Levy Economics Institute of Bard College

Summary

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Contents

Continued on page 3 ▸

Scholars by Program

The State of the US and World Economies

DIMITRI B. PAPADIMITRIOU, President and Program Director
JAMES K. GALBRAITH, Senior Scholar
JAN KREGEL, Senior Scholar
L. RANDALL WRAY, Senior Scholar
GREG HANNSGEN, Research Scholar
GENNARO ZEZZA, Research Scholar
MARSHALL AUERBACK, Research Associate
CLAUDIO H. DOS SANTOS, Research Associate
JESUS FELIPE, Research Associate
MICHAEL HUDSON, Research Associate
ROBERT W. PARENTEAU, Research Associate
C. J. POLYCHRONIOU, Research Associate and Policy Fellow

Monetary Policy and Financial Structure

JAN KREGEL, Senior Scholar and Program Director
DIMITRI B. PAPADIMITRIOU, President
JAMES K. GALBRAITH, Senior Scholar
L. RANDALL WRAY, Senior Scholar
MARSHALL AUERBACK, Research Associate
JÖRG BIBOW, Research Associate
STEVEN M. FAZZARI, Research Associate
JESUS FELIPE, Research Associate
MICHAEL HUDSON, Research Associate
ROBERT W. PARENTEAU, Research Associate
SUNANDA SEN, Research Associate
WILLEM THORBECKE, Research Associate
ÉRIC TYMOIGNE, Research Associate

The Distribution of Income and Wealth

JAMES K. GALBRAITH, Senior Scholar
EDWARD N. WOLFF, Senior Scholar
DIMITRI B. PAPADIMITRIOU, President
AJIT ZACHARIAS, Senior Scholar
SELÇUK EREN, Research Scholar
THOMAS MASTERSON, Research Scholar
ROBERT HAVEMAN, Research Associate
CHRISTOPHER JENCKS, Research Associate
SUSAN E. MAYER, Research Associate
BRANKO MILANOVIC, Research Associate
JACQUES SILBER, Research Associate
BARBARA WOLFE, Research Associate

Gender Equality and the Economy

RANIA ANTONOPOULOS, Senior Scholar and Program Director
DIMITRI B. PAPADIMITRIOU, President
KIJONG KIM, Research Scholar
NILÜFER ÇAĞATAY, Research Associate
LEKHA S. CHAKRABORTY, Research Associate
PINAKI CHAKRABORTY, Research Associate
VALERIA ESQUIVEL, Research Associate
INDIRA HIRWAY, Research Associate
TAMAR KHITARISHVILI, Research Associate
EBRU KONGAR, Research Associate
EMEL MEMIS, Research Associate
IMRAAN VALODIA, Research Associate
TAUN TOAY, Research Analyst

Employment Policy and Labor Markets

DIMITRI B. PAPADIMITRIOU, President
JAMES K. GALBRAITH, Senior Scholar
JAN KREGEL, Senior Scholar
L. RANDALL WRAY, Senior Scholar
RANIA ANTONOPOULOS, Senior Scholar
MARSHALL AUERBACK, Research Associate
VALERIA ESQUIVEL, Research Associate
MATHEW FORSTATER, Research Associate
FADHEL KABOUB, Research Associate
PAVLINA R. TCHERNEVA, Research Associate

Immigration, Ethnicity, and Social Structure

JOEL PERLMANN, Senior Scholar and Program Director
YUVAL ELMELECH, Research Associate
YINON COHEN, Research Associate
SERGIO DELLAPERGOLA, Research Associate
SANJAYA DESILVA, Research Associate
BARBARA S. OKUN, Research Associate
SEYMOUR SPILERMAN, Research Associate

Economic Policy for the 21st Century

JAMES K. GALBRAITH, Senior Scholar
DIMITRI B. PAPADIMITRIOU, President
RANIA ANTONOPOULOS, Senior Scholar
PHILIP ARESTIS, Senior Scholar
MARSHALL AUERBACK, Research Associate
WILLIAM J. BAUMOL, Research Associate
JÖRG BIBOW, Research Associate
LEKHA S. CHAKRABORTY, Research Associate
PINAKI CHAKRABORTY, Research Associate
SANJAYA DESILVA, Research Associate
STEVEN M. FAZZARI, Research Associate
JESUS FELIPE, Research Associate
MATHEW FORSTATER, Research Associate
GREG HANNSGEN, Research Scholar
MICHAEL HUDSON, Research Associate
THOMAS KARIER, Research Associate
STEPHANIE A. KELTON, Research Associate
TAMAR KHITARISHVILI, Research Associate
WILLIAM H. LAZONICK, Research Associate
MARY O'SULLIVAN, Research Associate
ROBERT W. PARENTEAU, Research Associate
C. J. POLYCHRONIOU, Research Associate and Policy Fellow
JAMES B. REBITZER, Research Associate
MALCOLM SAWYER, Research Associate
ANWAR M. SHAIKH, Research Associate
MARTIN SHUBIK, Research Associate
MICHAEL STEPHENS, Senior Editor and Policy Fellow
WILLEM THORBECKE, Research Associate
W. RAY TOWLE, Research Associate and Editor
ÉRIC TYMOIGNE, Research Associate
FATMA GÜL ÜNAL, Research Associate
L. RANDALL WRAY, Senior Scholar
AJIT ZACHARIAS, Senior Scholar

Equality of Educational Opportunity in the 21st Century

ELLEN CONDLIFFE LAGEMANN, Senior Scholar and Program Director
DANIEL KARPOWITZ, Research Associate

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Contents (continued)

LETTER FROM THE PRESIDENT

To our readers:

This issue begins with a public policy brief by Senior Scholar L. Randall Wray and me under the State of the US and World Economies program. We survey the prospects of a new global financial crisis being triggered by events in Europe or the United States, and suggest a number of ways a fresh disaster might be averted. The common diagnosis of a "sovereign debt crisis" ignores the crucial role of rising private debt loads and the significance of current account imbalances within the eurozone. Profligate spending in the periphery is not at the root of the problem and pushing austerity while ignoring these imbalances is a recipe for deflationary disaster. And the shaky US financial system is unlikely to withstand the pressures created by a financial collapse in the eurozone.

In a policy note, Research Associate and Policy Fellow C. J. Polychroniou finds that public-policy mania in Europe, which imposes fiscal tightening in the midst of recession, can only lead to catastrophic failure. What is needed is a political and economic revolution that includes a return to Keynesian measures and a new institutional architecture—a United States of Europe.

Three working papers are also included under this program. Esteban Pérez-Caldentey and Matías Vernengo find that the solution to the European debt crisis requires a profound institutional reform of the euro and its core principles, with charter mechanisms to clear the imbalances. Wray believes that the Irish bailout was a mistake and needs to be unwound. European Monetary Union countries such as Ireland need both debt relief and jobs, and could adopt a job-guarantee program using either conventional or unconventional financing. Robert Dubois expects violent economic downturns followed by significant liquidity-inspired asset rallies in the next 18–36 months. Policy-path consistency will prove highly challenging, he says, and the European banking sector is becoming a ward of the European Central Bank.

The Monetary Policy and Financial Structure program begins with a public policy brief and working paper by James Felkerson. He outlines both the conventional and unconventional transactions associated with the Federal Reserve's measures to stabilize the US economy in order to ultimately formulate policy in the event of another crisis. He finds that the Fed bailout was unprecedented in scale and scope, and wound up targeting the largest financial institutions worldwide.

In a working paper, Wray analyzes the relationship between the industrial and financial spheres of circulation, and determines that the monetary economy must take into account the parts played by bulls, bears, and the states in the circuit. In a second paper, Wray believes that the global financial crisis is a consequence of too much power in the hands of the financial sector, money managers, the predator state, and Europe's center. He calls for fundamental reform that is biblical in scale such as cancelling the debt of homeowners and heavily indebted countries. In a third paper, Bernard Shull finds that the Dodd-Frank Act is unlikely to eliminate "too big to fail" and reforms may be needed to alter the entire regulatory culture.

Under the Distribution of Income and Wealth program, Senior Scholars Edward N. Wolff and Ajit Zacharias, Research Scholars Thomas Masterson and Selçuk Eren, and Andrew Sharpe and Elspeth Hazell compare inequality and living standards in Canada and the United States using an expanded measure of the Levy Institute Measure of Economic Well-Being (LIMEW). Three factors account for the differences between the two countries: income from nonhome wealth, household production, and base income. In 2005, the median equivalent LIMEW in the United States was 8 percent higher than in Canada but inequality was much greater, due largely to the income from nonhome wealth component. In sum, the public sector was the leading source of growth in well-being for the middle class in both countries.

In a policy note under the Employment Policy and Labor Markets program, Research Associate Pavlina R. Tcherneva believes that the conventional approach of fiscal policy to create employment is backward. She proposes a grassroots job-guarantee program run by the nonprofit sector (with participation by the social entrepreneurial sector) but financed by the government. In a working paper, Tcherneva evaluates the transformation of Argentina's *Plan Jefes*, a job guarantee program, to *Plan Familias*, an income support plan, and finds that it represents a step backward for women by removing a number of benefits and reinforcing gender stereotypes. In a second paper, she extends her argument that targeted labor-demand policies (e.g., the government acting as employer of last resort) are more effective than aggregate demand management in connecting fiscal policy with full employment.

Under the Economic Policy for the 21st Century program, a working paper by Research Associate Michael Hudson proposes that neoliberal countries apply classical economic policies such as taxing rent and windfall gains, and removing the tax deductibility of interest. In a second paper, Hudson outlines the progression of capitalism and suggests reviving the logic underlying the Progressive Era's reform program. The great economic fiction of our time is that all debts can be paid. The solution, he says, is a debt write-down. In a third paper, Research Associate Sanjaya DeSilva and Mohammed Mehrab Bin Bakhtiar analyze the benefits of schooling for females in the Bicol region of the Philippines, where women are more educated than men.

As always, I welcome your comments and suggestions.

Dimitri B. Papadimitriou, *President*

Program: The State of the US and World Economies

Fiddling in Euroland as the Global Meltdown Nears

DIMITRI B. PAPADIMITRIOU and L. RANDALL WRAY
Public Policy Brief No. 122, 2012

President Dimitri B. Papadimitriou and Senior Scholar L. Randall Wray survey the prospects of a new global financial crisis being triggered by events in Europe or the United States, and suggest a number of ways a fresh disaster might be averted. Beginning with the troubles in Euroland, they argue that the common diagnosis of a "sovereign debt crisis" obscures more than it explains. This diagnosis ignores the crucial role of rising private debt loads and the significance of current account imbalances within the eurozone. The economic crisis itself is largely to blame for the rise in public debt ratios experienced by most eurozone nations—precrisis, only two had ratios that significantly exceeded the Maastricht limit. Profligate spending in the periphery is not at the root of the problem, say the authors, and austerity will not solve it. If a nation like Greece tries to reduce its public debt load through austerity, it will only be able to blunt the ensuing collapse in economic growth and expansion of private debt by reducing its current account deficit. But this requires that surplus countries like Germany change their policies. Pushing austerity in the periphery while ignoring these imbalances is a recipe for deflationary disaster.

The European Monetary Union (EMU), as the authors and others have long pointed out, was flawed from the start. Members became users of an external currency without setting up central fiscal or monetary policy bodies capable of kick-starting growth or backstopping member-state debt. The EMU is like a United States without a Washington. After surveying some of the potential solutions that have been discussed, Papadimitriou and Wray offer their own road map through this crisis, one that involves addressing the flawed setup of the EMU.

According to the authors, the United States has a shaky financial system that is unlikely to withstand the pressures created by a financial collapse in the eurozone. Even without a full-blown financial crisis in Euroland, the health of the US financial system is suspect. They believe that many of the biggest US banks are already insolvent: the banks have not fully recovered from the last crisis and their weaknesses have been papered over by a policy of "extend and pretend." Turbulence can be expected from numerous directions—from a struggling real economy, with its sluggish labor market, to a still-weak housing market, the inevitable deflation of a commodities bubble, and the banks' growing number of securities fraud cases. Although the spark for the next financial firestorm will likely come from Europe, it could arise from problems at America's biggest banks. The authors discuss what is needed to rebuild the US economy and its financial structure, and address the jobs situation, household debt relief, and how to shore up the brittle banking system.

Papadimitriou and Wray conclude with an examination of the situation in Greece, which is at the center of the eurozone storm. The various rescue packages on offer will not ultimately solve the problem and a default is a very real possibility. Inspired by neoliberal doctrine, the crisis is being used as a pretext for privatization and a rollback of social legislation, while harsh austerity measures are having devastating consequences in terms of unemployment, poverty, and fraying of the social fabric. If a new approach is not embraced, we are likely seeing the end of the EMU as it currently stands, say the authors. The future of the eurozone could break in either of two directions: nations leaving the euro in a coordinated dissolution, the consequences of which would be global and potentially devastating; or, far more desirable, a major restructuring of the EMU, featuring increased consolidation and a mechanism for dealing with the effects of competing internal imbalances.

This brief is derived from Working Paper no. 693, which is summarized on pp. 10–12 of the Winter 2012 *Summary*.
www.levyinstitute.org/pubs/ppb_122.pdf

Neo-Hooverian Policies Threaten to Turn Europe into an Economic Wasteland

C. J. POLYCHRONIOU

Policy Note 2012/1

Capitalism is capable of creating both immense wealth and massive destruction, says Research Associate and Policy Fellow C. J. Polychroniou. But rapid and constant growth is not a natural tendency of the capitalist system. Moreover, incompetent political leadership in Europe has conducted neo-Hooverian (scorched-earth) economic policies that are shrinking its economies and producing social misery as a result of massive unemployment. What is needed, says Polychroniou, is a political and economic revolution that includes a return to Keynesian measures and a new institutional architecture; that is, a United States of Europe.

We live in a terrifying world of policymaking—an age of free-market dogmatism where the economic ideology is fundamentally flawed. A pervasive myth is that of a "free market," when in fact most capitalist economies are essentially mixed and government is the key to long-term development, including a global economy. Capital accumulation is an inherently unstable process, and (unregulated) capitalism is prone to financial crises. Large-scale government intervention is thus critical to reviving an economy; the current public-policy mania, which imposes fiscal tightening in the midst of recession, can only lead to catastrophic failure. Europe's incompetent political leadership has jeopardized the eurozone's future, converted the financial crisis into a full-fledged economic crisis, divided the northern and southern economies, created permanent economic poverty in Greece and Portugal, and choked off a fragile global recovery.

The Greek debacle began soon after October 2009, when the newly elected government of George Papandreou exposed Greece's dismal fiscal condition but subsequently granted selective wage increases and failed to conduct aggressive reform policies or tackle the deeply rooted problem of tax evasion. When the government lacked the political will to reform the economy and address the ills of Greece's political culture, the country's credit rating was downgraded and yield spreads widened relative to German bunds. Thus, a national fiscal crisis became a severe debt crisis.

Europe's political leadership has fared no better in handling the Greek crisis. The adopted bailout packages have nothing to do with Greece's economic reality or the eurozone's problems (e.g., a flawed currency and the emergence of a "two-speed" Europe). As a result, the Greek economy has been devastated more by the imposed austerity measures than by the global recession. Fiscal consolidation and austerity have led to unemployment rates exceeding 20 percent (November 2011), while youth unemployment stands at 48 percent. These bailouts do not solve Greece's debt crisis but simply postpone an official default, says Polychroniou.

In contrast, Portugal has met all the terms of its bailout package, yet its debt ratio and unemployment rate continue to increase while economic growth continues to shrink. The same results hold for Ireland. Overall, the austerity measures demanded by Germany threaten to turn Euroland into an economic wasteland, where capitalism has a miserable future.

www.levyinstitute.org/pubs/pn_12_01.pdf

The Euro Imbalances and Financial Deregulation: A Post-Keynesian Interpretation of the European Debt Crisis

ESTEBAN PÉREZ-CALDENTEY and MATÍAS VERNENGO

Working Paper No. 702, January 2012

The conventional view is that the European debt crisis was caused by fiscal profligacy on the part of the peripheral (noncore) countries in combination with a welfare state model, and that the role of the common euro currency was minimal. The solution to the crisis, therefore, must focus on fiscal discipline.

This paper by Esteban Pérez-Caldentey, UN Economic Commission for Latin America and the Caribbean, and Matías Vernengo, University of Utah, finds that the crisis is the result of an imbalance between core and noncore countries that is inherent in the euro economic construct. Using a simple post-Keynesian heuristic model, the authors conclude that the solution to the crisis requires a profound institutional reform of the euro and its founding principles, with charter mechanisms to clear the imbalances. John Maynard Keynes's clearing union proposal, for example, would guarantee that balances were recycled from surplus to deficit countries, maintaining the dynamics of aggregate demand and thus ensuring that the burden of adjustment was shared by both debtor and creditor economies.

According to traditional currency-crisis models, the original source of an external crisis is domestic debt. More recent models remain committed to the assumption that public sector finances are central to currency crises. From a post-Keynesian perspective, however, a fiscal crisis (i.e., an increase in deficits and domestic debt) is the result rather than the cause of an external crisis. In terms of the European crisis, higher unit labor costs in the periphery led to a loss of competitiveness, along with greater external problems. Combined with the financial crisis, this circumstance implied a collapse of output and a fiscal crisis. The inability to depreciate the nominal exchange rate and the absence of a supranational fiscal authority that could transfer resources meant that economic contraction was the solution for external imbalances.

The thrust for financial deregulation in Europe was the adoption of a five-year financial harmonization program—the Financial Services Action Plan—in 1999. This plan was meant to harmonize European Union (EU) rules on a range of financial services. Its objectives included the development of a single market for wholesale financial services, the creation of open and secure retail markets, the establishment of prudential rules for the supervision of financial services, and the setting of conditions to optimize a single financial market. It enhanced financial liberalization so that both core and noncore countries became fully liberalized after adopting the euro. And fiscal convergence set out in the Maastricht Treaty meant that countries had to run surpluses in good times to offset deficits in bad times.

Harmonizing EU financial legislation and regulation in combination with adopting a single currency led to greater cross-border financial flows, converging short- and long-term interest rates, expanded balance sheets of member countries, and increased capital markets. The increase in cross-border flows was affected more by the adoption of the euro, which eliminated exchange-rate risk, than by financial liberalization and deregulation. With lower interest-rate margins, especially in the noncore countries, the rate of return over assets declined. Profitability was maintained through higher leverage (or indebtedness), which was particularly high in some core countries. Leverage for the major banks in Germany, for example, increased from 27 to 45 between 1996 and 2007. The freedom of financial flows, low borrowing costs, easy access to liquidity via leveraging, and no exchange-rate risk provided a false sense of prosperity in a low-risk environment.

The Maastricht Treaty, in conjunction with the Stability and Growth Pact (SGP), made private expenditure and exports central to aggregate demand, and became the lynchpin of growth. Core countries pursued wage moderation as well as policies to contain labor costs below those of noncore countries. Between 2000 and 2007, unit labor costs increased merely 7 percent in the core countries but 24 percent in the periphery. And in a fixed regime where the bulk of trade is intraregional, this led to a real devaluation and a basis for the core countries to pursue export-led, "beggar thy neighbor" growth policies. The noncore countries increased internal aggregate demand in order to grow, so their current account balances deteriorated.

According to the authors, unit labor costs impacted the external performance of European economies, and the common currency was central to the outcome. The noncore countries (initially) maintained their fiscal positions within the guidelines of the Treaty, and some noncore countries generated fiscal surpluses (e.g., Ireland and Spain). Private balances in these countries rose from a deficit of 1.6 percent of GDP in 2002 to 6.7 percent of GDP in 2007. Moreover, household indebtedness and the growth rate of mortgage loans were particularly significant. Public debt, the authors note, was relatively constant or declined in both core and noncore countries until the 2007–08 crisis.

From the authors' viewpoint, the evidence against a fiscal crisis is clear-cut and contrary to the notion that the debate should focus on whether the SGP should be strengthened or new arrangements implemented to promote fiscal centralization at the supranational level. In addition, fiscal centralization is seen as a step toward further stringent fiscal adjustment rather than toward reducing the problems of a common currency and promoting fiscal transfers to distressed economies. And an external sector–led recovery can only mean that low wages and deflation will increase external competitiveness. This is a self-defeating strategy that portends unemployment and further contraction of aggregate demand, say the authors.

The authors' optimistic outlook is that the rate of growth of GDP per capita in 2012 will be close to 1 percent in the core countries and minus 1.5 percent in the noncore countries. They suggest placing an equilibrating principle at the center of

monetary integration to rebalance the countries' external accounts, increase the policy space for fiscal expansion, and lead to economic growth and full-employment policies.
www.levyinstitute.org/pubs/wp_702.pdf

The Euro Crisis and the Job Guarantee: A Proposal for Ireland

L. RANDALL WRAY
Working Paper No. 707, February 2012

There is a fundamental relation between economic growth and the ability to pay interest to service debt. A rule of thumb is that a nonsovereign borrower should not pay an interest rate that significantly exceeds its growth rate. Highly indebted members of the European Monetary Union (EMU) are nonsovereign borrowers that are unable to service their debts and there is no alternative to debt relief, observes Senior Scholar L. Randall Wray. Austerity does not reduce budget deficits because tax revenues fall faster than spending cuts occur. An alternative path is a universal job guarantee program funded by the central government. Since EMU countries do not have a sovereign currency and cannot control their borrowing rates, they could at least adopt a limited job creation program using conventional, or unconventional, financing.

Ireland needs both debt relief and jobs, but it has little domestic policy space to use monetary and fiscal policy to deal with the crisis. Whereas Icelandic voters have responded in a rational and responsible manner by not agreeing to cover the euro-denominated debt of private financial institutions, the Irish government has chosen to guarantee the banks' debts, which are in essence denominated in a "foreign" currency (i.e., the euro). This choice "busted the budget" (e.g., borrowing costs exploded) and led to Ireland's current problems. There is neither the possibility of depreciating the "Irish euro" nor creating European Central Bank euros to meet the demands for clearing. The Irish bailout was a mistake and needs to be unwound, says Wray.

The conventional way to generate government revenues and service debt is to cut government spending and raise taxes—measures that hurt economic growth. And it appears that it will be difficult for Ireland to export its way out of debt, since the European economic situation is imploding and the global economy is weak. Ireland's transition from a government budget surplus of 2.5 percent of GDP to a deficit of 12.5 percent of GDP mirrors that of the United States. The difference is that Ireland lacks a sovereign currency and faces an insolvency constraint and default risk.

The construct of a job guarantee program would pay basic wages and benefits (e.g., health and child care, social security taxes, and vacation and sick leave) to anyone ready and willing to work, and adapt the jobs to the workers (as proposed by Hyman P. Minsky). Wages would be paid by the central government directly into the bank accounts of participants. The program sets a wage floor but does not drive wages up because it hires "off the bottom" at a fixed wage (it can never cause hyperinflation).

Wray recommends that a job guarantee program should be decentralized to include local governments and not-for-profit service organizations, and that it should provide for part-time work and flexible working conditions. He notes that the program operates like a buffer stock—expanding during an economic downturn and contracting during an upturn. Importantly, workers would not have to leave their communities to seek employment. And since the primary purpose of the program is to create jobs, the government should cover only a small portion of nonwage costs. Wray also notes that program spending would equate to approximately 1–2 percent of GDP and that the benefits would be several times greater than the costs.

In general, a job guarantee program does not compete with the private sector and can provide goods and services that are not provided by the markets and too expensive for low-income households. Examples include social services (child and elder care, public safety), small-scale public infrastructure (roads, water, and sewage projects), low-income housing, food preparation ("soup kitchens"), and green jobs. Selected jobs can also help to promote tourism and exports. Wray further notes that (contrary to neoliberal propaganda) the New Deal's job creation programs provided lasting benefits that helped to transform and modernize America (e.g., public buildings, roads, dams, and national parks). Moreover, such programs improve working conditions in the private sector, reduce inflation, and help to promote economic and price stability.

A sovereign nation operating with its own currency and a flexible exchange rate regime can always afford a job guarantee program, says Wray. Ireland does not qualify in this regard and, given its indebtedness, cannot implement a universal job guarantee. It would need to limit the impact on monetary demand by setting the program's monetary wage close to the minimum wage in the formal sector and providing extramarket necessities as part of its total compensation package (e.g., domestically produced food, clothing, shelter, and basic services such as health and education). And to further mitigate monetary demand, any required imports of tools and materials could be linked to export earnings. Also, phasing in the program would help to attenuate any undesirable impacts on the markets and government budget, while competency is gained to manage a larger program.

One alternative for Ireland is to develop a new currency for the payment of wages in the program (e.g., "local currency units") and for the payment of taxes, fees, and fines (the new currency would not be convertible to euros). Another alternative is to pay wages in euros and float bonds to raise euros as needed. The government could eliminate default risk by issuing special bonds acceptable in tax payment and align bond sales with the number of jobs created.

www.levyinstitute.org/pubs/wp_707.pdf

The European Central Bank and Why Things Are the Way They Are: A Historic Monetary Policy Pivot Point and Moment of (Relative) Clarity

ROBERT DUBOIS

Working Paper No. 710, March 2012

According to Robert Dubois, Trend Modus Capital Management, the collective global central banking policy posture has become more homogenized, synchronized, and directionally clear than at any time since early 2009. Central banks have become primary (nonresidual) sources of demand for their respective treasuries and agency debt (through secondary market purchases and secured lending), due to concerns that are skewed toward deflation risks.

Monetary easing became especially important during the fourth quarter of 2011 amid renewed signs of global economic weakness. Given the precarious positions of numerous sovereigns and significant banking segments, as well as the highly reactionary tendencies among major central banks, there is the distinct possibility of recurrent bouts of violent economic downturns followed by significant liquidity-inspired asset rallies in the next 18–36 months. Policy path consistency may prove highly challenging in this unstable environment, says Dubois.

The European Monetary Union (EMU) is at the center of the current crisis, and its bifurcated monetary and fiscal operations fuel the risk of extreme divergence in the economic fates of individual members. Intervention by the European Central Bank (ECB), however, appears to have slowed the downward spiral within the eurozone in light of the recently launched Long-Term Refinancing Operation (LTRO) program, which more fully equips the ECB to pursue broader policy objectives and respond to current market dynamics and public sensitivities.

The author notes that the EMU represents a partial federal integration, since fiscal matters (including treasury and budget policy) remain fragmented and disaggregated among 17 states. Furthermore, the level of institutional inertia that must be overcome to effect a material policy change is a function of the most politically dysfunctional state. Policy action, therefore, follows the arrival of crisis. Moreover, the potential for fiscal integration is limited due to a lack of political integration and wide-ranging dissimilarities across states. Heavily indebted nations such as Greece lack monetary policy alternatives, while the EMU lacks the authority to impose and enforce fiscal policy. Thus, a "two-speed Europe" has emerged—the northern states running massive current account surpluses and the peripheral states running corresponding current account deficits. This has led to a stark divergence in treasury yields between states and a brutal unwinding of debt.

Greece's bankruptcy saga entered a new phase following Standard and Poor's downgrade of Greek sovereign debt to "selective default" on February 27, 2012, following the Greek government's retroactive insertion of collective action clauses in documentation covering its sovereign debt. Dubois also notes that the ECB has gone to great lengths to characterize the negotiated write-downs as voluntary, since a nonvoluntary write-down (or default) would trigger potentially destabilizing payouts on credit default swaps; preclude additional ECB purchases of Greek sovereign debt or the acceptance of such debt as collateral; cause significant write-downs on ECB, International Monetary Fund, and other nonprivate holdings of Greek debt; and potentially serve as a precedent for the handling of troubled sovereigns. It remains to be seen if the collective action clauses will be invoked to force private holders of Greek debt to accept a bond “haircut,” whether 3.2 billion euros of credit default swaps will be triggered, and how the ECB will treat its pledged collateral in the form of Greek sovereign debt. A critical date is March 20, when 14 billion euros of Greek sovereign debt matures. With Greece having crossed the default threshold, only the manner of default and knock-on effects remain to be seen, observes Dubois.

Many sovereign nations in Europe are insolvent and most of the private banking entities would be insolvent but for various capital ratio–accounting measures, in combination with persistent opacity of the financial industry that is encouraged by the authorities. Furthermore, the global private-funding markets are entirely closed to the distressed elements of (European) sovereign and private-bank funding, as well as the markets’ liquidity needs. Additional ongoing concerns include the implications of currency debasement in the global struggle to secure demand, including risks of sharp inflationary pressures on the heels of deflationary struggles that stem from the world’s greatest debt binge and monetary expansion.

The LTRO program represents a massive form of (backdoor) quantitative easing that stabilizes private banking balance sheets. Round one dispensed 489 billion euros on December 21, 2011. The market impact reduced by half treasury yields with three-year maturities or less. The yields of maturities greater than three years, however, remained high and at unsustainable levels for servicing the debt loads of peripheral nations. Round two dispersed 530 billion euros on February 29, 2012. Since the ultimate size of potential interventions by LTRO is estimated at more than 3 trillion euros, much of the European banking sector is becoming a ward (i.e., a utility-like functionary) of the ECB.

www.levyinstitute.org/pubs/wp_710.pdf

Program: Monetary Policy and Financial Structure

A Detailed Look at the Fed’s Crisis Response by Funding Facility and Recipient

JAMES FELKERSON

Public Policy Brief No. 123, 2012

As part of the Ford Foundation project “A Research and Policy Dialogue Project on Improving Governance of the Government Safety Net in Financial Crisis,” James Felkerson, University of Missouri–Kansas City, has undertaken a comprehensive examination of the raw data on the Federal Reserve’s unconventional efforts to shore up the financial system in response to the 2007–09 crisis. The extraordinary challenge represented by that crisis provoked an extraordinary reaction by the Fed in the enactment of its role as lender of last resort. This policy brief provides a descriptive account of the Fed’s unconventional efforts as a first step in the process of both evaluating that response and thinking about how to set Fed policy for future crises.

The brief begins by summarizing the three measures used to determine the size and scope of the Fed’s interventions. It then outlines the unconventional facilities and programs that were created by the central bank in an attempt to stabilize the financial structure. The Fed’s activities are organized into three distinct “stages,” each one corresponding to a particular set of policy tools. As many of these programs and facilities were aimed at specific classes of markets or even specific financial institutions, the brief also highlights those markets and institutions that were the targets of the Fed’s interventions and provides a breakdown of the support provided to the major recipients. Where relevant, the amounts paid back or outstanding as of March 1, 2012, are noted.

The focus is placed on the unconventional actions that were initiated after the Fed had exhausted its conventional lender-of-last-resort operations—which is to say, excluding such tools as the provision of liquidity through open market operations or through direct lending to institutions via the discount window. Three different ways of measuring the Fed’s unconventional stabilization efforts over the course of the crisis are presented. First, the brief tallies the peak outstanding amounts committed by the Fed at a given point in time. Second, it reports the peak flow of loans and asset purchases over a period of time. And finally, the brief puts together a cumulative measure of the total amount of loans and asset purchases from January 2007 to March 2012. This last measure is informed by the view that each unconventional intervention by the Fed represents an instance in which private markets failed to perform their usual functions (of intermediation and liquidity provisioning). The three measurements are provided for each of the major facilities and purchasing programs, across all three stages. Aggregate totals are then provided for all of the Fed's unconventional operations over the period January 2007 – March 2012.

The three ways of measuring the Fed's response serve to highlight different aspects of the crisis and the central bank's role. Selecting the appropriate measure depends on the question being asked. The peak outstanding amount—the size of the balance sheet at a point in time—represents the maximum risk of loss faced by the central bank. The second measure, registering the peak flow of loans and asset purchases over a span of time, allows us to track the more severe periods of financial system distress. The final, cumulative measure of every individual unconventional transaction—an amount more than twice US GDP—gives us a picture of the sheer magnitude of the Fed's interventions in its attempts to stabilize the financial structure.

This brief is based on Working Paper no. 698, which is summarized below.

www.levyinstitute.org/pubs/ppb_123.pdf

$29,000,000,000,000: A Detailed Look at the Fed's Bailout by Funding Facility and Recipient

JAMES FELKERSON

Working Paper No. 698, December 2011

This is the first in a series of working papers on the Federal Reserve's response to the financial crisis of 2007–09. It is part of the Ford Foundation project "A Research and Policy Dialogue Project on Improving Governance of the Government Safety Net in Financial Crisis," directed by Senior Scholar L. Randall Wray.

James Felkerson, University of Missouri–Kansas City, outlines both the conventional and the unconventional transactions of the Fed, using three different methods to capture various aspects of the bailout: the size of the Fed's balance sheet at a point in time, the flow of lending over a period, and the cumulative total of all funds supplied by the Fed outside "normal" monetary policy. Such information combined with an assessment of the Fed's approach to the crisis should help in formulating policy in the event of another crisis—which seems increasingly likely.

The recent crisis required an extraordinary response by the Fed in fulfilling its lender-of-last-resort (LOLR) function. The explicit objective of LOLR is to halt financial instability by providing liquidity to financial institutions and markets. The conventional tools are threefold: lending directly to institutions through the discount window, improving the lending terms (i.e., decreasing the rate charged to borrowers or lengthening the repayment period), and providing liquidity through open market operations. Preoccupation with control of the money stock during a time of crisis shifted the emphasis from measures conducted at the initiative of the borrower to measures undertaken at the initiative of the Fed. And since the conventional tools were relatively ineffective, the Fed designed and implemented a host of unconventional measures to stabilize the US economy.

The Fed engaged in loans, guarantees, and outright purchases of financial assets that were unprecedented (and of questionable legality), amounting to more than twice US GDP. Its balance sheet ballooned from approximately $900 billion to more than $2.8 trillion, and the focus shifted from providing liquidity to purchasing long-term securities. The changing composition and size of the Fed's balance sheet offers insight into the scope of its actions, which were the result of targeted responses to events. According to Felkerson, an unconventional Fed transaction represents an instance in which private markets were incapable or unwilling to conduct normal intermediation and liquidity provisioning activities.

In the first stage, the Fed provided short-term liquidity to solvent banks and other depository and financial institutions. The objectives were deemed to be consistent with the intent of the Fed's traditional LOLR mandate. The Term Auction Facility (TAF), implemented in December 2007, provided liquidity to foreign and domestic depository institutions via an auction format that allowed banks to borrow as a group and pledge a wider range of collateral than generally accepted at the discount window. As of the last auction in March 2010, the

Fed had loaned $3.8 trillion. The Fed also lent $10 trillion under the Central Bank Liquidity Swap Lines (CBLS) program (December 2007) that allowed foreign central banks to borrow dollars against a prearranged line of credit. In addition, the Fed conducted a series of term repurchase transactions in 2008 ($855 billion) that were designed to provide direct liquidity support to primary dealers.

To supplement the aid provided to investment banks and address the widening spreads in the repo markets, which were having an adverse impact on the allocation of liquidity, the Fed extended its Treasury lending program by disbursing $1.94 trillion through the Term Securities Lending Facility (TSLF) (March 2008) and $62.3 billion through the TSLF Options Program (TOP) (July 2008), which was designed to facilitate access to liquidity in funding markets during periods of elevated stress. In addition, the Fed first offered assistance to a specific institution: Bear Stearns (and later to the American Insurance Group in terms of a revolving credit facility and a securities borrowing facility). And on March 16, 2008, the Fed announced the Primary Dealer Credit Facility (PDCF), a nonmarket source of liquidity to ease strains in the repo market, in an attempt to prevent the effects of Bear Stearns's liquidity funding problems from disrupting markets. The PDCF loans totaled approximately $9 trillion when this program closed in February 2010. All loans related to the TAF, CBLS, and PDCF programs are said to have been repaid in full, with interest, in agreement with the terms of the various facilities.

The goal of the bailout's second stage was to restart the flow of credit to households and businesses by buying assets in exchange for reserves—the most risk-free and liquid of assets. The Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF) (September 2008) was designed to extend nonrecourse loans to intermediary borrowers at the primary credit rate in order to forestall the liquidation of assets by funds and prevent further deflation in asset prices. Total borrowing amounted to $217 billion. In addition, the Commercial Paper Funding Facility (CPFF) (October 2008), which operated through a special-purpose vehicle, or SPV, because its logistics fell outside the Fed's traditional operating framework, was designed to improve liquidity in the commercial paper market. The CPFF was suspended in February 2010 and all loans amounting to $737 billion have reportedly been repaid in full under the conditions of the program. Nevertheless, pervasive uncertainty resulted in rising credit standards so the Fed created the Term Asset-Backed Securities Loan Facility (TALF) (November 2008) to confront gridlock in the asset-backed securities markets and to increase the flow of credit throughout the US economy. Loans through this program amounted to $71 billion when it was terminated in June 2010, with $10.1 billion outstanding (to March 2015).

The third and final stage of the Fed's bailout was the purchase of long-term securities to support the functioning of credit markets. Policy actions included the purchase of agency mortgage-backed securities (MBS) and subsequent rounds of quantitative easing. MBS holdings peaked at $1.1 trillion (June 2010) and totaled $1.85 trillion (July 2010). Most transactions related to 30-year maturities, while nine foreign primary dealers constituted more than half of MBS sellers.

The bottom line? Total transactions (direct lending plus asset purchases) across all unconventional LOLR facilities: $29.6 trillion. Amount outstanding as of November 10, 2011: $902 billion. In all, the Fed bailout was unprecedented in both scale and scope, and regardless of where it began, wound up targeting the largest financial institutions worldwide.

www.levyinstitute.org/pubs/wp_698.pdf

Is There Room for Bulls, Bears, and States in the Circuit?

L. RANDALL WRAY

Working Paper No. 700, December 2011

This paper by Senior Scholar L. Randall Wray extends an earlier analysis by Senior Scholar Jan Kregel (1986) regarding the relationship between the industrial and financial spheres of circulation. Wray examines the role of banks and argues that they should be modeled as active rather than passive players. This requires an extension of the circuit theory of money along the lines of the credit and state money approaches of modern Chartalists who follow A. Mitchell Innes.

The state must play the balancing role in keeping the industrial circulation operating at capacity, a part that requires floating exchange rates—just consider the European Monetary Union's inability to deal with the financial crisis, says Wray. Further understanding of the monetary economy must take into account the role of bulls, bears, and states in the circuit.

The hope is that the current crisis provides an opportunity to downsize finance, whereby the state replaces the interests of corporations with financing that focuses on public investment, education, and research.

Kregel's complaint was that the circuit approach is confined to John Maynard Keynes's theory of industrial circulation and gives short shrift to the financial circulation. For Kregel, the problem was an inconsistency in the usual Post Keynesian presumption that capital goods prices are determined as some exogenous markup over wages. It was assumed that the level of real profit is independent of interest rates and that interest rates do not affect the rate of investment. However, finance flows away from industrial circulation when financial assets offer better returns. Keynes used liquidity preference theory to determine the demand prices of all assets that can be held through time, including capital assets. A rise of liquidity preference increases the marginal efficiency of money and lowers the investment "demand curve" while raising the "supply curve." This results in less investment, which lowers profit (all else being equal) through the Kalecki profits equation.

According to Keynes, the equalization of expected returns is at the point in time when decisions are made. Short-term expectations govern decisions made regarding the use of existing capacity, while long-term expectations govern decisions to invest. Since capital assets include both current output (using existing capacity) and expected output (to generate returns in the future), the two price systems come together in the investment decision. Hyman P. Minsky noted the importance of self-fulfilling expectations during times of boom and bust, so it would be a mistake to leave bulls and bears out of the circuit, says Wray. Moreover, banks should not be treated as passive lenders.

Wray extends Kregel's paper by linking liquidity preference (or bearishness) to Minsky's claim that "anyone" can create money. The roles played by expectations, uncertainty, and default cannot be ignored. And the role of the state in the monetary system can make banks "special" by reducing the default risk on their own liabilities. A government's "fiat" currency is accepted because it is the main thing used in payment of government taxes. Neither reserves of precious metals (or foreign currencies) nor legal tender laws are necessary to ensure acceptance of the government's currency (i.e., taxes drive money). The sovereign power chooses the money of account when it imposes a tax liability on money IOUs, and the most liquid asset is the state's own IOU (high-powered money). Access to deposit insurance as well as to the central bank's discount window makes the bank's promise to convert secure.

A fundamental principle of debt is that one cannot pay one's debt using one's own IOUs. A sovereign state is special, however, because it makes its own payments (including paying off its debts) using its own IOUs. It can never be forced into default so long as it does not promise to convert its IOUs on demand to any other IOUs or to a precious metal. Banks intermediate between government and taxpayers, and by accepting borrowers' IOUs and issuing their own IOUs. Since a bank cannot pay its own IOUs by issuing its own IOUs, underwriting matters to ensure that the value of its assets does not fall below the value of its liabilities.

Financial institutions are important because they issue IOUs with little or no default risk. Banks are also special because almost all of their assets are purchased by issuing IOUs. As noted by Minsky, banks finance their positions in assets by issuing debt. Without guarantees of access to the central bank and government insurance, banks could not operate with such high leverage ratios (i.e., 12.5 to 20).

We have moved toward Minsky's vision that "anyone can create money," says Wray, and it is time for the circuitists to face reality: $600 trillion in derivatives is supported by global GDP that is miniscule by comparison. Layers of debt (pyramiding) represent commitments of prospective future income flows, but in 2007, shadow financial institutions found that they could not reissue liabilities to cover their positions. The crisis exposed the weakness of taking the circuit model too seriously. As argued by Minsky, the "run of good times" in the postwar period changed expectations in a way that diminished the value of liquidity and the margins of safety.

The individual states in the European Monetary Union adopted a currency board arrangement with a fixed exchange rate that constrains fiscal policy. These states could not deal with the financial crisis because their only option in the face of recession was austerity, which adds fiscal headwinds to the private headwinds and threatens national insolvency. What began as a great political experiment to ensure the end of the European Great Wars may end in a third violent go-round, warns Wray.
www.levyinstitute.org/pubs/wp_700.pdf

Imbalances? What Imbalances? A Dissenting View

L. RANDALL WRAY

Working Paper No. 704, January 2012

Most economists, orthodox and heterodox, see the global financial crisis as a consequence of domestic and global imbalances. Their solution to restoring balance requires higher exchange rates for China's currency, lower US trade deficits, and Teutonic fiscal discipline.

Following the sectoral balances approach of Wynne Godley in combination with modern money theory, Senior Scholar L. Randall Wray finds that the problem is not *financial* imbalance but rather too much *power* in the hands of the financial sector, money managers, the predator state, and Europe's center. Furthermore, there is too much privatization and too little use of government to serve the public interest; that is, excessive neoliberalism and insufficient democracy, transparency, and accountability of government.

Money was invented as a universal measure of our multiple and heterogeneous sins, observes Wray. He outlines the concept of balance since Babylonian times and the various means used to restore balance (e.g., debt cancellation in the Year of Jubilee). Bankruptcy was invented not out of compassion but to restore the balance between the rights of rulers and creditors. Since time and debt are inherently related, redemption allows time and debt to start over from balance. The first violation of natural law leading to imbalance was the notion of compound interest, which concentrated wealth. Roman law abolished circular time since creditors preferred inequality and imbalance. And when creditors have too much power, they destroy the balance (e.g., Wall Street and, in the case of the eurozone, Germany).

Wray notes that credit and debt—two sides of the same coin—are always in balance. Seeing the global mess as a financial imbalance is a mistake because there is always financial balance. In order to understand the problem as a balance of power rather than as an imbalance of finance, one must revisit John Maynard Keynes's *Treatise on Money* and combine his insights with those of Godley, G. F. Knapp, A. M. Innes, A. P. Lerner, H. P. Minsky, G. Ingham, and C. A. E. Goodhart. Money is a measuring unit that was originally created by rulers to value fees, fines, and taxes owed in order to give governments command over socially created resources. And since taxes drive money, money is always linked to sovereign power—the power to command resources. Too much debt owed to private creditors reduces sovereign power by destroying the balance of power needed to govern.

Records of credits and debts etched in clay are akin to modern electronic entries on computer tapes. Money is a unit of account representing social value and an IOU rather than a commodity. Coins, first created in the greater Greek region in the 7th century BC, have rarely been more than a small proportion of the "money things" involved in finance and debt payment. When democratic city-state governments (*polis*) used coins for their own payments and insisted on payment in coins, they inserted their sovereignty in retail trade in the marketplace (*agora*). The *polis* was required to mint high-quality coins because the aristocrats measured a man's worth by the quantity and quality of accumulated precious metals. By providing a standard measure of value, coinage was an egalitarian innovation that rendered labor comparable.

Rome's precious-metal coins represented a visualization of imperial power. Later on, the nominal value of these coins was determined by the authorities ("nominalism"), not by the value of the embodied metal ("metalism"). The coinage system was well regulated and, although the precious-metal content changed across coinage, there was no significant problem with debasement or inflation. This practice continued through the early modern period despite appearances that metalism reigned (sellers favored the "heavy" coins in private circulation). Court rulings indicated that the law favored a nominalist interpretation; that is, any legal coin had to be accepted. Coin holders, however, faced some uncertainty over the coins' nominal value, which was the prerogative of the king. And when foreign wars needed to be financed, there was a demand for more gold and silver that created a monetary mess in the home country. This situation was resolved gradually, with the rise of the modern nation state.

The use of precious metals set up a destructive dynamic of clipping, weighing, and punishing that was resolved with the move to paper money and an "efficient media of exchange": pure IOUs recorded electronically. In modern economies, a government's sovereign power is constrained in two ways: arbitrary self-imposed budgetary constraints and exchange-rate constraints (both are imposed in Euroland). Government needs to use its power to move the right amount of resources to serve the public purpose, while leaving enough for the private purpose (this is difficult to balance and mostly political). Setting deficit- and debt-ratio goals is counterproductive, says Wray, while pegged exchange rates such as the gold standard or an inflation target serve the interests of some privileged group (e.g., Wall Street).

Godley's sectoral balances approach shows balance in both normal and abnormal times. Whenever the private sector surplus rises, the budget deficit rises (the current account acts as the balancing item). Thus, financial balances balance. The sum of global government deficits equals the sum of private sector surpluses.

The problem in Euroland is that private creditors in the center have too much power, while sovereigns on the periphery have too little. The euro usurped sovereign power and handed it over to the banking elite. Germany has specialized in modern mercantile dynamics and become the low-cost producer in Europe despite reasonably high living standards. Its current account surplus allows its domestic private sector and government to run relatively small deficits. The noncompetitive wages and prices in the periphery guarantee current account deficits and rising debts (by the government or private sectors). Lower debt ratios in Greece or Ireland require a change in their current account balances, but this means that other nations must reduce their current account surpluses. The only price adjustment that can work in a region with a common currency is either (1) rising wages and prices in Germany or (2) falling wages and prices in the periphery. Aversion toward inflation in the center means that the only solution is persistent deflationary pressures in the periphery that slow growth and compound the debt-burden problems.

The imbalance of power is everywhere, observes Wray. The public sector is too small because too many essential public sector functions have been privatized. Money manager capitalism leads to fraud, unemployment, inequality, poverty, and inadequate health care, retirement, and welfare. There must be fundamental reform that is Babylonian or biblical in scale—for example, cancelling the debt of homeowners, nations in the periphery of Euroland, students, credit-card users, and heavily indebted poor countries. Also, says Wray, we must wipe out the creditors, punish the fraudsters, and increase the share of real income and wealth for the bottom 99 percent of the population. The predator state must be replaced by a government of the people that operates for the public purpose.

www.levyinstitute.org/pubs/wp_704.pdf

Too Big to Fail: Motives, Countermeasures, and the Dodd-Frank Response

BERNARD SHULL

Working Paper No. 709, February 2012

Government policies that support banks considered "too big to fail" (TBTF) raise several critical issues: (1) a moral-hazard issue that encourages excessive risk, (2) a competitive issue that puts smaller banks at a disadvantage, and (3) a behavioral issue that encourages inefficient growth to a "protected" size and complexity.

The most recent effort to eliminate TBTF—the Dodd-Frank Wall Street Reform and Consumer Protection Act (2010)—is unlikely to achieve its objective, says Bernard Shull, Hunter College, CUNY, and National Economic Research Associates. Dodd-Frank does little to constrain the growth of large banking companies directly and it does not give credence to complaints that bank regulators have not functioned in the public interest. Moreover, it fails to eliminate the misgivings that existed prior to the financial crisis and leaves the critical element for bailouts intact. By augmenting the authority of regulatory agencies to counter inadequate regulation and supervision (deemed to be the root cause of TBTF), Dodd-Frank is destined to fail. As always, much will depend on how the regulatory agencies exercise their extensive discretion.

The modern version of the TBTF problem in the United States developed approximately 30 years ago with the failure of Continental Illinois of Chicago. Concern for the systemic impact of large companies led the government to protect creditors of failed savings-and-loan associations, as well as large commercial banks, and to try and eliminate TBTF through more stringent regulation and supervision, along with increased capital requirements. Nevertheless, the persistence of favorable funding costs for very large banks between the early 1990s and 2008, combined with the behavior of the Federal Reserve, strongly suggests that TBTF was alive and well, as exemplified by the 1998 bailout of Long-Term Capital Management.

The conventional remedy for preventing bailouts is better regulation and supervision, but there is little empirical evidence that there would be substantial system-wide damage absent a bailout. Perhaps regulators are frail (if not malevolent) and tend to exaggerate systemic threats, says Shull. It is a small step to link such behavior to complaints about the political influence of large financial institutions. If the roots of TBTF lie in perverse regulatory behavior, then reforms are needed to alter incentives and, possibly, the entire regulatory culture.

There is a long history of interdependence in the bank-government relationship. The notion of applying a bailout to save "a national resource" can be applied to the bailout of nonfinancial firms such as Chrysler and General Motors. In these cases, the remedy lies in structural deconcentration; that is, diversifying the national interest among a large group of financial companies. Bank merger policy, however, has promoted the growth of a handful of megabanks in spite of the fact that economies of scale are well below the size of these banks.

The Dodd-Frank Act formally forbids future bailouts as well as all practices that would generate taxpayer losses. The newly created Financial Stability Oversight Council aims to identify and monitor risks to the financial system, and to coordinate responses. Systemically important financial institutions (SIFIs) are defined as all bank holding companies exceeding $50 billion in assets. SIFIs are supervised by the Federal Reserve and subject to "enhanced prudential standards" related to systemic risk. The Act requires SIFIs to develop credible resolution plans ("living wills") that would permit their safe liquidation through bankruptcy. In addition to more stringent regulation and supervision, Dodd-Frank includes new restrictions on financial industry structure, adds a new element to merger review, and extends bank regulation to nonbanking companies.

Congress has left it to the Federal Deposit Insurance Corporation and the Federal Reserve to ensure that future financial-company failures will not present a systemic threat. It remains to be seen how these bodies will deal with their new authority, says Shull. The 10 percent liability limit will not reduce the size of the largest financial companies, and it appears that the "risk to stability" factor in merger review does not preclude the approval of combinations that present a systemic threat. The higher capital requirements for SIFIs, however, will tend to restrain the growth of large financial companies.

This paper extends Working Paper No. 601, which is summarized on pp. 17–18 of the Fall 2010 *Summary*.
www.levyinstitute.org/pubs/wp_709.pdf

Program: The Distribution of Income and Wealth

Levy Institute Measure of Economic Well-Being

A Comparison of Inequality and Living Standards in Canada and the United States Using an Expanded Measure of Economic Well-Being

EDWARD N. WOLFF, AJIT ZACHARIAS, THOMAS MASTERSON, SELÇUK EREN, ANDREW SHARPE, and ELSPETH HAZELL
Working Paper No. 703, January 2012

Following the recommendations of the landmark report by the Canberra Group (2001), in association with a broader concept of income, Senior Scholars Edward N. Wolff and Ajit Zacharias, Research Scholars Thomas Masterson and Selçuk Eren, and Andrew Sharpe and Elspeth Hazell, Centre for the Study of Living Standards, Ottawa, Canada, compare estimates of the Levy Institute Measure of Economic Well-Being (LIMEW) for Canada (1999 and 2005) and the United States (2000 and 2004). They find that three factors account for the differences between the two countries: income from nonhome wealth, household production, and base income.

Despite Canada's more extensive welfare state, its fiscal system played little part in accounting for the differences because transfers and public consumption were offset by higher taxes. In 2005 the median equivalent LIMEW in the United States was 8 percent higher than in Canada, due to the greater number of hours worked, but inequality was much greater, due to the income from nonhome wealth component. Surprisingly, net government expenditures contributed little to the difference in inequality. The public sector was the leading source of growth in well-being for the middle class in both countries.

The LIMEW is a more comprehensive measure than gross money income because it includes noncash government benefits, public consumption, income from wealth, and household production, while netting out personal taxes. The authors suggest that a broader measure of well-being may be a better guide toward identifying the differences in standard of living across countries and over time. Moreover, their measure is a better indicator of disparities among key demographic groups and economic inequality.

Most studies find that Canadians are poorer than Americans but that there is greater inequality in the United States. Another finding is that there has been some convergence in labor market trends in both countries but no convergence in terms of tax and social-transfer policies. As a result, the situation of the poor in Canada has improved while the situation of the poor in the United States has deteriorated (and the income of the richest Americans has soared). A significant proportion of the poor in Canada are better off in absolute terms than the poor in the United States. The literature survey also shows that inequality in Canada began to increase by the mid-1990s, inequality in disposable income has increased in the United States since the 1980s, and the public sector has played an important role in redistributing income in both countries. According to the Index of Economic Well-Being by the Centre for the Study of Living Standards—a comprehensive composite measure of economic well-being—Canada's score in 2007 was higher than that of the United States because of greater economic equality and economic security (the United States scored higher in consumption and wealth per capita).

The authors create a synthetic microdata file for each benchmark year because the LIMEW estimates are not available within a single household survey. They start with a large microdata file of income and demographic characteristics and then add supplementary information via statistical matching or other imputation techniques to estimate the various components of the LIMEW. The main data sources for the United States are the public-use data files developed by the US Bureau of the Census from the Current Population Survey's Annual Social and Economic Supplement, the Annual Demographic Survey, the Survey of Consumer Finances (2001 and 2004), and the American Time Use Survey (2003 and 2004). The sampling frame of the synthetic data files for Canada is the Survey of Labour and Income Dynamics (including estimates of income from wealth, taxes, transfers, public consumption, and the value of household production), the Survey of Financial Security (data on assets and debts), the Survey of Household Spending (property taxes), the Input-Output Commodity Tax Model associated with the Social Policy Simulation Database and Model (consumption taxes), and the General Social Survey (time use in 1998 and 2005).

According to alternative LIMEW indices (the post-fiscal income and comprehensive disposable income measures), household production and public consumption are more important in Canada than in the United States. In terms of total hours worked, Canadian households work less than American households; particularly in terms of market work. By 2005, the median American household spent 12 percent more time in overall work. During the time period surveyed, the unemployment rate rose in the United States (to 5.1 percent) but declined in Canada (to 6.8 percent). The marked difference in real per capita LIMEW between the United States and Canada (29 percent) shrank to 18 percent by 2005. It appears that growth in US personal economic well-being lagged behind macroeconomic performance in the United States, while the opposite was true in Canada.

Income from wealth represents a much higher share of the LIMEW in the United States than in Canada (approximately 24 percent versus 16 percent). There are also differences across quintiles (e.g., base income and income from wealth). The authors find that the fiscal system in Canada is more redistributive than in the United States. The most notable change in the United States in the early 2000s was that net government expenditures as a share of the LIMEW rose by 3.6 percentage points in response to a sharp rise in the federal government deficit as taxes plunged. In contrast, the income from wealth component fell by 2.7 percentage points, largely due to the downturn in financial markets. There was rising earnings inequality as the middle quintiles experienced an absolute decline in base income. The pattern of change was substantially different in Canada, as the share of base income in the LIMEW increased for the bottom four quintiles. The absolute decline in income from wealth for the bottom two quintiles, however, suggests rising wealth inequality.

While base income and income from nonhome wealth were much higher in the United States than in Canada, income from home wealth and net government expenditures were substantially lower. Taxes, public consumption, and household production were also lower in the United States. In the early

2000s, mean LIMEW grew by a meager 1.1 percent in the United States (due to declines in base income and income from wealth) compared to a robust gain of 6.7 percent in Canada (due to increases in base income). The authors note that differences in the wealth surveys likely played a role in the observed outcomes (e.g., capturing the wealth holdings of the very rich). The main factor behind the higher value of household production in Canada was the higher wage of domestic workers. The public sector was the leading source of growth in middle class well-being in the United States, while base income (notably, labor earnings) and the public sector were the main sources in Canada.

The authors measure the disparities in well-being between population groups using the ratio of mean values based on marital status and the age and education of householders. The average LIMEW of single females was equivalent to just over 60 percent of married couples' LIMEW in both countries. The elderly benefit from higher income from wealth, which reflects the annuity value of nonhome wealth as income, greater transfers due to entitlement programs, and lower taxes. While the elderly were better off than the nonelderly in the United States (before convergence by 2005), this was not the case in Canada. Nevertheless, the elderly gained relative to the nonelderly (to 0.91). The gaps in well-being based on educational groups were larger in the United States than in Canada, differences that can be traced to the steeper gradient of income from wealth of the lower educational groups relative to college graduates in the United States.

The LIMEW Gini index was 42.6 in the United States but only 34.0 in Canada, and inequality based on equivalent LIMEW showed an even greater difference (12.0 Gini points). During the study period, the Gini coefficient fell by 0.6 points in the United States but rose by 1.7 points in Canada. Base income and income from wealth contributed positively to the gap in LIMEW inequality between the two countries, while net government expenditures had a neutral effect. The main difference was due to the income from nonhome wealth component.
www.levyinstitute.org/pubs/wp_703.pdf

Program: Employment Policy and Labor Markets

Full Employment through Social Entrepreneurship: The Nonprofit Model for Implementing a Job Guarantee

PAVLINA R. TCHERNEVA
Policy Note 2012/2

The conventional approach of fiscal policy is to create jobs by boosting private investment and growth. This approach is backward, says Research Associate Pavlina R. Tcherneva. Policy must begin by fixing the unemployment situation because growth is a byproduct of strong employment, not the other way around. She proposes a bottom-up approach based on community programs that can be implemented at all phases of the business cycle; that is, a grass-roots job guarantee program run by the nonprofit sector (with participation by the social entrepreneurial sector) but financed by the government.

Fiscal policy space appears to be limited to austerity and conventional aggregate demand management. We need a third option, says Tcherneva—one that eschews austerity and moves beyond the limits of conventional pump priming, which erodes the income distribution and fails to address unemployment, poverty, and long-run stability. A buffer stock of employment associated with a job guarantee program stabilizes demand quickly and does not allow mass unemployment to develop. It is an approach that fits fiscal policy to the people and their communities rather than an approach that fits the latter to a "macroeconomic agenda."

An effective way to launch a virtuous cycle is direct employment by the public sector, as proposed by John Maynard Keynes (on-the-spot employment) and Hyman P. Minsky (employer of last resort). A modern proposal inspired by these economists is the job guarantee program, whereby the public sector provides a voluntary job opportunity in a community project that serves a public purpose to anyone who is willing and able to work, but unable to find private-sector employment.

The status quo pro-investment, pro-growth agenda does not lead to full employment and tends to be inflationary. Such fiscal policy intervention is a tool that aims to keep the economy below its full capacity (a "quasi-slump"). Conventional economic wisdom, therefore, deems some measure of persistent unemployment to be acceptable, but relabeling this measure "full employment" is merely a rhetorical device adopted by the economics profession to sidestep a problem that it has failed to solve, says Tcherneva. A job guarantee program would lead to full employment over the long run and address an outstanding fault of modern market economies.

Tcherneva notes that nonprofit work is highly countercyclical and well suited as an automatic stabilizer. She also notes that nonprofit organizations are already in place, organized in an entrepreneurial fashion, and familiar with local needs and resources. Moreover, these organizations do many jobs overlooked by the public sector (e.g., environmental cleanup, sustainable agriculture, and urban farming) and fulfill crucial social needs. However, they lack adequate resources. A job guarantee program would employ the unemployed at a base wage in these community projects. Furthermore, the infrastructure required to execute this program (i.e., unemployment agencies) already exists in the United States. (See also Working Paper No. 706).

www.levyinstitute.org/pubs/pn_12_02.pdf

What Do Poor Women Want? Public Employment or Cash Transfers? Lessons from Argentina

PAVLINA R. TCHERNEVA

Working Paper No. 705, February 2012

Plan Jefes was a job guarantee program for unemployed heads of households in Argentina in response to the country's crisis in 2001. It was quickly reformed after a few years into *Plan Familias*, an income support policy for poor women with children. Research Associate Pavlina R. Tcherneva evaluates this transformation and finds that it represents a step backward for women by removing a number of benefits and reinforcing gender stereotypes. Paid work matters to women, says Tcherneva, and public employment plays a special role in providing an opportunity to work outside the home. Moreover, survey evidence explored in the paper indicates that the poorest and most vulnerable women gain the most from public employment. *Plan Jefes*, which was modeled after the employer-of-last-resort (ELR) proposal, demonstrates that ELR can enhance individual well-being, and that the role of fiscal policy extends beyond the goals of full employment and economic stability.

Tcherneva explores how public employment schemes such as *Plan Jefes* help to address women's concerns and gender disparities in ways that alternative (cash transfer) fiscal policies do not. In addition to providing income and assets, ELR offers women intangible benefits such as redefining the meaning of work (e.g., valuing care and social production); enhancing individual empowerment, civic engagement, and participatory democracy; and serving as an institutional vehicle for collective action to address the needs of individuals and communities. Moreover, job guarantee programs serve as agents of change that erode long-standing structures and social mores that perpetuate gender disparities, and could be the first step toward enhancing substantive freedoms and individual life chances.

The capabilities approach developed by Amartya Sen elucidates the transformative features of public-employment policies. Access to paid employment can enhance an individual's "substantive freedom" and depends on three key factors: policies must (1) recognize what individuals want and value, (2) provide these opportunities, and (3) ensure that individuals can take advantage of these opportunities. According to Sen, income is just one aspect of well-being, and it alone cannot create the preconditions to alleviate poverty.

Government surveys found that women liked the *Jefes* program for more important reasons than income: being able to do something, working in a good environment, and helping the community. Fiscal policy, therefore, must recognize that women want paid work, guarantee the universal right to work, and alleviate the obstacles to paid work, as it matters for female employment and gender equality. These aspects are missing in right-to-income policies such as *Plan Familias*. By contrast, ELR can redress some of the structural problems that cause gender disparities and erode the paternalistic social mores that perpetuate inequitable power relations. Public employment brings communities closer together, increases solidarity and common purpose, empowers the poor to become active agents of change, and enhances macroeconomic stability. *Plan Jefes* is an example of how basic income support can be effectively coupled with public service work, and how to target very specific needs and goals.

The replacement of *Plan Jefes* by *Plan Familias* was motivated by the belief that many women in the *Jefes* program were "unemployable" and "too poor or socially vulnerable" to work. Such belief confines women to traditional gender roles and institutionalizes poverty. Although *Plan Familias* offered a more generous cash allowance to poor mothers with many children, the opportunity to work was no longer a choice for women who wanted to work. *Plan Familias* had removed that opportunity and replaced it with a basic income guarantee that failed to deal with the sources of gender disparity in the same way as the *Jefes* program.

According to the author's (informal) survey, every woman interviewed wanted to work rather than receive a welfare check of equal amount. A Ministry of Labor survey found that women were disappointed to return to inactivity after they transferred into *Plan Familias*, and that they continued to work in community projects even though they were no longer qualified to participate in *Plan Jefes*. In an earlier study of *Plan Jefes*, the author found that poor women actively addressed the needs of their communities by setting up food kitchens, shelters for the homeless, butcher shops, and day-care centers. These women also benefited from the profound transformation in how they perceived their own self-worth and from the recourse to resist patriarchal attitudes.

The World Bank recognized that *Plan Jefes* provided an important income safety net and softened the effect of the crisis on the poorest and least educated women. The program also abided by Hyman P. Minsky's notion that an ELR program should take workers as they are and fit the jobs to workers, not the other way around. Tcherneva therefore questions why the *Jefes* wage was not increased and coverage not expanded. She notes that the main obstacles to *Jefes* participation were not children or poverty but rather the social mores of policymakers that drove them to reform the program. Moreover, few policymakers recognized that low wages and deficient public services were the reasons why there was no serious progress toward reducing poverty.

Plan Familias sought to separate the "employable" from the "unemployable," insert the "employable" into private sector employment, and provide income to the "unemployable" by divorcing the income benefit from participation in community work. Only women with children could benefit under this program (with the exception of single fathers), which coerced women by offering higher income support. And there were no explicit provisions for alleviating unpaid care within the household (contrary to *Plan Jefes*).

Tcherneva concludes that the best way to combine the goals of basic income and job guarantees is to design a universal program in the form of an ELR, supplemented by a universal child allowance and income support for the sick and the retired (neither *Plan Jefes* nor *Plan Familias* offered equal access). This is also an effective way to redress the precariousness of the labor market and produce stronger countercyclical effects. Making *Plan Jefes* universal rather than eliminating it would have set a better course. Furthermore, ELR must be accompanied by provisions such as fair hiring laws and affirmative action.

www.levyinstitute.org/pubs/wp_705.pdf

Inflationary and Distributional Effects of Alternative Fiscal Policies: An Augmented Minskyan-Kaleckian Model

PAVLINA R. TCHERNEVA
Working Paper No. 706, February 2012

This paper by Research Associate Pavlina R. Tcherneva evaluates different fiscal policies in light of their ability to address two of society's fundamental problems: the failures to generate full employment and to secure equitable income distributions. Using the basic two-sector (consumption and investment) and three-sector (consumption, investment, and government) pricing (markup) models that are the hallmark of Post Keynesian analysis, Tcherneva compares unemployment insurance with alternative government policies that aim to stimulate employment creation. She also compares policies that seek to redistribute income and addresses such factors as taxes, trade deficits, consumption out of profits, and saving out of wages.

Current fiscal policies have failed to guarantee full employment even when these policies support and inflate prices and profits, observes Tcherneva, and employment resting solely on the determination of profits leads to an unstable system. Furthermore, how government spends and what government buys are of crucial importance in determining income and inflation.

Tcherneva extends her previous argument that targeted labor-demand policies are more effective than aggregate-demand management in connecting fiscal policy with full employment. The best way to gain full employment is for the government to act as an employer of last resort (ELR). This option stabilizes prices, favors wage incomes and consumption, and distributes income better than other alternatives. Moreover, it is cheaper and noninflationary. In conditions of true full employment, however, economists will still need to devise anti-inflationary policies dealing with (demand-side and cost-push) inflation generated by the private sector.

Three traditional functions of government are providing income support to the unemployed and poor, and investment subsidies to companies; acting as a direct employer in the public sector; and becoming an indirect employer when buying goods and services from the private sector (e.g., military investments and private infrastructure contracts). Fiscal policies with alternative government expenditures affect sectors differently in terms of employment, prices, and income distributions. In fact, Hyman P. Minsky argued that government in the modern era is both “a blessing and a curse” because it can stabilize profits and outputs, but it can also impart an inflationary bias and is unable to stabilize the economy at or near full employment. Tcherneva notes that government spending peaked at 46 percent of GDP during World War II and is 27 percent of GDP today.

The two-sector model describes a system of volatile prices and sizable inflationary and deflationary forces, where idle capacity is the normal condition (e.g., pre–World War I market economies where neither government nor trade contributed much to final demand). And in conditions of less than full employment, policies that produce an investment boom will create proportionately greater inflationary effects and smaller employment effects. This association indicates why unemployment has been used as an inflation-inhibiting tool.

Using the three-sector model, Tcherneva finds that government deficit spending (equivalent to unemployment insurance) is a direct injection into aggregate profits and that countercyclical government spending in the presence of investment volatility stabilizes profits. Although unemployment insurance is an important safety net for the immediate short term, it is not a pro-employment policy. The policymaker, therefore, should devise a pro-employment safety net that allows individuals under forced idleness to find employment.

Investment subsidies represent pro-profit policy because any increase in investment increases aggregate profit by the same amount, while redistributing income away from the wage share to the capital share of income. Similar to unemployment insurance, investment subsidies may prove to be a temporary fix. Pro-consumption policy has a taming effect on the markup even as it inflates profits, but the problems of not knowing which industries to target and ongoing unemployment remain regardless of the size of government spending. ELR addresses both problems directly but at the cost of producing a higher yet stable markup. In contrast, the markup from unemployment insurance, investment subsidies, or purchases of goods from the investment sector is not only higher but also rising.

Stimulating the production of investment and consumption means that the deficit is spent partially on the newly created wage bill in these sectors and partially on profits earned from producing for the government. A pro-investment policy generates the largest deficit because it has the smallest employment creation effects (and more government spending is required for full employment). In contrast, ELR spending does not leak into profits of the investment or consumption sectors because it only pays for the wage bill of ELR workers. So investment policy that pumps up demand to produce full employment is bound to be more inflationary than ELR. And in the face of structural unemployment, it does not matter how much demand is pumped up via unemployment insurance, investment subsidies, or government purchases. Tcherneva also notes that the ELR wage must serve as an anchor and increase with discretion, but should not be indexed to prices. A particularly desirable feature of ELR policy would allow the unemployed and poor to actively participate in the design of community projects, and to organize production around their needs.

The author’s Kaleckian model enables one to observe the price-stabilization feature of government policy that creates full employment. With the ELR in place under conditions of full employment, price increases occur when the private sector expands and government shrinks. Conversely, falling employment in the consumption and investment sectors is immediately absorbed in the ELR labor force, which prevents the markup from collapsing and stabilizes prices.

Direct job creation is virtually nonexistent today. Government policies add to the markup and boost profits, but they do not lead to a full-employment level of output. Moreover, a negative saving rate adds to the markup and has been another source of inflation from the private sector. In contrast, US trade deficits serve to export domestic inflation to US trading partners. Including profit taxes and consumption out of profits in the models' equations adds to the markup, while saving out of wages mitigates this process.
www.levyinstitute.org/pubs/wp_706.pdf

Program: Economic Policy for the 21st Century

Explorations in Theory and Empirical Analysis

Trade and Payments Theory in a Financialized Economy

MICHAEL HUDSON
Working Paper No. 699, December 2011

Today's determining factor in trade competitiveness is the finance, insurance, and real estate (FIRE) sector. According to Research Associate Michael Hudson, the US industrial trade balance has deteriorated because of financialization in the US economy and the concomitant decline in the classical analysis of economic rent and policies that minimize debt overhead and reduce opportunities to extract economic rent. He proposes that neoliberal countries rectify matters by applying classical (anti-rentier) economic policies such as taxing rent and windfall gains, and removing the tax deductibility of interest. We are entering the end days of the post–World War II credit/debt expansion, he says.

Theoretical economist David Ricardo claimed that debt service and military spending could not create economic problems because they are self-financing. His nonfinancial "barter" approach to trade and exchange rates, however, does not recognize how debt service adds to the costs of living and doing business, and depresses exchange rates. Moreover, the classical analysis of economic rent (and unearned income) is overlooked in the economics curriculum. People continue to believe that debt (a product of the banking system) contributes to, rather than burdens, economic growth. Post-Classical economics maintains that rentier income provides economically helpful services—a concept underlying the US National Income and Product Accounts.

Hudson points out that most credit is spent on assets, not goods and services. More than 99 percent of spending in the financialized economies is for real estate, mortgages and packaged bank loans, and stocks and bonds. By limiting the analysis to commodity prices and wages, mainstream monetarist theory leaves these credit transactions and debt service out of account, which has far-reaching implications in terms of trade competitiveness. The legacy of Ricardian trade theory focuses on subsistence consumption rather than debt-financed housing costs, education, financialized pensions, Social Security, and other FIRE-sector charges.

Trade competitiveness reflects financial dynamics, economic rent, and tax policy in four main national variables: (1) labor's cost of living, wages, and nonwage benefits (mainly pensions and health care); (2) land rent and debt overhead; (3) the incidence and level of taxation; and (4) the terms on which governments provide infrastructure services, Social Services, and health care, along with economic subsidies. Debt service in the post-2001 bubble economy has absorbed more of the national economic surplus. Rentier payments and taxes now absorb as much as 75 percent of family budgets in the United States. And housing absorbs approximately 40 percent of family incomes, compared to 20 percent in Germany, due to different institutional and financial practices (e.g., looser lending terms in the United States fueled a larger debt pyramid).

Neoliberals favor the imposition of economic austerity by monetary and income deflation, while leaving financial and tax structures in place. They prefer anti-labor policies such as an "internal devaluation" (lowering wages) as a means of making economies more competitive. Policy discussion is limited to fiscal austerity and currency depreciation. But the cost of labor can be reduced just as effectively by a tax policy that shifts the fiscal burden off employment and onto property and other economic rents, says Hudson. He notes that the banks used the Fed's quantitative easing program mainly for foreign currency arbitrage rather than domestic consumer spending. In order to secure its privileges and tax favoritism, the financial sector opposes government power to tax or to regulate, favors "free markets," and fights to centralize the power of economic planning in financial centers such as Wall Street. Moreover, an "independent" central bank is not independent from the interests of commercial banks.

The eurozone's constitution prevents the European Central Bank (ECB) from creating credit to loan to government. This rule is based on fears of hyperinflation, but hyperinflation is caused by international payments deficits as a result of foreign military spending, which is also responsible for the growth in public debt. The ECB fails to distinguish between creating money to spend on employment, production, and consumption in the "real" economy, and creating credit for banks to buy or lend against assets. The latter inflates asset prices but deflates current spending. Similarly, the $13 trillion increase in US Treasury debt in the post-2008 financial meltdown was not spent in the product markets or employment in the "real" economy but rather to help the banks' balance sheets.

The eurozone's financial crisis in 2011 shows the importance of distinguishing between two applications of central bank money and debt creation: spurring "Keynesian-style" deficits by spending on employment, goods, and services versus increasing balance sheet debt without necessarily spending on current output. Opposing public social spending obliges governments to borrow from financial institutions. The resulting debt overhead leads to debt deflation that slows the economy and its tax yield, leading to a fiscal and financial crisis.

The financial sector's political strategy uses deficits as an opportunity to insist that governments balance their budgets by selling off public enterprises and other assets. Intergovernmental financial institutions such as the International Monetary Fund, World Bank, and ECB have thus gained authority over national governments. When central banks are deprived of the opportunity to create credit, governments must rely on commercial banks to finance their budget deficits with interest, providing a free lunch to the commercial banks. And when bank deposits are insured by government agencies, banking system losses are transferred onto public balance sheets. Privatizing credit creation (and public infrastructure) raises the cost of living and doing business by building in financial overhead charges.

Analyzing costs and trade competition requires integrating the "real" production and consumption economy with balance sheet transactions in assets and the debt overhead, as well as with government fiscal policy. Financialization, however, has reversed Progressive Era policies designed to minimize the debt overhead and the economic rent-extracting opportunities that are the prime objective of the banks' marketing departments.
www.levyinstitute.org/pubs/wp_699.pdf

Women, Schooling, and Marriage in Rural Philippines

SANJAYA DESILVA and MOHAMMED MEHRAB BIN BAKHTIAR
Working Paper No. 701, December 2011

Eliminating gender disparity in education is a key instrument in promoting gender equity and empowering women. As a result, the United Nations' Millennium Development Goals have declared this instrument to be a top priority of developing countries.

This paper analyzes the benefits of schooling for females in the Bicol region of the Philippines—a rural and impoverished area relying predominately on agriculture—where women are more educated than men. It examines the causal relationship between schooling and spousal earnings in order to determine if there are sufficiently large household-level pecuniary returns to schooling for Filipino women.

Research Associate Sanjaya DeSilva and Mohammed Mehrab Bin Bakhtiar, Bard College, find that women experience returns to schooling of approximately 20 percent in the labor and marriage markets. By comparison, the labor market return for men is 12 percent. The analysis presents a cautionary tale for developing countries that rely on supply-side interventions and provide skilled-employment prospects for women in order to narrow the gender schooling gap.

In the Philippines, including the Bicol villages, educational homogamy is widely observed: schooling increases the likelihood of marrying a spouse with a high income and also enhances the labor market productivity of a spouse and other family members. It is a particularly interesting case study because a relatively traditional and gender-segregated labor market coexists with a relatively egalitarian and individual choice–based marriage market. The authors use the 2003 Bicol Multipurpose Survey to examine the marriage and labor market outcomes of children in the households originally surveyed in 1983. The availability of detailed information on the sibling and parental background of married adults of working age in 2003 provides the instrumental variables to identify the causal effect of schooling attainment on spousal earnings.

According to the sample, women on average spend 0.64 more years in school than men. The absence of a gender gap is partly attributed to an educational system that provides equal access and to familial institutions that are relatively egalitarian. The educational gains, however, are not reflected in corresponding gains in the labor force participation rate relative to men (56 percent versus 86 percent). In addition, the earnings distribution shows a segmented labor market where women reap returns to schooling only as they acquire higher levels of education and find employment at the high end of the earnings distribution. College-educated women are more likely to engage in nonhousehold work than women with an elementary education. Moreover, there is an earnings advantage for women with a college degree relative to men with a college degree.

The coexistence of lower average wages and higher returns to schooling for women have been observed in countries as varied as Indonesia, Guinea, and Peru. But women are typically less educated than men in these developing countries due to social, cultural, and institutional factors that keep many women out of the labor force. The authors' goal is to test whether the education of Filipino girls has a causal effect on their future well-being through the marriage market rather than the labor market. Are there cross-productivity gains when married couples share ideas and households engage in joint production and entrepreneurial activities?

The authors propose an identification strategy that relates variations in schooling with sibling structure (size, gender, and birth order) and parental education. Their regression results conform with previous findings that Filipino women experience considerably higher labor market returns to education than their male counterparts. Women also reap a 6.4 percent return per year of schooling through marriage. Moreover, women who choose to stay out of the labor market benefit from schooling more than men who participate in the labor market. Substantial marriage market returns similar in magnitude to labor market returns allow women to separate the schooling decision from the labor force–participation decision.

The authors also find that own earnings improve with age at an increasing rate for women and a decreasing rate for men, and are not influenced by household wealth or family background. Spousal earnings are significantly predicated by schooling but not by age or land ownership, thus supporting the contention that Filipino women select their marriage partners through schooling rather than family background. A further finding is that the likelihood of employment for both men and women increases with age and decreases with birth order. Parental education has a highly significant and large impact on children's attainment in schooling, with a mother's schooling having more of an impact than that of the father. Birth order has a positive and significant impact on the educational attainment of younger siblings for both girls and boys. But there may be some gender bias in favor of boys in the parental allocation of resources.

www.levyinstitute.org/pubs/wp_701.pdf

The Road to Debt Deflation, Debt Peonage, and Neofeudalism

MICHAEL HUDSON

Working Paper No. 708, February 2012

Classical economists sought to free society from the legacies of feudalism tied to a landed aristocracy and banking class. According to Progressive Era reformers, a free market included a government strong enough to tax away land rent and to either break up monopolies or keep them in the public domain.

Research Associate Michael Hudson outlines the progression of capitalism—from industrial capitalism's tangible investment in plant and equipment, and the use of labor to produce output at a markup (profit); to finance capitalism, where rentier wealth from the financial sector dominates the economic and political systems, and wages, corporate cash flows, and tax revenues have been diverted to pay interest and amortization. He notes that industrial capitalism failed to complete its political destiny: freeing economies from post-feudal rentiers.

Economies are retrogressing toward pre-Enlightenment rentier societies where banks are the recipients of rent, debt deflation is polarizing society, and austerity is shrinking the internal market. We must revive the logic underlying the Progressive Era's reform program by reestablishing value, price, and rent theory (and its concomitant tax policies), as well as monetary theory respecting the financing of public budget deficits, says Hudson. The solution is a debt write-down, which must come from outside the industrial economy. The great economic fiction of our time is that all debts can be paid.

Finance is stifling the industrial economy by destroying domestic consumer markets for the outputs produced by employees. Most debt is associated with buying real estate and financial securities, and the buildup of rentier wealth comes from real estate and monopolies more than manufacturing. Rentiers have rejected the classical political doctrine of value and price, and its corollary distinctions between earned and unearned income, and productive and unproductive labor. Moreover, neoliberal ideology has expunged the history of economic thought from the academic curriculum despite the fact that retained earnings are the main source of tangible capital investment. Debt service by financial institutions is not used to finance tangible investment but to generate additional claims on people (the 99 percent), corporate industries, and governments.

Finance capitalism has a number of offshoots that include pension fund capitalism, the bubble economy, debt deflation, austerity, and insolvency. And current trends point toward a terminal stage of debt peonage and neofeudalism. The idea behind pension fund capitalism was to set aside part of the wage bill for professional money managers on Wall Street to invest in the stock and bond markets (not on consumer goods produced by labor). This measure pushed up asset prices and created wealth at a greater rate than wages and salaries. The only way to sustain a high rate was to flood the economy with credit. Thus, pension fund capitalism became dependent on a bubble economy (characterized by steadily lower interest rates) where corporate profits and real estate rents were capitalized into bank loans at rising multiples. An understanding of the bubble economy–credit wave requires an understanding of the transformation of the international financial system in 1971, when overseas military spending forced the US dollar off gold, says Hudson. Historically the military was the major cause of balance-of-payments deficits. The removal of gold as an international constraint, combined with greater US payments deficits, meant that more dollars ended up in foreign central banks. And running up foreign debt created a proportional inflow of funds to buy Treasury bonds (this reversed the traditional impact of trade and payments deficits on interest rates). The US economy achieved a free lunch under the Treasury Bill standard, as foreign central banks absorbed the cost of US military spending and the US private sector took over the global economy. Contrary to the norm the US payments deficit became inflationary (not deflationary) but the inflation was contained entirely within the US financial and real estate markets. By 2002, a full-blown financial and real estate bubble was under way, with people expecting to get rich by leveraging debt and tax policy favoring capital gains over wages, salaries, and profits.

Economies shrink and financial risks rise when debt service diverts spending from consumption and investment. Moreover, bank lobbyists parrot the absurd falsehood that central bank financing of budget deficits is inherently inflationary when it actually saves economies from depression. Proposed solutions by neoliberals such as abandoning progressive taxation, excluding rentier income, and scaling back the social safety net would impose fiscal deflation on top of debt deflation. Neoliberal logic is a public relations tactic in today's financial war against society at large, but the debt overhead cannot be paid.

A mixed economy includes an active public sector that absorbs the cost of public infrastructure (a "fourth factor of production"), education, health care, and pensions by taxing the rental value of land and natural resources. Economic return is measured by the ability to lower the national price structure, not by profits and price markups. The monetary sphere centers on replacing interest-bearing debt with equity profit-sharing arrangements and public money creation with private bank credit; that is, lending is supposed to be productive. Unearned income is taxed to preserve a fair society and prevent the development of vested special interests. In contrast, the pro-rentier movement is based on a new idea of competition—privatizing infrastructure on credit—where good management symbolizes rent-seeking opportunities financed by interest-bearing debt (including education and health care) and pensions are subject to (high-cost) finance rather than (low-cost) industry.

Today's economic theory does not realize that there is no inherent tendency toward equilibrium, says Hudson, and "automatic stabilizers" cannot rectify financial imbalances and predatory behavior. The notion that there is no such thing as a "free lunch" masks the reality that much of the economy is indeed a free lunch (economic rent), and this notion deters the study of who gets the rent and who is exploited. The first step toward the survival of industrial economies is to revive the classical political economy's distinction between cost value and price, and recognize that unearned income has no necessary cost of production. The fight is between employed labor (and retirees) and a financial elite allied with real estate and monopolies, and it is being waged over who will control government—an economic democracy or a financial oligarchy.
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INSTITUTE NEWS

Upcoming Events

21st Annual Hyman P. Minsky Conference

Debt, Deficits, and Financial Instability
Ford Foundation, New York City
April 11–12, 2012

In April 2012, leading policymakers, economists, and analysts will gather at the New York headquarters of the Ford Foundation to take part in the Levy Institute's 21st Annual Hyman P. Minsky Conference. This conference will address, among other issues, the challenge to global growth represented by the eurozone debt crisis; the impact of the credit crunch on the economic and financial markets outlook; the sustainability of the US economic recovery in the absence of support from monetary and fiscal policy; reregulation of the financial system; the design of a new financial architecture; and the larger implications of the debt crisis for US economic policy and the global financial system.

For the events program and list of participants, visit our website (www.levyinstitute.org).

The Hyman P. Minsky Summer Seminar

Blithewood, Annandale-on-Hudson, N.Y.
June 16–24, 2012

The Levy Economics Institute of Bard College will hold its third annual Minsky Summer Seminar in June 2012. The Summer Seminar provides a rigorous discussion of both the theoretical and applied aspects of Minsky's economics, with an examination of meaningful prescriptive policies relevant to the current economic and financial crisis. It is of particular interest to graduate students, recent graduates, and those at the beginning of their academic or professional career.

For more information, visit www.levyinstitute.org.

PUBLICATIONS AND PRESENTATIONS

Publications and Presentations by Levy Institute Scholars

RANIA ANTONOPOULOS *Senior Scholar*
Publication: "Economic Turbulence In Greece" (with D. B. Papadimitriou), *Economic and Political Weekly* (India), Vol. 47, No. 5, February 6, 2012.
Presentations: "Establishing the Social Supports Needed for Women's Equal Participation in the Economy," "Conference on Women's Economic Empowerment," organized by the Canadian International Development Agency and UN Women, Ottawa, Canada, October 3–4, 2011; "Causes of the Sovereign Debt Crisis in Greece: Myths and Realities," "Forum on the Greek Financial Crisis," organized by the Association of Greek American Professional Women, New York, N.Y., November 17; "Household Production Deficits: Time Use, Unpaid Work, and Poverty" (with A. Zacharias), "International Seminar on Unpaid Work and Social Well-Being," Autonomous

University of Madrid, Spain, December 12–13; "Women, Time and Poverty: Why Women's Lack of Time Must Be Factored into Poverty Measurements and Policy," United Nations Development Programme, New York, N.Y., February 6, 2012.

PHILIP ARESTIS *Senior Scholar*

Publications: "The Ongoing Euro Crisis" (with M. Sawyer), *Challenge: The Magazine of Economic Affairs*, Vol. 54, No. 6, November–December 2011; "Ideas on Fiscal Union Welcome but Inadequate: Letter to the Editor" (with M. Sawyer), *Financial Times*, December 6; "The EU Fiscal Compact" (with M. Sawyer), Triple Crisis Blog, December 12.

Presentations: "The Dysfunctional Nature of the Economic and Monetary Union" (with M. Sawyer and G. Fontana), conference on "The European Union's Economic and Social Model—Still Viable in a Global Crisis?" School of Law, University of Leeds, England, December 8–9, 2011; "Social Norms Meet Financialisation: Fair-wage Constraints and Gender and Race Stratification in the US Labour Market" (with A. Charles and G. Fontana), "Henley Interdisciplinary Workshop on the Evolution of Social Norms," Henley Business School, Henley-on-Thames, Oxfordshire, England, December 15–16; "Macroeconomic Policies and the 'Great Recession'" (with M. Sawyer), Association for Evolutionary Economics, Annual Allied Social Science Associations Meetings, Chicago, Ill., January 6–8, 2012.

JAMES K. GALBRAITH *Senior Scholar*

Publications: "The Continent Is Destroying the Weak to Protect the Strong: But Will That Be Enough?" *Salon*, November 10, 2011; "Austerity and Fraud under Different Structures of Technology and Resource Abundance" (with J. Chen), *Cambridge Journal of Economics*, Vol. 36, No. 1, January 2012.

Presentations: organizer and speaker, conference on "The Crisis in the Eurozone," The University of Texas at Austin, November 3–4, 2011; "Some Economists Got It Right," Southern Economic Association 81st Annual Meeting, Washington, D.C., November 19; keynote address, conference on "Inequalities in Europe and the Future of the Welfare State," sponsored by members of the European Commission, Brussels, Belgium, December 5–6; keynote address, "The Great Financial Crisis and the Future of Economics—If It Has One," 39th Annual Conference in Economics, Associaç o Nacional dos Centros de Pós—Graduaç o en Economia (ANPEC), Foz da Iguacu, Brazil, December 6–9; lecturer, International Celso Furtado Center for Development Policies, Rio de Janeiro, Brazil, December 12.

GREG HANNSGEN *Research Scholar*

Publication: Contributor, "Seven Ways to Fix the Economy," Kiplinger.com, December 2011.

KIJONG KIM *Research Scholar*

Publication: "Ex-ante Evaluation of a Targeted Job Program: Hypothetical Integration in a Social Accounting Matrix of South Africa," *Economic Modelling*, Vol. 28, No. 6, November 2011.

JAN KREGEL *Senior Scholar*

Presentations: "Summing Up and Conclusions," Ford Foundation – Levy Institute Research and Policy Dialogue Project on Improving Governance of the Government Safety Net in Financial Crises, New York, N.Y., November 4, 2011; "The BICs Strategies for Weathering the Crisis" and "From Weathering the Crisis to Re-Building Prosperity: New Policy Perspectives," conference on "New Economic Thinking, Teaching and Policy Perspectives: A Brazilian Perspective within a Global Dialogue," sponsored by the Ford Foundation and MINDS, Rio de Janeiro, Brazil, November 7–9; "How Reformed Is International Finance," Central Bank of Sri Lanka Public Lecture Series, Colombo, November 22; "Recent US Legislation: The Dodd-Frank Bill and Financial Instability," workshop on "New Directions in Financial Regulations," organized by the International Development Economic Associates (IDEAs) and The Centre for Banking Studies, Central Bank of Sri Lanka, November 22–26; "Minsky and the Current Financial Crisis," conference on "Il Profeta della crisi: Tributo a Hyman Minsky," organized by the Fondazione A. J. Zaninoni and the Dipartimento di Scienze Economiche "Hyman P. Minsky," Università di Bergamo, Italy, December 5; "Greek Crisis, Euro Crisis: Sovereign Crisis or Bank Crisis?" workshop on "The Debt Crisis in Greece and the Eurozone: Is there a Solution?" Greek General Confederation of Labour Institute, Athens, Greece, December 8; "Governance of Global Finance, Regulation of Global Liquidity, and Global Financial Instability," conference on "Regulating Finance for Economic Development," School of Economics and the International

College, Renmin University of China, Suzhou, December 19–20; "Recovering a Traditional Model of Financing Economic Development: Savings Gaps, External Finance and Debt Crises in Latin America" and "The Impact of Global Financial Integration on Latin American Financial Markets and Financial Instability," The Third Latin American Advanced Programme on Rethinking Macro and Development Economics (LAPORDE), São Paulo School of Economics, Fundação Getulio Vargas, São Paulo, Brazil, January 9–13, 2012; "Dimensions of the Global Financial Crisis," IDEAs Tenth Anniversary Conference, "The Global Economy in a Time of Uncertainty: Capitalist Trajectories and Progressive Alternatives," Muttukadu, Chennai, India, January 24–26; "The Dominance of Finance in the Current Crisis," seminar on "Whither Global Capitalism?" Jawaharlal Nehru University, New Delhi, India, January 28; "Proposals to Resolve the Current Crisis," symposium on "The Global Crisis and Progressive Alternatives," ANVESHAN-ERF International Conference, New Delhi, January 29; "The Rise to Dominance of Finance over Production," lecture series on "Beyond Financialisation—Understanding the Relations between Finance and Production," International Institute of Social Studies, Erasmus University, Den Haag, Netherlands, February 13; "Six Lessons from the Euro Crisis for Completing the European Project," Society for International Development, Den Haag, February 14.

THOMAS MASTERSON *Research Scholar*

Publication: "An Empirical Analysis of Gender Bias in Education Spending in Paraguay," *World Development*, Vol. 40, No. 3, March 2012.

Presentation: "International Comparisons of Economic Well-Being: The Levy Institute Measure of Economic Well-Being (LIMEW)," International Confederation of Associations for Pluralism in Economics (ICAPE) Third Conference, "Re-thinking Economics in a Time of Economic Distress," Amherst, Mass., November 11–13, 2011.

DIMITRI B. PAPADIMITRIOU *President*

Publications: "Need jobs? Call on Government," *Los Angeles Times*, January 5, 2012; "Economic Turbulence in Greece" (with R. Antonopoulos), *Economic and Political Weekly* (India), Vol. 47, No. 5, February 6; "Greece: How to Slow the Nosedive," *The Huffington Post*, February 9.

Presentations: Interview regarding the crisis in the eurozone with Apostolos Zohs, *Eleftheria* and *Elliniki-Gnomi*, November 27, 2011; interview regarding the euro crisis with Ian Masters, *Background Briefing*, Pacifica Radio, November 28; interview regarding austerity plans not preventing the collapse of the European Monetary Union with Yalman Onaran, *Bloomberg News*, December 6; speaker, conference on "The Debt Crisis in Greece and the Eurozone: Is There a Solution?" Greek General Confederation of Labour Institute, Athens, Greece, December 8; interview regarding the debt crisis with Kathleen Hays, "The Hays Advantage," Bloomberg Radio, December 9; interview regarding Greece and the euro with Kathleen Hays, January 23, 2012; interview regarding the Greek speculative rally with Paul LaMonica, CNNMoney, February 8; interview regarding whether austerity can bring about prosperity with Daria Chernyshova, *Crosstalk*, Russia Today TV, February 9; interview regarding the Greek austerity plan with Kathleen Hays, February 10; interview regarding Greece's choice of deep budget cuts or default with Paul Wiseman and Christina Rexrode, Associated Press, February 10; interview regarding the fragility of the latest Greece bailout agreement with Robert Moon, *Marketplace Index*, February 10; interview regarding a Marshall Plan for Greece with Federica Bianchi at *L'Espresso*, February 13; interview regarding private sector wage cuts with Uri Friedman, *Foreign Policy*, February 13; interview regarding the European and Greek sovereign debt crisis with Ben Rooney, CNNMoney, February 16; interview regarding the threat posed to the shaky US financial system by the worsening economic situation in Europe with Sinclair Noe, Money Radio, February 16.

EDWARD N. WOLFF *Senior Scholar*

Publication: *The Transformation of the American Pension System: Was It Beneficial for Workers?* W. E. Upjohn Institute for Employment Research, Kalamazoo, Mich., 2011.

GENNARO ZEZZA *Research Scholar*

Publications: "Godley and Graziani: Stock-flow Consistent Monetary Circuits," in *Contributions to Stock-Flow Modeling: Essays in Honor of Wynne Godley* (edited with D. B. Papadimitriou), Palgrave Macmillan, 2011; *The Stock-flow Consistent Approach: Selected Writings of Wynne Godley* (edited with M. Lavoie), Palgrave Macmillan, 2011.

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