i.e., using net resource transfers from developing to developed countries to support global growth and development). Moreover, at least one country has to maintain Ponzi financing if other countries have hedge or speculative profiles, and there is no means to safeguard that country against instability.

An external surplus must be based (initially) on a commercial surplus that may eventually produce a capital services account that “crowds out” real exports of goods and services, which affects employment and consumption. This calls into question the sustainability of the current account balance and the ability of hedge financing to ensure domestic stability. In the absence of IMF control or a clearing union, capital controls are the only hedging scheme that keeps financial imbalances within reasonable bounds.

The characteristic feature of the new financial architecture built up in the United States in the 1990s restored the market (rather than the government) as the seat of pricing and the allocation of finance. A major change was the creation of financial products that could be traded and priced more efficiently, along with the transformation of fixed income instruments into floating rate instruments (i.e., financial engineering). This reduced transparency and the amount of information required by the market, and shifted the market’s role from valuation to arbitrage and over-the-counter, arms-length transactions. There was no market discipline, and prices could be readily manipulated.

The absence of an organized market shifted the risk from both buyer and seller to the counterparty. The most important innovation was the leveraging of credit ratings (e.g., using AIG’s triple-A credit rating associated with its insurance subsidiaries to create AIG-Financial Products, a standalone investment bank). The financial markets now trade and invest in credit risk directly, so they depend more on pricing the probability of future events than on valuing future income flows. Banks will continue to be a source of international financial instability as long as their business models focus on risk arbitrage and leverage, which can reduce transparency and increase volatility.

*For the complete text, go to [www.levy.org/pubs/wp\\_558.pdf](http://www.levy.org/pubs/wp_558.pdf).*



# Program: The Distribution of Income and Wealth

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## Special Report

### Who Gains From President Obama's Stimulus Package . . . And How Much?

AJIT ZACHARIAS, THOMAS MASTERSON, and KIJONG KIM  
Special Report, June 12, 2009

When President Obama signed the American Recovery and Reinvestment Act (ARRA) in February, his administration estimated that the \$787 million package of transfers and tax cuts would create or save approximately 3.5 million jobs by the end of 2010, providing relief to low-income and vulnerable households while supporting aggregate demand.

Senior Scholar Ajit Zacharias and Research Scholars Thomas Masterson and Kijong Kim provide a preliminary assessment of ARRA that points toward the necessity for a comprehensive employment strategy that goes well beyond the current legislation. While the stimulus plan's ameliorating impact on the employment situation is surely welcome, say the authors, the government could have achieved far more at the same cost by skewing the stimulus toward outlays rather than tax cuts.

The authors' strategy to assess the implications of ARRA consists of three main steps: constructing a baseline scenario, estimating the increase in employment by occupation and industry, and simulating the accompanying effects of changes in earnings on the distribution of money income. The baseline scenario of labor market conditions and distribution of income was constructed using the 2008 Annual Social and Economic Supplement to the Census Bureau's monthly Current Population Survey. The authors impute labor force status in January 2009 and total income for 2008. They estimate that the fiscal stimulus imparted by ARRA was \$531 billion for the period 2009–11, of which 54 percent was accounted for by tax cuts, while government purchases and transfers each accounted for only 23 percent. The 2006 input-output table for 201 industries was used to estimate the employment effect of government purchases of goods and services. The estimates generated by the input-output method

and the conventional method (using CBO tax cut and transfer multipliers) were combined to arrive at the total additional employment that accrued to each major industry as a result of the stimulus.

The authors find that the estimate of new jobs under their "medium" scenario is nearly identical to the Obama administration's estimate (i.e., an additional 6.2 million jobs over 2009–11). However, total employment has already fallen by 7 million jobs since the start of the recession in December 2007. Given that a further sizable decline in employment is expected, the effect of ARRA on the employment crisis is largely palliative, not curative. The authors also find that the amount of stimulus required per new job created is much higher for taxes than outlays under all scenarios. They further find that the level of employment for women will be slightly higher than at the start of the recession as a result of ARRA, while whites lose ground and nonwhites make no significant gain. Individuals who have not graduated from high school will suffer the largest loss.

Median household income declined in 2008 by 1.5 percent, and the effect of ARRA is expected to slightly more than offset that decline and soften the blow to the middle class. The average money income of the middle quintile of working-age families is estimated to increase by 1.8 percent (versus 2.3 percent according to the Obama administration), and ARRA is shown to improve the shares of all quintiles in aggregate income with the exception of the topmost. The legislation's likely effect on overall inequality in money income might be negligible, say the authors, since it does not address systemic inequality in the U.S. economy (e.g., nonwhite households continue to receive an annual income that is 28 percent less than that of white households).

*For the complete text, go to [www.levy.org/pubs/sr\\_06-12-09.pdf](http://www.levy.org/pubs/sr_06-12-09.pdf).*

### Distributional Impact of the American Recovery and Reinvestment Act: A Microsimulation Approach

AJIT ZACHARIAS, THOMAS MASTERSON, and KIJONG KIM  
Working Paper No. 568, June 2009

Senior Scholar Ajit Zacharias and Research Scholars Thomas Masterson and Kijong Kim provide a preliminary assessment of the likely impact of the American Recovery and Reinvestment Act (ARRA) on median household income, gaps between

population subgroups, and income inequality (i.e., the employment channel). They find that ARRA partially replaces lost jobs and has a remedial effect on median household money income but is unlikely to restore robustness to middle-class incomes or improve the money income of the bottom 60 percent of households. It is also unlikely that the legislation will redress the substantial gaps in money income between nonwhites and whites, single female-headed families and married couples, and less-educated and college graduates. The analysis points toward the necessity for a comprehensive employment strategy that goes well beyond ARRA (e.g., an expanded role for public employment).

ARRA represents a package of spending increases and tax cuts initiated by the Obama administration that is expected to provide relief to low-income and vulnerable households hurt by the economic crisis, while supporting aggregate demand (e.g., modernizing health care and infrastructure, improving schools, and investing in clean energy technologies). The authors' preliminary assessment of the Act's impact consists of three main steps: constructing a baseline scenario of labor market conditions and the distribution of income, estimating the increase in employment by industry and occupation, and simulating the changes in earnings on the distribution of money income.

In the first step, the authors adopt the Annual Social and Economic Supplement as the basic sample and impute labor force status by industry, age, and sex for all civilian adults 16 years and older. The resulting baseline scenario is an imputed dataset with complete labor force characteristics and income profiles for 2008.

In the second step, the authors use a "comparative-static" approach to estimate the effects of ARRA on income distribution relative to the baseline scenario. (They note that their simulated effects represent a best-case scenario for employment, since labor market conditions have worsened in 2009.) Using Congressional Budget Office estimates of the budgetary costs of the Act over the 2009–19 period, the authors make adjustments in terms of expected cutbacks in state and local government spending, and with respect to coverage and timing, to derive an appropriate amount of fiscal stimulus over the 2009–11 period. This stimulus is split between outlays (purchases of goods and services, transfers, and subsidies) and tax cuts in order to apply a set of multipliers and estimate the employment effects by industry. A different method based on input-output analysis is

used to estimate the employment effect of government purchases of goods and services. It is assumed that the additional employment created by ARRA will be split across occupations in each industry in the same proportions as the Bureau of Labor Statistics' occupation-industry matrix for 2006.

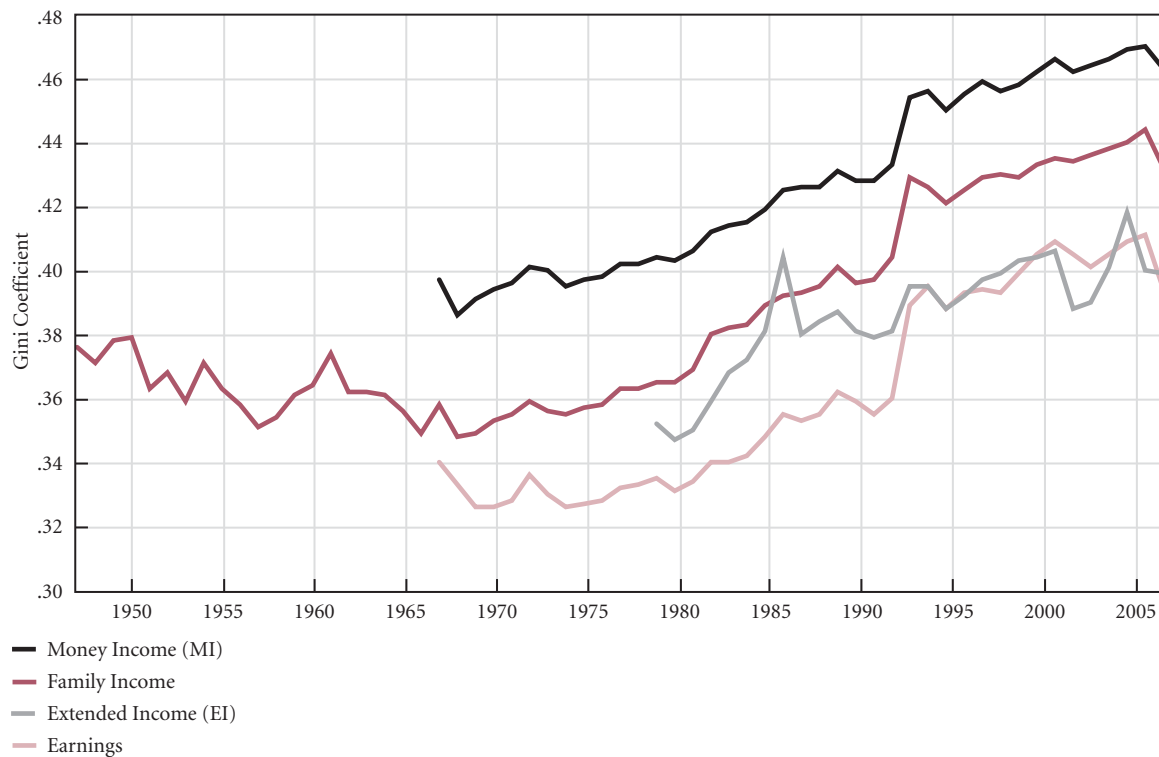
Zacharias, Masterson, and Kim estimate the potential additional employment from the stimulus created by the Act under two sets of multipliers for transfers, taxes, and subsidies (high and medium) and under two assumptions regarding the industrial distribution of final demand generated by government purchases (termed "government" and "private"). They find that their estimates of new jobs under the medium scenarios (i.e., an additional 6.2 million jobs between 2009 and 2011) are nearly identical to the administration's estimate—a finding contrary to charges that the administration's estimates are not robust. Nevertheless, say the authors, it is sobering to note that total employment has already fallen by 6.5 million (from December 2007 to March 2009), and that even the "high" scenario estimates would have merely a palliative rather than a curative effect on the employment crisis.

The authors also find that the amount of stimulus required per ARRA job is much higher for taxes than for outlays. It appears that the government could have achieved more employment at the same cost, since 55 percent of the fiscal stimulus is expected to come from tax cuts.

As expected, there is a much lower share of government employment under the "private" as compared to the "government" scenario. Nevertheless, the government sector is the largest employer under both assumptions, followed by professional and business services, and education and health services. Additional employment generated by ARRA is expected to favor blue-collar and low-end service occupations, males, nonwhites, college-educated workers, and people over 60 years of age. The authors estimate that average annual earnings from ARRA jobs are likely to be approximately 3 percent higher than earnings from non-ARRA jobs. (The most striking increase is for workers in the bottom quintile of the earnings distribution). In general, the effect of ARRA is to raise the lower end of the earnings distribution and distribute gains in a pro-poor fashion, but this will have only a negligible effect on overall inequality in money income.

*For the complete text, go to [www.levy.org/pubs/wp\\_568.pdf](http://www.levy.org/pubs/wp_568.pdf).*

**Figure 1 Trends in Inequality, 1947–2007 (in Gini coefficients)**



Note: Earnings refer to earnings of full-time year-round workers.

Source: U.S. Census Bureau

## Levy Institute Measure of Economic Well-Being

### New Estimates of Economic Inequality in America, 1959–2004

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

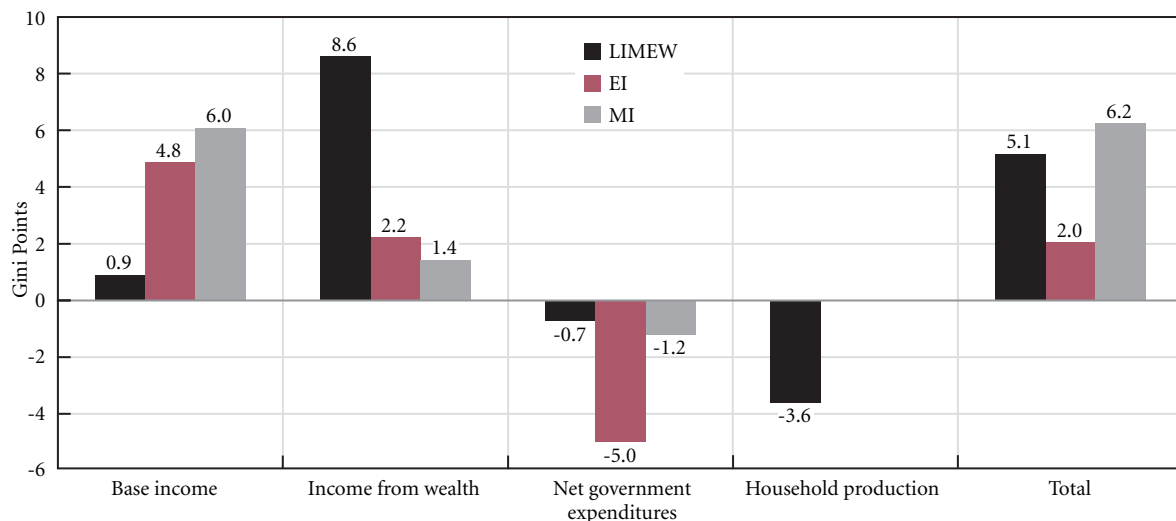
In previous LIMEW reports, Senior Scholars Ajit Zacharias and Edward N. Wolff, and Research Scholar Thomas Masterson describe a picture of postwar trends in economic well-being in the United States that is very different from the official measures. They also examine long-term trends in economic well-being within various population subgroups based on household characteristics such as race/ethnicity, age, education, and marital status. The authors' key motivation in creating and extending the LIMEW—a comprehensive, alternative

measure of economic well-being—is that economic inequality is broader than earnings inequality, which is the leading factor behind the inequality trends related to the conventional measures of income.

In this report, the authors present new evidence on the pattern of economic inequality in the 1959–2004 period. They find that both the LIMEW and two official measures of inequality indicate higher inequality in 2004 than in 1959 (Figure 1). The money income (MI) measure had the highest Gini coefficient for all households, followed by LIMEW and the extended income (EI) measure. MI shows greater inequality because it is a pretax measure and does not account for government noncash transfers. The LIMEW shows relatively lower inequality because it includes household production and public consumption, which are distributed much more equally among households as compared to earnings.

The surge in inequality between 1989 and 2000 reflects the large increase for the top quintile in income from wealth,

**Figure 2 Changes in Inequality by Income Measure, 1959–2004 (in Gini points)**



Notes: Income from wealth in MI consists of property income (sum of dividends, interest, and rent). Net government expenditures in MI consist only of cash transfers.

Source: Authors' calculations

according to the LIMEW, and base income (consisting mainly of labor income), according to the official measures. Moreover, the income shares of the middle three quintiles were lower in 2004 than in 1959 according to all three measures. The authors' findings suggest a rather bleak picture for the lower and middle classes in terms of sharing the economic pie.

The factors determining the level of inequality at a given moment or changes in inequality over time are sensitive to the income measure. Decomposition analysis sheds light on the differences between alternate measures. According to LIMEW, MI, and EI, base income and income from wealth contributed positively to the increase in inequality, while government expenditures and taxes moderated that increase (Figure 2). In terms of the LIMEW, the effectiveness of government expenditures and taxes in restraining the growth in inequality was less than the conventional measures suggest. Rather, household production (not included in the official measures) was the largest component that contributed to the decline in inequality between 1959 and 2004.

The principal reason for the decline in inequality during the latest subperiod (2000–04) in terms of the LIMEW and EI measures (MI showed a slight increase) was the fall in income from nonhome wealth. This was in response to the collapse of

financial markets rather than a reduction in earnings inequality or changes in government redistributive policies (e.g., effective tax rates in 2000 and 2004 were lower for the top decile than for the ninth decile).

For the complete text, go to [www.levy.org/pubs/lmw\\_apr\\_09.pdf](http://www.levy.org/pubs/lmw_apr_09.pdf).

### Caste and Wealth Inequality in India

AJIT ZACHARIAS and VAMSI VAKULABHARANAM  
Working Paper No. 566, May 2009

Caste is a persistent determinant of power, economic inequality, and poverty in contemporary India. Senior Scholar Ajit Zacharias and Vamsi Vakulabharanam, University of Hyderabad, contribute to the general lack of economic literature on caste relations by analyzing the relationship between overall wealth inequality and caste divisions. Using data compiled in 1991–92 and 2002–03, they find that the average Dalit and Adivasis (SC and ST) groups had a substantial disadvantage in wealth relative to other groups. Moreover, the relative median wealth of the rural and urban ST group was lower in 2002–03 than in 1991–92; there was also an increase in within-group inequality for the SC/ST groups, with the exception of the rural SC group.

Furthermore, they confirm that there is a sizable wealth gap between the Hindu forward castes (FC) and everyone else. The picture that emerges is one of comprehensive and persistent disparities for the disadvantaged groups.

Previous studies also show a persistence of systemic disparities among certain castes. Inequalities in land ownership are a significant determinant of economic inequality among households, while the quality and quantity of schooling varies positively with household wealth.

The authors use the All-India Debt and Investment Survey conducted in 1991–92 and 2002–03. Wealth is computed as total household assets net of debts and measured on a per capita basis (there are no “economies of scale” associated with wealth). They outline a number of problems associated with the wealth data, such as the concentration of wealth at the very top of the distribution and underreporting of wealth holdings and debt. The definition of caste groups is dictated by the data and does not adequately reflect the complexity of the caste system.

According to the 1991–92 survey (Scheme I), the entire population is classified according to three groups: Scheduled Castes, or the “Dalits” (the so-called “untouchables”); Scheduled Tribes, or the “Adivasis”; and Other Communities (OC). According to the 2002–03 survey (Scheme II), there is an additional category called Other Backward Classes (OBC), as well as a religion category that allowed the separation of OC into OBC, as well as Hindu forward castes and non-Hindus (NH) who are not SC, ST, or OBC.

The authors find that the disadvantaged groups (SC and ST) experienced relatively higher rates of growth in mean per capita wealth in both urban and rural areas than the majority (OC) group. However, in terms of median per capita wealth for the ST group, wealth rose only 7 percent in the urban areas (versus 42 percent for the urban OC) and 21 percent in the rural areas (versus 25 percent). By contrast, there was a 40 percent increase in wealth for the rural and urban SC groups. Nevertheless, the average person in these groups continued to experience a considerable wealth disadvantage in 2002. Furthermore, the median wealth of the urban OC group was 21 percent higher than its rural counterpart. A similar picture of SC/ST group disadvantages emerges using mean values.

In terms of Scheme II subdivisions, the average OBC and urban NH individuals had less than 90 percent of the wealth

of the average rural OC individual. The most advantaged OC subgroup is the FC. The ranking of the groups in terms of median wealth follows an expected pattern: the urban and rural HC groups are at the top, followed by the OBC and urban NH groups. The rural NH group is at the bottom.

The authors analyze the relationship between overall wealth inequality and caste using the Yitzhaki decomposition method. This approach separates overall inequality into within-group and intragroup components, and distinguishes between caste stratification and caste inequality. It is especially important in the context of ongoing political debates about affirmative action and the so-called “creamy layer”; that is, the emergence of an economically well-off group within castes whose average member is worse off relative to the rest of the population.

A reranking of groups according to mean values indicates the extent of within-group inequalities. Comparison of within-group distributions reveals that caste divisions and the urban-rural divide act as distinct, yet interrelated influences on the distribution of wealth. The wealth gap favors rural individuals at the bottom of the distribution for all castes because it reflects the incidence of land ownership in rural areas versus the urban poor. The evidence suggests that the wealth advantage of urban individuals within all castes increases by (higher) percentile with the exception of NH, where the disparity in favor of the urban population declines after the 70th percentile. In terms of the ST group, the urban advantage skyrockets due to the well-known fact that the rural tribal areas are among the most economically backward in India. The overall picture of change across the distributions suggests a pattern of wealth accumulation that is not heavily biased in favor of those at the top, with the exception of the urban ST group.

The index of overlapping is a measure of the degree to which the range of wealth in each group overlaps the range of wealth for the total population (i.e., the opposite of stratification). The higher the amount of overlap between a group and the general population, the less stratified the group in terms of wealth. The authors find very little change in overall wealth inequality or in within-group and intragroup inequalities from 1991 to 2002. However, the SC/ST groups (excluding the rural SC group) witnessed an increase in within-group inequality between 1991 and 2002. There appears to be the emergence of a “nouveau rich” and growing income polarization within the ST groups. The FC groups have the highest degree of overlap

with one another and a much lower degree of overlap with all other groups, especially with the SC/ST groups (which are more stratified). The remaining groups show a fairly high degree of overlapping with the general population, as well as with one another.

*For the complete text, go to [www.levy.org/pubs/wp\\_566.pdf](http://www.levy.org/pubs/wp_566.pdf).*

## **Program: Gender Equality and the Economy**

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### **Promoting Gender Equality through Stimulus Packages and Public Job Creation: Lessons Learned from South Africa's Expanded Public Works Programme**

RANIA ANTONOPOULOS

Public Policy Brief No. 101, 2009

Beyond loss of income, joblessness is associated with greater poverty, marginalization, and social exclusion; the current global crisis is clearly not helping. There is, therefore, a particular urgency to engage in dialogue and pursue new policy directions.

Research Scholar Rania Antonopoulos explores the impact of both joblessness and employment expansion on poverty, paying particular attention to the gender aspects of poverty and poverty-reducing public employment schemes targeting poor women. The author advocates public employment as a policy instrument that, when set up as a permanent institution, acts as an automatic stabilizer. Its main feature is that the government steps in as a guarantor to make available a job to those who fail to secure one through the market.

Antonopoulos notes that such public job opportunities have typically been created primarily in the construction and maintenance of physical infrastructural assets, often bypassing equally meaningful jobs that enhance social service delivery. She argues that the latter have a bigger impact on poverty reduction, especially for women, who account for the majority of the poor in many developing countries. This is because social sector public employment converts the burdens of unpaid work—a key feature of female poverty—into paid employment, in addition to improving women's job market skills.

The author presents the results of a Levy Institute study that examines the macroeconomic consequences of scaling up South Africa's Expanded Public Works Programme by adding to it a new sector for social service delivery in health and education. She notes that gaps in such services for households that cannot afford to pay for them are mostly filled by long hours of invisible, unpaid work performed by women and children. Her proposed employment creation program addresses several policy objectives: income and job generation, provisioning of communities' unmet needs, skill enhancement for a new cadre of workers, and promotion of gender equality by addressing the overtaxed time of women.

A budgetary allocation of 9.2 million rand creates approximately 571,000 full-time social sector jobs, the vast majority going to the unskilled poor and ultrapoor; 60 percent of these jobs are expected to be filled by women. The expenditure amounts to 1.1 percent of GDP (in 2000 prices), yet it impacts GDP growth by 1.8 percent. All ultrapoor participants in the program cross the ultrapoor poverty line, and all poor households with income levels previously at or just above the ultrapoor poverty line are lifted above the poverty line datum. Antonopoulos concludes by noting that drawing in marginalized segments of the population via social sector public job creation has the strong potential to fulfill multiple policy objectives.

*For the complete text, go to [www.levy.org/pubs/ppb\\_101.pdf](http://www.levy.org/pubs/ppb_101.pdf).*

### **The Current Economic and Financial Crisis: A Gender Perspective**

RANIA ANTONOPOULOS

Working Paper No. 562, May 2009

In the midst of the current global crisis, there is grave concern that progress made in poverty reduction and women's equality will be reversed, impeding realization of the United Nations' Millennium Development Goals. Research Scholar Rania Antonopoulos explores both well-known and less discussed paths of transmission through which crises affect women's work and overall well-being in female-intensive industries such as textiles, agriculture, and tourism, as well as in unpaid production activities that are particularly important in the context of developing countries.

Financial markets and the private sector cannot be relied upon to turn the global economy around, so it is up to national governments and the international community to intervene with measures such as fiscal stimulus packages, along with policies and strategies that will lift all boats more evenly. The cost of not acting boldly may have irreversible consequences for both the developed and the developing world, says the author. However, the current situation has created the opportunity for leadership and bold policy action to reduce inequalities between countries and across poverty and gender lines.

Antonopoulos believes that macroeconomic and institutional arrangements are of paramount importance for gender equality. She outlines the rationale for a gender-aware analysis prior to setting policy targets and instruments directed toward alleviating the impact of the global economic crisis—instruments that include both paid and unpaid work. She also discusses the gender dimensions of the crisis in terms of work and social reproduction, prior to outlining various policy responses that would ensure that the welfare of women and the poor would not be overlooked.

A plausible intervention to contain the financial sector crisis as well as the meltdown of production and employment is a massive Keynesian response (i.e., fiscal stimulus packages). The concern is that there are differentiated impacts of the crisis with respect to work (the economy is not gender neutral) as well as policy space, so the international community and its policymakers must adopt a mechanism for coordinated countercyclical policy action worldwide. Since markets alone do not deliver broad-based prosperity, there is a fundamental global demand constraint (i.e., productivity is replacing labor), and peace and security are at risk. This means that the renewed emphasis on pro-poor growth, the importance of public sector investment, and the promotion of employment-generating strategies that existed prior to the crisis need to continue unabated. The use of fiscal stimulus and other expansionary instruments, however, are options that most developing countries cannot afford. Therefore, international systematization and new coordinating institutional facilities must be put in place immediately.

Antonopoulos notes that local and national economies rely on unremunerated work in subsistence production, unpaid family work, and unpaid care work, but that these activities remain outside policy considerations. In terms of

women's work, the key areas include paid work (e.g., textiles and agriculture), informal work, unpaid work, and remittances. Women are particularly vulnerable to economic shocks because their employment is concentrated in extremely procyclical industries.

Prior to the crisis and contrary to expectations, countries with high growth rates experienced more growth in informal rather than formal employment (e.g., India). At least 60 percent of women are engaged in informal employment (e.g., home-based work and agriculture). "Vulnerable" employment is a new concept introduced by the International Labour Organization that applies to more than 50 percent of female employment worldwide. Moreover, there is a close connection between vulnerable employment and poverty because of a lack of social protection and safety nets during economic slowdowns. Projections on the impact of the economic crisis suggest that the poverty rolls will increase by as many as 50 million people in 2009.

There is a need for policy responses directed toward social protection measures due to gender-specific patterns of employment, and toward limitations women face in gaining access to credit and assets. Furthermore, time-use surveys show that the average gender gap for unpaid work (e.g., household duties) is up to five hours per day. This burden depends in part on the existence of physical infrastructure and the availability of public goods and services. Unfortunately, these social provisioning items are the first to be cut when governments retrench, so the burden shifts onto the time spent by women (and girls). Thus, women are faced with little paid work and too much unpaid work during an economic crisis. Therefore, the procyclical nature of unpaid work must be recognized, so that there are counteracting policy mandates that *increase* government budgetary allocations.

Remittances appear to reduce poverty and can constitute between 17 and 40 percent of a country's GDP. They are used to finance small businesses, improve housing, and support community development projects. Countries that rely on tourism and remittances need international policies to offset remittance declines during an economic crisis. Therefore, successful policies would expand government spending in direct job creation or social cash transfers, supporting dependent families and mitigating shrinkage of local economies.

Since policy attention has shifted to issues other than food security, government strategies should focus on public

investment in rural areas. Rural women produce half of the world's food (up to 80 percent in developing countries) but receive less than 10 percent of the credit provided to farmers. Therefore, government agricultural extension services should target women rather than men with resources such as tools, education, and credit in an effort to increase food production.

Gender should be considered in a countercyclical policy agenda by promoting access to remunerative work opportunities, reinforcing access to productive resources, recognizing existing inequalities in unpaid work, and providing universal access to social safety nets. However, prevailing conditions make it extremely difficult for countries to engage in pro-poor, gender-aware macroeconomic strategies.

Antonopoulos recommends new international rules and regulations for financing development and trade that reflect the concerns of multiple stakeholders, address microcredit concerns regarding the credit freeze, revive community development banks, support countercyclical fiscal stimulus packages that benefit the disadvantaged, and increase public sector funding. She notes that the state has become indispensable and should assume the role of employer of last resort in addition to its roles as lender and investor of last resort. Another very important gender perspective is that donor countries honor their official development assistance commitments in health and education.

*For the complete text, go to [www.levy.org/pubs/wp\\_562.pdf](http://www.levy.org/pubs/wp_562.pdf).*

### **From Unpaid to Paid Care Work: The Macroeconomic Implications of HIV and AIDS on Women's Time-tax Burdens**

RANIA ANTONOPOULOS and TAUN TOAY

Working Paper No. 570, July 2009

Traditional economics focuses on the economic marketplace. However, a significant amount of production takes place through unpaid (informal) work, which is outside the boundaries of market transactions. This market focus is especially problematic for developing countries, and in the context of the HIV/AIDS epidemic the intersection between unpaid work, gender, and poverty has yet to receive adequate policy attention.

Research Scholar Rania Antonopoulos and Research Analyst Taun Toay address the gender dimensions of employer-

of-last-resort policies. They focus on the Expanded Public Works Programme (EPWP) in South Africa because of its initiatives with respect to social service delivery, the number of people living with HIV/AIDS in the country (estimated at 5.5 million), and the fact that women account for three-quarters of the time spent on unpaid work. There are two priority areas for job creation within the social sector: community- and home-based care, and early childhood development. EPWP has created policy space to enable caregivers to make the transition from unpaid to paid work in these areas, and to establish a gender-informed public employment program.

The authors note that public employment programs are linked to time spent on unpaid work. According to time-use survey data, home-based care and early childhood development are primarily the responsibility of women in most countries. Moreover, the gender division of labor is replicated in the context of HIV and AIDS. The increased burden of unpaid work affects women's ability to engage in paid work and reinforces existing gender inequalities. There is a "time tax" of unpaid work for caregivers because they are subsidizing the social sector. As a result, women work longer hours and receive less pay than men.

There is an important distinction between "care in the home" and "home-based care" (i.e., ad hoc care provided by untrained women and girls versus formal treatment programs), and that this distinction involves drastically different approaches. Moreover, the aggregate unemployment rate in South Africa hides the fact that unemployment is disproportionately high among particular segments of the population (e.g., the urban ultra poor). Thus, a program can be designed to counter the very high unemployment rate as well as the skewed disposition of time spent on unpaid work.

Antonopoulos and Toay employ a social accounting matrix model to analyze the macro and micro implications of scaling up the community- and home-based care component of EPWP. The original program, which relied on volunteers, was insufficient to address the challenges of equipping thousands of unemployed people with the skills and experience to enter a community health-training program. The authors propose an additional 110,000 full-time EPWP jobs to create a cadre of (professional) community health workers who have completed a graduate program in home-based care. They also expand the list of job types and extend the duration of enrollment (to two consecutive years per job), at a projected annual



cost of 1.6 billion rand (merely 0.2 percent of GDP). The expectation is that the majority of jobs created will be directed toward women, since they are the main caregivers and spend the most time in unpaid work. Paid workers who were formerly unpaid volunteers have the added advantages of local knowledge and a stake in the community, and require little or no transport.

The authors estimate that there will be an additional indirect job created for every three new program-related jobs. In the simulation, GDP expanded by 1.8 percent, so one third of the cost of the scaled-up program would be paid for through an increase in taxes associated with the multiplier effect. The simulation also showed proper pro-poor growth, as it reduced poverty by 60 to 80 percent (but job rationing might be required to favor the selection of ultra-poor households).

Based on previous studies, the intervention is expected to result in social inclusion (e.g., greater self-respect and dignity) for the unemployed, a reduction in income and asset poverty, and an increase in social service delivery and gender equality. Providing women with training, certification, work experience, and income can be instrumental in helping them participate in the mainstream economy.

The authors stress the fact that South Africa is faced with a pandemic that requires a multifaceted response, and that their recommendations are specific to the historical context and current situation in South Africa.

*For the complete text, go to [www.levy.org/pubs/wp\\_570.pdf](http://www.levy.org/pubs/wp_570.pdf).*

## **Program: Employment Policy and Labor Markets**

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### **Conference**

#### **Employment Guarantee Policies: Responding to the Current Economic Crisis and Contributing to Long-Term Development**

With poverty, inequality, and unemployment trending upward worldwide, job creation, especially for marginalized populations, is urgently needed. By mobilizing unused domestic labor resources, direct job creation can become an engine

of pro-poor growth while also promoting gender equality and meeting social inclusion targets—key international development goals. Public works projects, employment guarantees, and employment-of-last-resort strategies can play a crucial role in reducing unemployment and poverty, ameliorating distress migration, and delivering physical infrastructure and social services in ways that particularly benefit underserved communities.

On June 22 and 23, 2009, The Levy Economics Institute, in partnership with the United Nations Development Programme, Regional Bureau for Latin America and the Caribbean, and the Bureau for Development Policy, convened an international conference to present the merits and challenges of public job creation programs as a constitutive component of an economic recovery strategy. Titled “Employment Guarantee Policies: Responding to the Current Economic Crisis and Contributing to Long-Term Development,” the conference was held at Blithewood, the Institute’s main research and conference facility, on the campus of Bard College in Annandale-on-Hudson, New York. Top policy advisers, members of government organizations, academics, and international development specialists met to analyze and exchange views on various public employment initiatives, drawing on existing research and the outcomes of country-level programs in South Africa, Argentina, India, Iran, and Chile.

For a summary of the various presentations and panel sessions, as well as audio and video archives, visit the News & Events section at [www.levy.org](http://www.levy.org).

### **A Crisis in Coordination and Competence**

MARTIN SHUBIK

Policy Note 2009/4

The ad hoc emergency approach to the current economic crisis could waste billions of dollars by mismatching skills and needs. According to Martin Shubik, Yale University, we need to line up and coordinate at least four sets of talents—political, bureaucratic, financial, and industrial—for both a “quick fix” and a longer-term solution. Moreover, we have to enlist the help of individuals associated with bringing on the crisis in the first place.

A healthy economy should dampen both the downward and upward swings in expectations, because most Americans want stability. In principle, government should not buy assets where it does not have the ability to manage them. Financial institutions and management should be reorganized, with the government taking a senior position in providing financial guarantees at a potential profit. Bankruptcy measures, both for reorganization and for liquidation, should be used decisively. Contrary to public fears of massive layoffs, bankruptcy can lead to a new, more efficient management that retains and expands its workforce. Another myth is that top senior managers would leave and destroy economic innovation if their pay and bonuses were capped.

The primary targets in the current crisis are employment, consumption, and innovation. Immediate measures aimed at these targets include tax cuts, deficit spending, reinsurance to revalue distressed assets, revamping credit controls, and saving incentives. Pump priming via public works programs depends not only on the availability of unemployed resources but also on the availability of the right resources. We must be prepared to see an explosion in entrepreneurial retraining programs and new for-profit educational establishments, says Shubik.

*For the complete text, go to [www.levy.org/pubs/pn\\_4\\_09.pdf](http://www.levy.org/pubs/pn_4_09.pdf).*

## **A Proposal for a Federal Employment Reserve Authority**

MARTIN SHUBIK

Policy Note 2009/5

One of the more successful government financial institutions in the United States is the Federal Reserve System (Fed). However, when the financial control mechanisms are insufficient to prevent serious damage to the fundamental economy, a fail-safe mechanism, similar in power and structure to the Fed, is needed. Martin Shubik, Yale University, proposes a Federal Employment Reserve Authority (FERA) devoted to monitoring the “natural rate of unemployment,” which is dependent on society’s existing institutions, laws, customs, and technology.

FERA would require a central Authority in Washington, with branches in each state to supervise oversight of projects. The board of governors of each state branch would comprise

representatives from business, labor, academia, and federal and state governments. Each branch would monitor unemployment and maintain a list of potential public works projects. The Authority would develop state and federal taxation, as well as funding guidelines in concert with the Fed and Treasury via a Joint Assessment Financing Board. This board would monitor proposals and determine the breakdown of unemployment that is attributable to recession versus new technology. Having legislation in place in advance would allow quick action in terms of emergency financing.

The author lists several basic principles that should guide the central Authority: never own assets without adequate in-house expertise, do not employ individuals directly, ensure transparency of information sources, and coordinate bids for projects with the federal and state funding authorities.

*For the complete text, go to [www.levy.org/pubs/pn\\_5\\_09.pdf](http://www.levy.org/pubs/pn_5_09.pdf).*

## **Labor-market Performance in the OECD: An Assessment of Recent Evidence**

SERGIO DESTEFANIS and GIUSEPPE MASTROMATTEO

Working Paper No. 559, April 2009

In 1994, the Organisation for Economic Co-operation and Development (OECD) published the *OECD Jobs Study*, which concluded that high unemployment in Europe originated from rigidities in the labor market; that is, a generous welfare state and a highly redistributive tax policy. Sergio Destefanis, University of Salerno, and Giuseppe Mastromatteo, Catholic University of Milan, evaluate the OECD view and find that coordinated bargaining enhances labor market performance, even in conjunction with powerful unions. They also find strong interactions between labor market performance and welfare reform, but weak support for the influence of strict labor market regulations on levels of unemployment. The authors suggest that structural changes should be evaluated in terms of factors such as industrial structure, financial markets, and the housing sector, since measures of institutions and policies have accounted for only minor differences in labor market performance across OECD countries over the past 10 years.

Evidence based on bivariate relationships between policy reform indicators and employment rates suggests a direct link between structural reform and labor market outcomes, while

the result is less clear cut for more complex, multivariate models. The authors review the relationships between labor market policies and outcomes, and the factors believed to contribute to poor labor market performance in Europe (e.g., generous social safety nets, high taxes, strong unions, and restrictive employment legislation), as well as the structural and institutional differences outside the labor markets. Their empirical framework consists of 21 OECD countries within a cross-country setup similar to the most recent follow-up study to the *OECD Jobs Study* (2005) over the 1994–2004 period.

The authors consider the following policy fields: taxes and social security contributions, employment protection legislation, unemployment benefit systems, active labor market policies, retirement and pension schemes, wage formation, and working-time flexibility. They examine the bivariate relationship between policy change indicators and labor market performance, and consider the impact of past labor market performance and structural shocks.

While the literature tends to conclude that labor market institutions are a key part of the story, the role of these institutions is far less robust and uniform than commonly believed. Much of the unemployment problem in the European Union is concentrated in France, Germany, Italy, and Spain, and labor market performance in recent years has been hampered by sluggish output growth. Although there has been thorough welfare reform in most OECD countries (e.g., reduced funding of passive labor market policies, reform of unemployment benefit entitlements, and fiscal incentives), expenditures on active labor market policies continue to be greater in Europe than in the United States (1 percent of GDP versus 0.2 percent). Tax reform has reduced corporate and personal income marginal tax rates, and employment protection legislation has led to a greater share of nonstandard forms of employment in some countries. Although union power is weakening, bargaining coordination remains high.

The literature also indicates that labor market performance has improved following a shortening of the unemployment benefit entitlement period and stricter entitlement tests. Policies favoring young, first-time job seekers are less effective than those designed for adult males, and there is doubt about the long-run effects of job-creation schemes. Studies showing a positive impact of tax credits on employment may be due to the interaction of these credits with other institutional and

structural changes, say the authors. They also observe that coordinated bargaining provides better macroeconomic outcomes than decentralized bargaining and that statutory minimum wages are too low to have any impact on unemployment, at least for adult males, in most OECD countries.

The authors believe that structural and institutional differences between the United States and Europe should be evaluated outside the labor market in order to fully account for diverging labor market trends. Variation in the industrial composition of national economies (e.g., manufacturing versus services) leads to a variety of labor market outcomes. Economy-wide regulatory barriers to entry obstruct the natural pattern of structural change, so that countries with tighter restrictions on entry are expected to have a relatively underdeveloped service sector. Also, differences in credit markets and barriers to geographical mobility (e.g., the cost and availability of housing) may play a role in constraining employment creation in Europe relative to the United States and the Scandinavian countries. Levels of homeownership and unemployment rates are correlated at a surprisingly high level across countries and throughout time.

The lag between policy changes and labor market performance is approximately four to five years. The authors find that past labor market performance matters, and that the impact of tax reform and employment protection legislation is very heterogeneous. While reform of unemployment benefits is significant, reform of taxes, retirement benefits, and wage formation is not. Reform relating to employment protection legislation and working-time flexibility is sometimes significant but negative.

Much of the explanatory power of labor market institutions for labor market performance derives from the performance-enhancing effects of active labor market policies. The authors find that all indicators were much more significant for employment than for unemployment. In sum, recent OECD cross-country data show that changes in labor market performance are consistently (and inversely) linked to its lagged level, while structural changes are also important.

*For the complete text, go to [www.levy.org/pubs/wp\\_559.pdf](http://www.levy.org/pubs/wp_559.pdf).*

## The Social and Economic Importance of Full Employment

L. RANDALL WRAY

Working Paper No. 560, April 2009

The global economic downturn in 2008 caused most economists to return to the theories of John Maynard Keynes, as almost everyone supported fiscal stimulus policies in stagnating nations worldwide. Keynes recognized that unemployment is a persistent feature of the capitalist economy because there are no endogenous market processes to eliminate it.

Senior Scholar L. Randall Wray notes that economists and policymakers have resisted policy that would actually achieve full employment and have overlooked the fact that Keynes advocated “targeted” spending programs; that is, focusing government spending on areas that are operating well below capacity and directing spending toward increasing capacity to meet social goals (e.g., President Roosevelt’s New Deal jobs programs). He advocates a government employer-of-last-resort program, and maintains that it is affordable because the United States is a sovereign government operating with its own currency in a floating exchange rate regime.

According to Keynes, firms produce only the quantity of output they expect to sell and it would be highly unlikely that this would happen to coincide with full employment. His main point is that unemployment results from insufficient effective demand, not by faulty operation of the labor market, and can only be resolved by creating more jobs; that is, through purposive, well-targeted social policy that raises aggregate demand and provides jobs for the unemployed. This action will go a long way toward reducing inequality and poverty. However, the supposed Phillips-curve trade-off (lower unemployment at the expense of higher inflation) has caused economists and policymakers to resist strategies that would actually achieve full employment.

Keynes believed that the lower limit to unemployment from raising aggregate demand without generating inflation is approximately 5 percent. Therefore, he rejected general “pump priming” (e.g., tax cuts, government spending increases, and lower interest rates) in favor of “targeted” spending programs. When stagflation afflicted many developed countries in the 1970s, there was a belief that Keynesian policy was no longer useful—largely because Keynes’s followers failed to follow his

theory closely. Keynes did not recommend general demand pumping as the one-size-fits-all solution to unemployment, nor did he believe that price hikes result solely from excessive demand. Rather, he focused on directing government spending toward areas operating well below capacity as a means of meeting social goals. Most importantly, Keynes wanted to put unemployed labor to work in socially productive ways.

Wray outlines the economic benefits of various employer-of-last-resort (ELR) job guarantee programs, including their representation as a fundamental human right. He also notes that the burden of joblessness is borne unequally among disadvantaged groups. In Hyman P. Minsky’s ELR proposal (1965), the federal government provides funding for a job creation program that would offer a uniform hourly wage with a package of benefits (e.g., health care and payment of Social Security taxes). The uniform wage would be well below the market for skilled workers, so the program would not be in competition with the private sector except for workers with the lowest skills and least work experience. However, private sector employers would have to offer a wage and benefit package commensurate with the ELR program. Furthermore, an ELR program would help to promote economic and price stability, and act as an automatic stabilizer, since employment in the program would grow in an economic recession but shrink during an expansion.

Job creation programs have been implemented worldwide, including a variety of programs in Sweden, the Plan Jefes y Jefas de Hogar in Argentina, and in response to the National Rural Employment Guarantee Act in India. In a previous study, the author estimated that net spending by the U.S. government for a universal ELR program would be well under 1 percent of GDP.

*For the complete text, go to [www.levy.org/pubs/wp\\_560.pdf](http://www.levy.org/pubs/wp_560.pdf).*

## Program: Immigration, Ethnicity, and Social Structure

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### Housing Inequality in the United States: A Decomposition Analysis of Racial and Ethnic Disparities in Homeownership

SANJAYA DESILVA and YUVAL ELMELECH

Working Paper No. 565, May 2009

Homeownership is viewed as a key measure of economic well-being and wealth, and a significant indicator of social assimilation. However, it is unevenly distributed, particularly along racial and ethnic lines. Research Associates Sanjaya DeSilva and Yuval Elmelech study the trajectory into homeownership of black, Asian, white, and Latino households. They find that neoclassical economic theory is insufficient to explain racial and ethnic inequality, and that immigration and spatial attributes are key to understanding racial-ethnic differences in homeownership. Moreover, family structure and unobserved factors such as prejudice and discrimination may continue to play a role in shaping the black-white homeownership gap.

This paper extends previous research on housing inequality by studying the spatial determinants of racial and ethnic differences in homeownership, and the extent to which immigration characteristics, labor market attainment, and residential patterns shape trajectories to homeownership. The authors merge data from the 2000 Integrated Public Use Microdata Series and the 2006 American Community Survey. The two datasets include identical variables, along with comparable Public Use Microdata Area (PUMA) information at the household level. The merged data enables the authors to distinguish assimilation from immigration cohort effects, and to include contextual variables. A variant of the Blinder-Oaxaca decomposition method is used to estimate the portion of the white-minority homeownership gap that is explained by between-group compositional differences in economic, demographic, immigration, and spatial characteristics.

Beginning in the mid-1960s, a substantial increase in the nonwhite population coincided with growing socioeconomic disparities in terms of race and ethnic origin. Neoclassical economic theory models the decision to purchase a house as an intertemporal expected utility maximization problem subject

to a lifetime budget constraint. There are no racial-ethnic differences in housing prices and interest rates (i.e., no discrimination and segregation in housing and credit markets), so racial and ethnic inequality in homeownership reflects between-group differences in income, values and attributes regarding homeownership, and lifecycle characteristics. This straightforward temporal perspective on housing assimilation—that immigrants enter at the bottom of the occupational ladder and experience upward mobility and higher incomes—ignores differences in the quality of immigrant cohorts and the market conditions encountered in the host society.

Four sets of variables are key to the analysis: race/ethnic (non-Hispanic white, non-Hispanic black, Asian, Mexican, and other Hispanic), life cycle and socioeconomic factors (e.g., age, education, and household characteristics), immigration attributes (e.g., age, language proficiency, and years since migration), and spatial indicators (to capture the racial, immigrant, and economic environment of the household's location). The authors find that the homeownership rate of the white population far exceeds that for nonwhites (70 percent versus 55 percent or less). Mexican and black households report the lowest levels of household income, white and black households reside in PUMAs that have a relatively small number of recent immigrants, and Asians and whites are more likely to reside in areas with a high average household income.

Because of distinct demographic, economic, and educational disadvantages in the housing market, blacks, Mexicans, and other Hispanics are less likely to be able to afford a home. The authors are particularly interested in how race and ethnicity effects on homeownership are mediated by immigration characteristics. They find that the differences between Asians and whites are small, with the exception of the immigration dimension (i.e., a large percentage of Asians are immigrants). For Mexicans, however, both race and immigration characteristics influence homeownership. They also find that PUMAs with a high percentage of recent immigrants and low incomes have lower homeownership rates. Surprisingly, the presence of a higher proportion of non-Hispanic whites in a PUMA has a negative effect on homeownership. It appears that the assimilation process is rapid for Asians but difficult for the “other Hispanics” group. Blacks and Asians suffer few negative impacts from linguistic isolation, perhaps because of an “enclave” effect.

According to the authors' decomposition analysis, approximately 40 percent of the homeownership gap remains unexplained for non-Hispanic blacks, while demographic variables represent almost 30 percent of the explained portion of the gap, spatial variables are less influential, and immigration and education play minimal roles. Marriage and gender have a direct and strong impact on the demand for housing for blacks (household heads are often unmarried and female). Thus, non-Hispanic blacks have a unique set of demographic characteristics that makes homeownership less desirable or affordable.

Most of the white-Asian homeownership gap is explained by immigration and, to a lesser extent, spatial characteristics. For the two Hispanic populations (Mexicans and other Hispanics), all factors play a part in explaining the homeownership gap, so the roles of immigration and spatial characteristics cannot be overlooked. Housing stratification along immigration lines is more visible among whites than any other racial/ethnic category. With the exception of blacks, most of the minority-white gap is explained by differences in immigration and spatial characteristics.

Three distinct models of minority trajectory into homeownership emerge from the data: (1) Asian-white inequality is unique by being relatively small and explained entirely by differences in immigration and special attributes; (2) immigration has no impact on the black-white gap and there is no substantial spatial effect (their unique family structure seems to play an important role); and (3) the Latino-white model is characterized by a more balanced pattern that combines demographic, economic, immigration, and spatial factors (e.g., linguistic isolation, age structure, low level of education, occupational status, and residence in communities with a high immigrant population).

*For the complete text, go to [www.levy.org/pubs/wp\\_565.pdf](http://www.levy.org/pubs/wp_565.pdf).*

## Program: Economic Policy for the 21st Century

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### The “Unintended Consequences” Game

MARTIN SHUBIK

Policy Note 2009/6

Whenever there is new legislation, there are also new beneficiaries when the legislation takes care of special interest groups and entrepreneurs (and their lawyers) locate loopholes. Martin Shubik, Yale University, proposes a straightforward solution to the problem—create a “war gaming group” within the Department of Justice. The group would design a game around a new piece of legislation and award a prize of say, one million dollars, to a lawyer or team of lawyers who finds the most egregious loophole.

*For the complete text, go to [www.levy.org/pubs/pn\\_6\\_09.pdf](http://www.levy.org/pubs/pn_6_09.pdf).*

### Whither New Consensus Macroeconomics? The Role of Government and Fiscal Policy in Modern Macroeconomics

GIUSEPPE FONTANA

Working Paper No. 563, May 2009

The current New Consensus Macroeconomic (NCM) model lays the foundation for the ubiquitous inflation-targeting policy strategies of modern central banks. In the face of recent dramatic economic events and the inability of academics and policymakers to prevent them, the NCM model has faced much criticism. Giuseppe Fontana, University of Leeds and Università del Sannio, analyzes one of the main criticisms of the model; namely, the absence of any essential role for the government and fiscal policy. He concludes that fiscal policy could be at least as relevant to the NCM model as monetary policy.

Fontana considers the recent evolution of formal models in macroeconomics since the 1960s. The comprehensive structural models derived in the 1970s and 1980s and based on the neo-classical synthesis proved to be too complex for policy purposes; these were discarded in favor of smaller (post-Lucas) critique models built on microeconomic foundations and the rational expectations hypothesis, but required the use of simplistic (and

often controversial) assumptions. The NCM model is the most successful version of these small macroeconomic models, but it does not address the role of the public sector and fiscal policy.

The NCM model consists of three equations representing an IS-type curve, a Phillips curve, and monetary policy. It has several standard features of the modern New Keynesian approach to macroeconomics (e.g., the equations can be derived from the explicit optimizing behavior of individual agents in the presence of market failures). Price and wage stickiness plays a key function in relating the monetary policy rule to the IS-type curve. The central bank (via changes in the short-run nominal interest rate) is able to control the short-run real interest rate and thus, the current level of output. Another important tenet of the model is that low and stable inflation is conducive to growth, stability, and market efficiency. The central bank faces a short-run trade-off between inflation and output that is captured by the Phillips curve (i.e., the aggregate supply component of the NCM model).

Fontana outlines a simplified version of the NCM model that describes the dynamics of changes in the output gap, the inflation rate, and the interest rate policy rule. The IS-type curve relates the real interest rate to the level of output and employment. It differs from the traditional IS curve by having a rigorous microfoundation, along with lagged and forward-looking elements, and by relating the real interest rate to the output gap. In the Phillips curve, inflation is determined by the current output gap, as well as past and future inflation rates (the current rate of inflation is determined by the current output gap rather than the level of output). The third equation is a simple monetary policy rule (i.e., a standard Taylor rule) where the nominal interest rate is explained by the current output gap, the deviation of current inflation from its target, and the equilibrium real interest rate. This equation represents a major innovation of modern formal models of the economy and replaces the old LM curve of the neoclassical synthesis. This means that the quantity of money is a residual of the money supply process, and that monetary policy is a systematic response to inflation and output.

According to Fontana's set of equations, the central bank is key to achieving and maintaining price stability in the long run, and, at the same time, providing output stabilization in the short run. These goals are achieved through an aggregate demand channel and an inflation expectations channel related

to the transmission mechanism of monetary policy. These channels are strongly related to each other in a closed economy: the aggregate demand channel is strengthened by the working of the inflation expectations channel, and the central bank can be more activist in pursuing its short-run output stabilization objective.

Criticisms of the NCM model are organized around two broad themes: the amended roles of both monetary policy and fiscal policy. The criticisms of conventional monetary policy relate to unemployment bias, distributional effects, and financial instability effects. Fontana notes that Levy Institute scholars (including Hyman P. Minsky) have argued that financial matters, rather than asset prices, should be a major concern for the central bank, and that continuous manipulation of the short-term interest rate generates financial instability and speculation (i.e., the short-term rate should be set permanently at zero). He finds that the reasons for excluding an explicit role for fiscal policy in the NCM model are inadequate.

Fontana notes that academics are unsure about the effects of fiscal interventions. By contrast, academics and policymakers agree on the utility and effects of monetary policy (according to the NCM model). He also notes that there are at least two theoretical models from which to study the effects of fiscal policy—the neoclassical and New Keynesian models—as well as two alternative methodologies for calculating the effects of changes in fiscal policy (the “dummy variable” and “structural vector auto regression” approaches).

From a theoretical perspective, there is no reason to justify the marginalization of fiscal policy in modern macroeconomics, says Fontana. Based on the NCM's set of equations, fiscal policy should have the most prominent role, since its effects are more direct than those of monetary policy. In the long run, there is no aggregate demand channel for the transmission mechanism of monetary policy, so the reliance on short-run price and wage rigidities severely limits the central bank's role in the NCM model (i.e., it has only indirect control of the real interest rate). On the other hand, the government can directly affect aggregate demand and hence, the output gap. Fontana concludes that the NCM model can encompass a transmission mechanism of fiscal policy that is as powerful as the transmission mechanism of monetary policy, in spite of the model's limitations and problems.

*For the complete text, go to [www.levy.org/pubs/wp\\_563.pdf](http://www.levy.org/pubs/wp_563.pdf).*

## New Consensus Macroeconomics: A Critical Appraisal

PHILIP ARESTIS

Working Paper No. 564, May 2009

Senior Scholar Philip Arestis highlights the main characteristics of a New Consensus Macroeconomic (NCM) model in an open economy, where the exchange rate provides a channel for monetary policy in addition to aggregate demand and inflation expectations. He raises a number of issues with the model's theoretical foundations and its inflation-targeting framework. In his view, two of its main weaknesses are based on the absence of money and banks, and the equilibrium real rate of interest. Arestis is critical of the NCM model from a Keynesian perspective, and concludes that it is based on inconsistencies and a great deal of "ad hoc" input. He notes that both academics and economic policymakers are in general agreement that applying the NCM paradigm to monetary (interest rate) policy is an effective means of price stability and inflation control. He also notes that two of the key assumptions of the NCM framework are that price stability is the primary objective of monetary policy, and that inflation is a monetary phenomenon that can only be controlled by the central bank's manipulation of the (single) rate of interest.

The author outlines six equations that describe an NCM model in an open economy. The first describes aggregate demand where monetary policy is thought to influence the output gap. He finds that the model has become nonmonetary because private banking institutions and monetary variables are not essential to its framework, and is amazed that central banks have accepted this approach. Moreover, the role of investment is questionable because there is no independent investment function outlining the effects of variations in private spending on an economy's productive capacity and future supply costs.

The other equations in the NCM model relate to a Phillips curve; a monetary policy rule, which embodies the notion of an equilibrium rate of interest; the exchange rate, which is a function of real interest rate differentials, the current account position, and expectations of future exchange rates; the current account position, which is a function of the real exchange rate and domestic and world output gaps; and the nominal exchange rate expressed in terms of the real exchange rate.

The unknown variable in each of the six equations is output, the interest rate, inflation, real and nominal exchange rates, and the current account, respectively.

The main economic policy implication of NCM is that monetary policy has been upgraded in the form of interest rate policy where a major objective is maintaining price stability by means of inflation targeting. The belief is that the central bank can influence real interest rates and hence, real spending in the short run because of temporary nominal rigidities in the form of sticky wages, prices, and information. Forecasting is a key element of inflation targeting, but there are large margins of error that present a serious problem for the reputation and credibility of central banks. The usefulness of NCM models for policy analysis is therefore in doubt, since these models do not identify accurately the source of inflation persistence and expectations. Moreover, fiscal policy is downgraded and not an active instrument of economic policy.

The author focuses on three criticisms of the NCM framework respecting the absence of banks (the role for financial intermediation) and monetary aggregates, monetary policy issues, and the use of the equilibrium real rate of interest in the monetary policy rule equation. He believes that downgrading of monetary aggregates has gone too far, and that banks play a significant role in the transmission mechanism of monetary policy and in granting credit. In essence, the NCM model is incomplete and unsuitable for monetary policy analysis.

In terms of monetary policy issues, Arestis notes that the NCM theoretical framework relies heavily on the efficient markets hypothesis, thereby making disequilibria, such as bubbles, unlikely. Outright acceptance of this hypothesis leads to serious policy mistakes, says Arestis. Targeting net wealth of the personal sector (as a percentage of disposable income) is a more important monetary policy option, as it is an ideal variable to monitor and control bubbles (net wealth is at the heart of the transmission mechanism of asset prices and debt to consumption). Furthermore, NCM omits the part played by "animal spirits," where individuals act irrationally and for noneconomic reasons (e.g., reducing interest rates has had a very feeble effect, and recapitalizing banks has not worked). Quantitative easing (the government guarantees assets acquired by the central bank) and full-scale nationalization of the banking sector may be necessary.



Changes in the rate of interest are also absent in the NCM model, but these changes may influence aggregate supply. Since a significant number of firms and households depend on bank lending, aggregate demand and inflation are ultimately affected. Moreover, interest rate changes can impact the supply of credit (and granting of loans) through the narrow and broad credit channels of monetary policy under the assumption of imperfect capital markets (i.e., the role of banks as lenders and the financial health of borrowers). Furthermore, there is a role for corporate cash flows and asset prices. For example, a policy-induced change in the interest rate affects a firm's gearing ratio (i.e., the proportion of an investment that must be financed from external funds) and asset values determine the value of collateral that firms and consumers use to support loan applications.

The equilibrium real rate of interest is crucial to the framework of the NCM, but there is a serious problem with its role in the conduct of monetary policy. The interest rate gap is not a sufficient summary variable that captures all possible determinants of price changes. Cost-push shocks are a significant source of inflation but are not mirrored by the natural rate of interest. Moreover, the equilibrium real interest rate is not readily computable from observable economic data.

*For the complete text, go to [www.levy.org/pubs/wp\\_564.pdf](http://www.levy.org/pubs/wp_564.pdf).*

## INSTITUTE NEWS

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### Conference

#### **Gender and the Global Economic Crisis: 9th GEM-IWG International Conference on Gender, Macroeconomics, and International Economics**

On July 13 and 14, 2009, The Levy Economics Institute and the International Working Group on Gender, Macroeconomics, and International Economics (GEM-IWG) sponsored a conference on "Gender and the Global Economic Crisis" at United Nations Headquarters in New York City. The conference immediately followed a two-week intensive seminar held June 29 – July 10 at the Institute's main research and conference facility in Annandale-on-Hudson, New York. Both events were part of the Knowledge Networking Program, established by GEM-IWG in 2003 to strengthen intellectual links among economists whose work lies at the interface of gender, globalization, and macroeconomic policy. This year's program, organized in partnership with the Levy Institute's Gender Equality and the Economy program with support from the Ford Foundation, UNDP, UNIFEM, and the International Development Research Centre, focused on the origins and consequences of the global economic downturn. In addition to theoretical papers, presentations included empirical contributions with regional and country-level emphasis; evaluations of government responses to the crisis, and policy recommendations; and comparisons of the current crisis with earlier ones—including lessons learned. For additional information, visit [www.genderandmacro.org](http://www.genderandmacro.org).

### New Program Director

The Levy Institute welcomes ELLEN CONDLIFFE LAGEMANN as senior scholar and director of our recently instituted Project on Equality of Educational Opportunity in the 21st Century. Lagemann is Levy Institute Research Professor at Bard College, Bard Center Distinguished Fellow at Simon's Rock, and director of the Bard Center for Education and Democracy. The former dean of the Harvard Graduate School of Education, she is currently Charles Warren Professor of the History of American Education at Harvard, on leave. A

nationally known expert on the history of education and education research, Lagemann has lectured across the United States and in South Africa. She is the author or editor of nine books, most recently, *An Elusive Science: The Troubling History of Education Research* (2002), as well as numerous articles, reports, reviews, and book chapters. A former president of the Spencer Foundation and past chair of the Social Science Research Council's Committee on Philanthropy and the Nonprofit Sector, she has served on numerous other boards and national commissions, including the boards of the Russell Sage, Markle, and Greenwall Foundations, and the Teaching Commission. She is currently a director of the Rennie Center for Education Research and Policy in Cambridge, Mass., and co-chair of the National Research Council's Committee on Teacher Preparation. Lagemann holds an A.B. (cum laude) from Smith College, an M.A. from Columbia University's Teachers College, and a Ph.D., with distinction, from Columbia.

Under Lagemann, the Project on Equality of Educational Opportunity in the 21st Century will serve as an umbrella for a variety of projects at the interface of demography, schooling, and labor markets. These include assessments of the Bard Prison Initiative and a seminar on Youth Education and Employment.

### **New Research Associates**

SANJAYA DESILVA has joined the Levy Institute as a research associate working in the programs on Immigration, Ethnicity, and Social Structure, and Economic Policy for the 21st Century. DeSilva is an assistant professor of economics at Bard College specializing in development economics and applied microeconomics. He is a former teaching fellow in the Department of Economics at Yale University and the author of *Labor Supervision and Institutional Conditions: Evidence from Bicol Rice Farms* (with R. E. Evenson and A. Kimhi), *American Journal of Agricultural Economics*, 2006; and "Country Case Studies: Brazil" (with A. F. D. Avila, R. E. Evenson, and F. A. de Almeida), in Evenson and D. Gollin, eds., *Crop Variety Improvement and Its Effect on Productivity: The Impact of International Agricultural Research*, 2003. He is currently engaged in research on the political economy of education policy, and race and immigration in the housing market.

DeSilva holds a B.A. from Macalester College, and an M.A., an M.Phil., and a Ph.D. (in economics) from Yale.

DANIEL KARPOWITZ has joined the Institute as a research associate in the Project on Equality of Educational Opportunity in the 21st Century. He is currently visiting assistant professor of political studies at Bard College. As a Fulbright Scholar in Nepal, he worked on constitutional and property rights, and later taught in the Rhetoric Department at the University of California, Berkeley. In 2003, Karpowitz received a Soros Justice Fellowship for his work with the Bard Prison Initiative, of which he is director of policy and academics.

Karpowitz holds a B.A. from the University of Pennsylvania and a J.D. from the University of Chicago Law School, where he studied on a public interest fellowship.

## **PUBLICATIONS AND PRESENTATIONS**

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### **Publications and Presentations by Levy Institute Scholars**

**RANIA ANTONOPOLOUS** *Research Scholar*

**Publication:** *An Alternative Theory of Long-run Exchange Rate Determination*. VDM Verlag: Saarbrücken: VDM Verlag, 2009.

**Presentations:** "Policy Responses to the Economic Crisis: Gender Dimensions from a Developing Country Perspective," Third Congress of Feminist Economics, Universidad Pablo Olavide de Sevilla, Baeza, Spain, April 2–3; "The Current Global Financial Crisis: Gender Implications," Forum on Gender and the Economic Crisis: Opportunities for Equitable Responses, Carnegie Endowment for International Peace, Washington D.C., April 22; "Lessons Learned from South Africa's Public Job Creation Programme (EPWP): Impact on Gender Equality and Pro-poor Economic Development," *An International Conference on the Economic and Financial Crisis from a Gender Perspective: Understanding the Impacts on Poverty and Employment for Women*, organized by the Ministry of Foreign Affairs and the Institute for the Advancement of Women, Government of Mexico; the Economic Commission for Latin America and the Caribbean; United Nations

Development Fund for Women; and United Nations International Research and Training Institute for the Advancement of Women, Mexico City, July 22–24.

**PHILIP ARESTIS** *Senior Scholar*

**Publications:** “On the Convergence and Divergence of Economics” (with M. Sawyer), in S. Ghatak and P. Levine, eds., *Development Macroeconomics: Essays in Memory of Anita Ghatak*, Routledge, 2009; “Price and Wage Determination and the Inflation Barrier: Moving Beyond the Phillips Curve” (with M. Sawyer), in *Monetary Policy and Financial Stability: A Post-Keynesian Agenda*, Elgar, 2009; “On the Effectiveness of Fiscal Policy as an Instrument of Macroeconomic Policy” (with J. McCombie), *Economic Affairs*, Vol. 29, No. 1, March; “The New Monetary Policy: An Analysis of the Inflation Targeting in Brazil” (with L. F. de Paula and F. Ferrari-Filho), *Economia e Sociedade*, Vol. 18, No. 1, April (in Portuguese).

**Presentations:** staff/student seminar, Division of Economics and Strategy, The Business School at Oxford Brookes University, March 9; “Current Financial Crisis and Regulatory Implications,” conference on “Global Economic Crisis and Impact on Employment,” Cyprus Labour Institute, INEK, Nicosia, Cyprus, March 20–21; staff seminar, Business School, Greenwich University, March 26; “Flexible Rules Cum Constrained Discretion: A New Consensus in Monetary Policy” (with A. Mihailov), workshop on “Central Banking in the Twentieth Century,” University of Reading, April 24; staff/student seminar, Department of Economics, Kingston University, May 6; staff seminar, Department of Economics, University of Macedonia, Greece, May 22; and staff seminar, University of Paris 13, France, May 29; “21st Century Keynesian Economic Policy” (with M. Sawyer), workshop on “21st Century Keynesian Economics,” School of Oriental and African Studies, University of London, May 8.

**JAMES K. GALBRAITH** *Senior Scholar*

**Publications:** “The Roots of the Crisis and How to Bring It to an End,” *The RMA Journal*, March; “The Geithner Plan Won’t Work,” *The Daily Beast*, March 24; “No Return to Normal,” *The Washington Monthly*, March–April, 2009 (translated as “No habrá regreso a la normalidad: La solución de la crisis económica,” *Ola Financiera*, May); “The Recovery to Come,” *New American Contract*, April.

**Presentations:** “The Financial Crisis,” International Scene Lecture Series, Hofstra University, Hempstead, N.Y., February 24; “Comments on the Financial Crisis and Its Implications for Brazil,” seminar on “The Role of the State in a Postcrisis World and the Challenges for Brazil,” Council of Economic and Social Development, Brasília, Brazil, March 5–6; “Today’s Path to Growth: What Do the 1930s Tell Us about Now?,” symposium on “A Second Look at the Great Depression and New Deal,” Council on Foreign Relations, New York, N.Y., March 30; “Is the Stimulus the Solution?” panel on “The 2009 Stimulus Package: What’s in It (or Not) for Texas,” 24th Annual Public Conference, Texas Lyceum, Austin, April 3; “The Economic Crisis and Obama’s Response,” Clark University, Worcester, Mass., April 6; “Financial Crisis,” “The University of Chicago Conference on the Financial Crisis,” Chicago, Ill., April 10–11; guest speaker, “The Great Deleveraging,” organized by Meketa Investment Group, San Diego, Calif., April 20; “A New, New Deal,” “Hammer Forum” series, The Armand Hammer Museum of Art and Cultural Center, University of California, Los Angeles, April 21; “The World Recession: Causes, Consequences, and Cures,” “The Predator State and the Free Market,” and “The Growing Divide Between Rich and Poor Worldwide,” The American University in Cairo, Egypt, May 11–14; “Transformational Times,” 154th ARL Membership Meeting, Association of Research Libraries, Houston, Tex., May 20; “Current Analysis of the Economic Situation, the Outlook for Jobs, and the Role of Policy so Far in the Crisis,” The Global Economic Crisis: Is the “New” New Deal in Sight, University of California Center, Sacramento, May 27; “The Great Transition—A Green New Deal?,” “Building Workforce Partnerships Conference 2009: The Great Transition,” San Jose, Calif., May 27–28;

**GREG HANNSGEN** *Research Scholar*

**Presentation:** “Do the Innovations in a Monetary VAR Have Finite Variances?” Eastern Economic Association Annual Meeting, New York, N.Y., February 27 – March 1.

**FERIDOON KOOHI-KAMALI** *Research Associate*

**Presentation:** “Intrahousehold Inequality and Child Gender Bias in Ethiopia,” Eastern Economic Association Annual Meeting, New York, N.Y., February 27 – March 1.

**JAN KREGEL** *Senior Scholar*

**Presentations:** “From Mortgage Crisis to Global Depression,” expert meeting on “Crises in Global Governance, Opportunities for Global Justice,” Brussels, Belgium, February 12; “Taming the Bond Market Vigilantes: Gaining Policy Space,” panel on “From the Financial Crisis to the Global Economic Crisis: Impacts and Lessons, XI International Conference of Economists: Globalization and Development Problems,” Havana, Cuba, February 27; “Brazil and the Global Recession of the Twenty-first Century,” seminar on “The Role of the State in a Post-crisis World and the Challenges for Brazil,” Council of Economic and Social Development, Brasília, Brazil, March 5; “Keynes, Liquidity Preference, and Bank Bailouts in the Subprime Financial Crisis,” 4th International Conference on Keynes’s Influence on Modern Economics, Sophia University, Tokyo, Japan, March 16–17; “Re-regulating Finance: Using Minsky to Learn from the Crisis,” IDEAS conference on “Re-regulating Global Finance in the Light of the Global Crisis,” organized by International Development Economics Associates (IDEAs), Tsinghua University, Beijing, China, April 9–12; “From U.S. Subprime Mortgage Crisis to Global Depression,” meeting sponsored by the Advisory Committee to the Carolyn Benton Cockefair Chair in Continuing Education, University of Missouri–Kansas City, April 23; “Global Response to the Crisis and the President of The General Assembly of the United Nations’ Commission of Experts on Reform of the International Monetary and Financial System: The Economic Logic behind the Commission’s Major Proposals,” Regional High-Level Consultative Forum on the Impacts of the International Financial Crisis on the ESCWA Member Countries: The Way Forward, Damascus, Syrian Arab Republic, May 5–7; “The Economic Logic Behind the Commission’s Major Proposals,” thematic debate on “Principles of the Reform: Towards a New Bretton Woods?,” Parliamentary Conference on the Global Economic Crisis, organized by the Inter-Parliamentary Union, Geneva, Switzerland, May 7–8; “The Global Crisis and the Implications for Emerging Countries: Is the ‘B’ in BRICS Justified?,” National Institute of Advanced Studies XXI National Forum, “In the Midst of a World Crisis, the New Global Role of the BRICs (BRIMCs?) and Brazil’s Opportunities (Crisis as an Opportunity, Using the Action Plan),” The Brazilian Development Bank (BNDES), Rio de

Janeiro, Brazil, May 18; “Minsky and the Regulation of the Financial System,” presentation at “The Global Crisis, the Financial System and its Regulation,” Center of Economics and Finance for Development of Argentina (CEFID-AR), National Bank of Argentina, Buenos Aires, May 20.

**THOMAS MASTERSON** *Research Scholar*

**Presentation:** “What Are the Long-Term Trends in Intergroup Economic Disparities?” Eastern Economic Association Annual Meeting, New York, N.Y., February 27 – March 1.

**DIMITRI B. PAPADIMITRIOU** *President*

**Presentations:** interview regarding the latest version of TARP with Ron Fink, *Financial Week*, February 10; interview regarding the consequences of the crisis on consumption with Kay Glans, *Glasshouse Forums*, February 18; interview regarding AIG with Petra Boehm, Ard German TV, February 2; interview regarding international coordination on world recovery with Laurent Belsie, *Christian Science Monitor*, March 11; interview regarding perspective on TARP survey findings with Paul Davis, *American Banker*, March 27; workshop organized by Socialist International on the global economic crisis, recovery, governance, and regulatory reform, March 31; interview regarding the future of the SEC on Rose Aguilar’s radio program *Your Call*, April 6; interview regarding the relationship of contingent workers to aggregate demand and profits with Peter Coy, *BusinessWeek*, April 8; interview regarding the difficulty in the banking sector and its implications for the economy with Paul Davis, *American Banker*, April 9; interview regarding fiscal policy trends and the role of the state in the next 20 years with Giselle Machado, Kaiser Associates Latin America, April 9; interview regarding the 18th Annual Hyman P. Minsky Conference with Kathleen Hays, Bloomberg Television, April 16; “Full Employment Policy: Theory and Practice,” Global Foundation for Democracy and Development, Dominican Republic, April 27–28; interview regarding Minsky and his theories for the current crisis with Nikolaus Piper, *Süddeutsche Zeitung*, May 12, “Global Imbalances and Economic Growth,” XXI Villa Mondragone International Economic Seminar on “Global Crisis and Long-Term Growth: A New Capitalism Ahead,” Frascati, Italy, June 24–25; interview regarding banking industry expectations that unemployment will peak at 10 percent with Paul Davis, *American Banker*,

July 23; interview regarding the sustainability of the decline in early stage delinquencies with Paul Davis, *American Banker*, July 28; “Time of Upheaval,” HSBC Emerging Markets Conference on “Realities and Opportunities in 2009 and Beyond,” Zurich, Switzerland, September 8.

**JOEL PERLMANN** *Senior Scholar*

**Presentations:** “Evaluations of *A Just Zionism* by Chaim Gans” (with A. Follesdahl) and “Creating the Mizrahim” (with Y. Elmelech), Association for Israel Studies, Beer Sheva, Israel, June 1–3.

**EDWARD N. WOLFF** *Senior Scholar*

**Publication:** “Household Wealth and the Measurement of Economic Well-Being in the United States” (with A. Zacharias), *Journal of Economic Inequality*, Vol. 7, No. 2, June.

**Presentation:** “The Middle Class Squeeze,” Paduano Seminar in Business Ethics, Stern School of Business, New York University, April 2.

**AJIT ZACHARIAS** *Senior Scholar*

**Publication:** “Household Wealth and the Measurement of Economic Well-Being in the United States” (with E. N. Wolff), *Journal of Economic Inequality*, Vol. 7, No. 2, June.

**Presentation:** “Do Alternative Measures of Well-Being Matter for Assessing Economic Inequality?” Eastern Economic Association Annual Meeting, New York, N.Y., February 27 – March 1.

**GENNARO ZEZZA** *Research Scholar*

**Presentations:** “Stock-flow Consistent Post-Keynesian Models as Tools for Short- and Long-period Analysis,” Centro Sraffa, Rome, Italy, May 8; “Stock-flow Consistent Post-Keynesian Models in Theory and Practice,” workshop on “Nonequilibrium Monetary Dynamics,” Trento, Italy, May 28; “Measuring Life Satisfaction in Italy,” conference on “Monitoring Italy,” Rome, Italy, June 3–4.

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