The Levy Economics Institute of Bard College

Report

April 2009 Vol. 19, No. 2

Strategic Analysis, December 2008

PROSPECTS FOR THE UNITED STATES AND THE WORLD: A CRISIS THAT CONVENTIONAL REMEDIES CANNOT RESOLVE

WYNNE GODLEY, DIMITRI B. PAPADIMITRIOU, and GENNARO ZEZZA

There is a broad consensus that the prospects for the U.S. economy have become dire, requiring extensive government intervention. In this new Strategic Analysis, Distinguished Scholar Wynne Godley, President Dimitri B. Papadimitriou, and Research Scholar Gennaro Zezza take a more skeptical view of the effectiveness of the policy prescription now on offer and argue that the global economy must be run in an entirely new way, though they admit to having few specific proposals on how to bring this about at present.

Figure 1 shows the three financial balances—government, foreign, and private—as the major forces driving the U.S. economy, and indicates how the recessions in the 1980s and '90s were caused by falls in private expenditure relative to income. It also shows that the brief "dot-com" recession of 2002–03 was partly offset by a fiscal stimulus, sending the budget into deficit. Between 2004 and the first half of 2007, there was a renewed expansion in private expenditure, caused by a steep rise in the financial balance of the private sector (i.e., a fall in private net saving). Moreover, the change in debt logically implies an equivalent fall in net lending to the private sector, equal to 13 percent of GDP between the third quarter of 2007 and the third quarter of 2008. The authors note that this violent shift in the flow of net lending must have been the result of an extremely sharp fall in receipts from new loans through 2008, and warn (since there is no natural floor to the flow of net lending as it reaches zero) that we should expect gross lending to continue falling below repayment (causing negative lending) for a considerable time. Hence, they believe that the Fed's unprecedented slashing of interest rates may not be effective in reactivating standard lending practices if confidence in future profits and income growth is not restored (although low rates will keep mortgage payments low) and the growth rate of disposable income sustained. The projected steep rise in the private sector balance and abrupt fall in GDP over the next few years (Figure 1) crucially depend on the dramatic fall in

Continued on page 3 ►

Contents

NEW STRATEGIC ANALYSES

NEW PUBLIC POLICY BRIEFS

NEW POLICY NOTE

NEW LIMEW REPORTS

NEW WORKING PAPERS

LEVY INSTITUTE NEWS

PUBLICATIONS AND PRESENTATIONS

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

The *Report* is published four times per year by The Levy Economics Institute of Bard College.

Editor: Feridoon Koohi-Kamali
Text Editor: Barbara Ross

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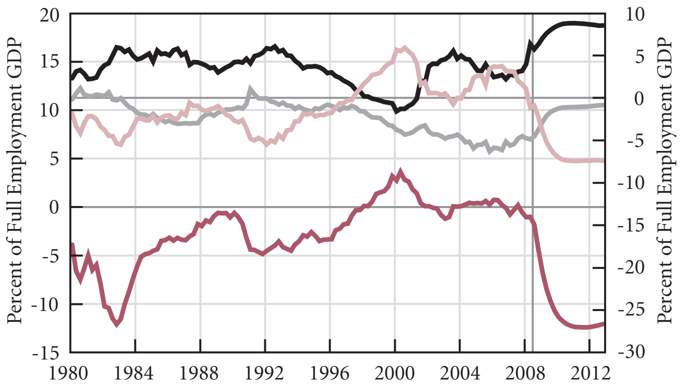
New Strategic Analyses *Continued from page 1*

Figure 1 **U.S. Main Sector Balances and Output Gap**



Government Deficit (right-hand scale [RHS])
External Balance (RHS)
Private Sector Investment - Saving (RHS)
Output Gap (left-hand scale)

Sources: Federal Reserve and authors' calculations

net lending to the private sector. The trade balance is projected to improve quite a lot, mainly as a result of the collapse of U.S. GDP.

The authors' projection for exports is consistent with that published by the International Monetary Fund. As illustrated in the extreme right section of Figure 1, GDP is projected to fall about 12 percent below trend between now and 2010, while unemployment will rise to about 10 percent. The virtual collapse of private spending, the authors contend, will make it impossible for U.S. authorities to apply a fiscal and monetary stimulus large enough to return output and unemployment to tolerable levels within the next two years. Therefore, fiscal policy alone cannot restore the current crisis, although it will help counter the drop in private expenditure and reduce unemployment if it is large enough.

However, fiscal policy in such circumstances will bring back a large and growing external imbalance unless it is accompanied by a rapid acceleration in net export demand. The authors argue that it would have been possible to achieve such an outcome with a dollar devaluation of 25 percent a decade ago. Given the current severe downturn in world trade, exports would have to grow in three to four years to a level 25 percent higher than they would be (at the current growth rate) in order to expand sufficiently to counter the external imbalances. The authors conclude that such a large rebalancing could not possibly occur without drastic changes in the institutions responsible for running the world economy—changes that would include placing far less reliance on market forces.

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

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

GENNARO ZEZZA

Strategic Analysis, January 2009

In this new Strategic Analysis, Research Scholar Gennaro Zezza examines the Federal Reserve's most recent data on outstanding household debt and unemployment, and reports a drop in borrowing that is steeper than previous projections in April 2008. The author notes that past recessions saw a marked fall-off in business borrowing and minor consequences for households, while the current recession's drop in credit is having a greater effect on household finances. According to the Levy Institute's macro model, a fall in borrowing has immediate effects, resulting in the continued decline of real GDP and a likely significant rise in unemployment, thus substantiating a central contention of the December 2008 Strategic Analysis by Godley, Papadimitriou, and Zezza.

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

New Public Policy Briefs

After the Bust: The Outlook for Macroeconomics and Macroeconomic Policy

THOMAS I. PALLEY

Public Policy Brief No. 97

"Change"was the buzzword of the U.S. presidential campaign, in response to a political agenda precipitated by financial turmoil and a global economic crisis. According to Research Associate Thomas I. Palley, the neoliberal economic policy paradigm underlying the current agenda must itself change if there is to be a successful policy response to the crisis. Palley argues that the current recession provides an ideal climate for progressive, fiscally based, Keynesian economics to replace the neoliberal economics paradigm and prevent its future return to dictate disastrous policies.

In Palley's view, three challenges face the developed market economies: stopping asset price deflation and restoring credit flows, getting the economy and employment to grow once again, and ensuring that future growth is characterized by full employment and shared prosperity. The author argues that differences among policymakers regarding the first two challenges are largely a matter of degree, but significant disagreement remains with respect to the third, mainly due to the influence of neoliberal economics. He notes that the disconnection between wages and productivity growth is the single most salient feature of the neoliberal agenda; another is the retreat from full employment, based on the "new classical" macroeconomic notion that policy can have no permanent impact on employment, and that the market by itself gravitates quickly to full employment. By contrast, Post Keynesian macroeconomics has a good record of predicting the vulnerabilities of neoliberal economics, along with clear alternative fiscal and monetary policies to deal with the current crisis. The challenge, Palley argues, is to win recognition for this record, and he notes that major obstacles must be overcome in order to achieve this.

The first obstacle concerns the split among social democratic parties regarding the neoliberal economic paradigm. "Third Way" social democrats remain committed to the neoliberal model, as long as it is amended to allow for financial regulation and social welfare plans; in the United States, the "New Democrat" critique of the Bush administration is that it abandoned budget discipline and pursued inegalitarian tax and social policies. The split between labor and Third Way social democrats risks bringing about a full-blown neoliberal triumph, says Palley. This points to a second obstacle: the continuing intellectual dominance of neoliberal economics in academic and public policy discourse, and its claim of representing scientifically proven principles. Finally, neoliberal economics "places its eggs" in a Keynesian "nest" by blurring distinctions, promoting the claim that Keynesian economics is a "special case" of neoclassical economics, and recommending Keynesian policies in times of economic crisis—in other words, adopting only those ideas that leave unchanged the core analytical assumptions driving modern neoclassical macroeconomics, giving the paradigm an astounding capacity to reinvent itself.

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

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

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

Public Policy Brief No. 98

The Federal Accounting Standard Advisory Board (FASAB) has proposed subjecting the entire federal budget to "intergenerational accounting," which purports to calculate the debt burden that the current generation will leave for future generations. In this new Public Policy Brief, Senior Scholars James K. Galbraith and L. Randall Wray, and Warren Mosler, Valance Company, Cambridge Centre for Economic and Public Policy, University of Cambridge, and Center for Full Employment and Price Stability, University of Missouri–Kansas City, argue that intergenerational accounting is a deeply flawed and unsound concept, and as such should play no role in federal government budgeting. They find the concept particularly objectionable when employed to make a case for cutting Social Security and Medicare.

In intergenerational accounting, federal government revenue and expenditure streams are compared over very long periods. "Deficit gaps" are then used to measure the financial burden of these commitments, and thus the alleged solvency or insolvency of the government. Discounting the sum of the differences back to the present permits infinite sums to be translated into very large, but finite, numbers. However, the authors point out that federal budgeting does not, and should not, follow the exact accounting procedures adopted by households and business firms because there is no operational limit on government spending; that is, its spending is not constrained by revenues or borrowing. Indeed, with the exception of a few brief periods, federal spending has exceeded tax revenues since the founding of the United States. Moreover, while spending of individual households and firms is constrained by the size of their budget, the position is different in the aggregate because the private sector's ability to spend *more* than its income depends on the willingness of *another sector* to spend less than its income: for one sector to run a deficit, another must run a surplus (saving). In the real world, the federal government tends to run persistent deficits. This is matched by the tendency of the nongovernment sector (which includes the foreign sector) to save. In addition, the exposure drafts contain no mention of the assets that correspond to the liabilities of the nation. In particular, they treat the obligations of Social Security as a liability without acknowledging that the same funds are also an asset to the public. Furthermore, the fiscal gaps as defined by the FASAB would apply to Medicare and Social Security as entities separate from all other government programs, once again ignoring the accounting identity between the government and nongovernment sectors discussed above. What matters for the long-range projection of the future real burden of such programs are demography, technology, and economic growth, say the authors—not financing.

The authors conclude that the exposure drafts have not made a persuasive argument for the accounting change since the FASAB does not count as real assets the infrastructure and other public assets that the current generation leaves for future generations, nor does it understand that federal spending can, and almost always does, exceed tax receipts.

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

The Return of Big Government: Policy Advice for President Obama

L. RANDALL WRAY

Public Policy Brief No. 99

The dire condition of the U.S. economy has created a favorable climate of opinion for large-scale economic intervention by the federal government. However, there are influential forces trying to steer policy away from the "Big Government" model. In this new Public Policy Brief, Senior Scholar L. Randall Wray puts forward arguments in defense of "Big Government" intervention, and proposes affordable short- and long-term policies that would ensure its success.

The author notes that the United States enjoyed the benefits of Big Government intervention during its "Golden Age" of economic prosperity immediately following World War II. He proposes a set of policies that could revive the Golden Age, and notes that such policies should have different time dimensions. First are those intended to deal with the urgent problems created by the current crisis. However, Wray invokes Minsky's hypothesis that stability breeds instability to warn that, as the economy improves with the application of short-term policies, economic agents will return to the type of risky behavior that resulted in the current crisis. He therefore examines long-term policies to prevent the return of instability.

For the short term, Wray suggests that the government increase lending to financial institutions without limit or collateral while abandoning the "too big to fail" mantra of outgoing Treasury Secretary Henry Paulson in favor of a "too big to save" approach to such institutions. He also recommends an immediate payroll tax "holiday" and fiscal stimulus, in addition to mortgage relief and serious government plans for pursuit of financial fraud at all levels, right up to the top. The author also suggests medium- and long-term policies for sustainable growth, such as "green" initiatives, particularly to prevent oil price increases after recovery. He argues for payroll tax reform since such taxes discourage work and employment, and for removing regressive local government sales and excise taxes in return for increased federal funding to the states. Containing inequality by promoting industry over finance will weaken the forces keeping wages stagnant. Wray also favors nationally funded, universal health care, along with infrastructure and social spending; he details a public works program that maintains job stability and full employment without being inflationary. Finally, the author turns to the affordability question of his recommended policy package. He rejects as false the "balanced budget" analogy between households and the federal government, noting that households cannot issue Federal Reserve notes, and that a sovereign currency government cannot become insolvent; it simply generates a budget deficit by crediting bank accounts.

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

New Policy Note

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

PAVLINA R. TCHERNEVA

Policy Note 2009/1

The ability of employment policy to create jobs is a major concern in the United States today. Much depends on President Obama's stimulus plan, the scrutiny of which has revealed a number of potential shortcomings. In this new policy note, Research Associate Pavlina R. Tcherneva suggests a simple amendment to the Obama plan based on Hyman P. Minsky's employer-of-last-resort policy—a job guarantee program that could create three million jobs in a matter of months, without putting upward pressure on wages or leaving women and minorities behind.

Tcherneva argues that the Obama plan is not bold enough—not necessarily because its budget is too small, but rather because of its extremely modest goal of 3.7 million new jobs by the end of 2010. The problem is that the plan aims to create jobs by raising aggregate demand, but in order to do so, it must manage to stimulate growth at a faster rate than that by which unemployment falls. This is because not all of the public funds reach the poor and the unemployed; part of the stimulus package will "leak" in the administrative process (e.g., administrative costs as well as tax cuts and investment subsidies that have no direct job creation effects). The budget recently unveiled by House Democrats proposes approximately $275 billion in cuts and $550 billion in spending, thus committing roughly $183,000 to each of the three million jobs that it expects to create. Rather than going toward salaries, most of this amount will leak into the economy in the form of unemployment insurance, food stamps, state aid, and private contracts for public works. By contrast, the author argues, a much better employment outcome is obtained by targeting the plan *directly* to the unemployed. If the plan were to guarantee to all persons willing and able to work a wage of, say, $12 per hour, or an annual salary of $25,000 per person, it would create a wage bill of $125 billion for five million new public sector jobs—1.3 million additional jobs, and at a fraction of the budget currently proposed.

For the complete text, go to www.levy.org/pubs/pn_09_01.pdf.

New LIMEW Reports

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

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

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

By construction, both MI and EI (a post-tax, post-transfer measure) have average values that are less than LIMEW. In this report, Senior Scholars Edward N. Wolff and Ajit Zacharias and Research Scholar Thomas Masterson compare the three measures over the 1959–2004 period and find different rates of change in median well-being by subperiod. Between 1959 and 1972, both MI and EI grew substantially faster than LIMEW. In contrast, all three indices recorded very high growth rates in the 1982–89 period, but LIMEW grew much faster than either MI or EI. Subsequently, from 1989 to 2000, LIMEW again grew faster, at a rate of 0.9 percent per year versus 0.4 and 0.7 percent per year for MI and EI, respectively. LIMEW continued to grow, at an even faster pace, between 2000 and 2004 (almost 1.0 percent per year), while both MI and EI declined in absolute terms. Comparing trends in real per capita GDP with the above three measures shows the growth in household well-being was much slower than the growth in total per capita output during 1959–2004. Moreover, changes in well-being are sensitive to the business cycle; this is most evident for 1982, when there was a deep recession and the unemployment rate was 9.7 percent. Both median LIMEW and median MI recorded negative growth between 1972 and 1982.

The report also highlights the composition of the LIMEW by income quintile.

Looking at income from wealth across quintiles shows its increasing importance, ranging in 2004 from 4.2 percent for the lowest quintile to 32.1 percent for the highest, while the opposite is the case for net government expenditure, ranging from 22.2 percent for the lowest quintile to minus 2.7 percent for the highest. The report also examines the third quintile of LIMEW distribution, a close approximation to median LIMEW for all households, and notes its dramatic shift in favor of net government expenditure between 2000 and 2004. According to the LIMEW, the public sector was the leading source of the growth of middle class well-being between 1959 and 2004; labor income also contributed strongly to well-being. According to the MI and EI measures, however, most of the growth of middle class well-being was due to the rise in labor earnings. In conclusion, the report draws attention to the crucial role of net government expenditures in the economic well-being of the population, particularly the poor and the middle class.

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

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

THOMAS MASTERSON, EDWARD N. WOLFF, and
AJIT ZACHARIAS

LIMEW Report, February 2009

Government policy has had an important impact on economic disparities among population subgroups over the last half century; for example, special tax treatment for families with children has improved the well-being of single mothers, while Medicare and Social Security have enhanced the overall well-being of the elderly. In this second LIMEW report, authors Masterson, Wolff, and Zacharias examine economic well-being in the United States from 1959 to 2004 based on the following household characteristics: race/ethnicity, age, education, and marital status. Their aim is to highlight the extent to which the sources of changes in disparities are the result of policy or broader economic trends. (See the report above for the LIMEW's components and how these differ from the official measures.)

Employing a ratio of mean or median values of nonwhites to whites as a disparity indicator, the report notes that from 1959 to 2004, both the LIMEW and EI show similar rising trends in the ratio of median values, from 0.61 to 0.85 in LIMEW, and from 0.57 to 0.74 in EI. It attributes the gap to differences in income from wealth, since the gap narrowed in almost all other components of the LIMEW over the same period. The report also examines well-being over five age groups, showing that the standard "hump" shape relationship holds true (i.e., the middle-age groups are better off than both the youngest and the oldest groups) for LIMEW, MI, and EI measures from 1959 to 1989. However, in 2000 a new pattern emerged for LIMEW: well-being for the 65-and-older group was 9 percent higher than the average nonelderly household, attributable to the greater income from accumulated wealth and shorter remaining life expectancy.

Concerning education, the report's main finding is that the living standard of the less educated (with high school or less, and some college education) deteriorated relative to college graduates over the 1959–2004 period. The mean LIMEW ratio of household heads with less than a high school degree to those with a college degree fell from 0.53 to 0.50, a trend even more pronounced in terms of mean MI and EI. Finally, all three measures show a very wide gap in well-being between single female–headed families with children and married couples with children (families with a married head). The report explains this outcome in terms of greater gains in school spending and child tax credits over the period, which, according to MI and EI, is largely a refection of the gap in labor income.

For the complete text, go to
http://www.levy.org/pubs/lmw_feb_09_2.pdf.

New Working Papers

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

FATMA GÜL ÜNAL

Working Paper No. 551

Despite more than 40 years of research, there is no consensus on what causes the inverse relationship between farm size and yield per acre—a relationship that has far-reaching implications for rural development policy. Economic research has widely revealed smaller farms in developing countries to be more productive, and the explanation for this outcome has been a major concern of agricultural economists. In this working paper, Research Associate Fatma Gül Ünal analyzes the evidence for an inverse size-yield relationship (IR) in Turkey in light of some of the explanations offered in the literature.

The author discusses a wide range of explanations—for example, the land-quality explanation for IR, according to which fertile lands can support higher population densities, resulting in land fragmentation; hence, the estimate of farm size effect on productivity would be distorted if land-quality variables were left out of the analysis. However, she argues that the labor-based hypotheses provide the most plausible explanations for IR. Based on the notion that the marginal cost of employing additional rural labor in labor-surplus countries is zero, the labor-based approaches explain the existence of IR as a result of the intense use of labor; that is, the cheapness of labor in smaller farms leads to the intense use of it, thereby resulting in higher yields per acre. Ünal applies this approach to a 2002 World Bank household survey of 5,302 households from seven agricultural regions in Turkey. She estimates IR with two equations in which output per decare (1,000 square meters, or .25 acre) and labor per decare are the dependent variables defined as a function of farm size, and a number of other relevant, conditional variables (e.g., age and education of household head, share of sharecropped land to total land holdings, and so on). Moreover, she notes that each Turkish agricultural region is very homogenous, and that this feature can be exploited to control for variation in land quality by estimating IR for each region separately.

The author finds that there is a very strong inverse size-yield relationship in rural Turkey. Doubling the farm size results in a 51 percent decrease in productivity per decare nationally. Furthermore, IR also exists, with variations, within each region; it is most pronounced in the Black Sea region and least pronounced in the Marmara. Ünal notes that the robustness of IR for Turkey contradicts proposals by the Organisation for Economic Co-operation and Development and the U.N. Food and Agriculture Organization based on the need to consolidate land in order to achieve higher productivity. Given the evidence for smaller farms' increased productivity, and the fact that 30 percent of Turkey's population lives in rural areas, she concludes that what is needed is land redistribution, along with technical and financial assistance for farmers.

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

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

KIJONG KIM

Working Paper No. 552

Multiplier analysis based on a social accounting matrix (SAM) is often used for simulation purposes, and rests on the supposition that the technical coefficients of production remain constant; its fixed-price analysis assumes that an increase in exogenous demand is to be satisfied by a corresponding increase in output, not prices, because there are excess capacity and unused resources in the economy. This working paper by Research Scholar Kijong Kim proposes a simple modification to a SAM in order to analyze the multiplier effects of a *new* sector. He applies this method to the case of the Expanded Public Works Programme (EPWP) in South Africa, and shows that the proposed approach effectively represents policy-targeted types of labor and a new-factor income distribution.

SAM employs data from an input-output table that represents the multiplier effects of a change in one sector across all other sectors. The table shows how each good or service employs other goods in its production (backward linkages), and in turn enters into the production of other goods (forward linkages). Assessing the full impact of adding a new sector to an input-output table involves working out its forward and backward linkages to the rest of the economy. This "rebalancing" is often an enormous task when a new economic sector with its own specific features (new technical coefficients) is added. The approach taken in this paper allows impact analysis of a new sector without the necessity of rebalancing the SAM. It scales down the absolute value of the new industry's output while maintaining the relative contribution of other sectors (as intermediate input suppliers to the new sector's output). This simple adjustment preserves the new sector's multiplier effects (e.g., health and elder care) that serve households' final demand (its backward linkages), while its output does not enter into other sectors' production (its forward linkages).

The policy aims of the injected funds are to produce EPWP output (e.g., care of HIV patients) by offering employment in the new sector that is more biased in favor of unskilled, poor, and female labor. Kim compares the results of a simulated 9.29 billion rand injection (using the above method) with a baseline scenario of no cash injection. He notes that the reformulation correctly represents the factor-intensity requirement of the program, which is based on using more labor-intensive technology than their counterparts in the economy in health and social services. He also notes that the changes in income distribution as mandated in policy to improve the pronounced existing income inequality favoring South Africa's nonpoor (defined as income level above the 50th percentile). The reformulated SAM increases both poor (25th–50th percentile) and ultrapoor (below the 25th percentile) households' shares of total income to 5.6 and 2.6 percent from 5.5 and 2.3 percent, respectively, while the share of nonpoor households declines from 92.2 to 91.8 percent.

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

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

JÖRG BIBOW

Working Paper No. 553

A striking feature of the current global financial system is the sizable current account surpluses that developing countries run, with massive outflows into low-yielding U.S. dollar assets. This is a paradox, since capital should flow from rich to poor countries rather than the reverse, and is often explained in terms of "self-insurance" for risks against capital outflows, a trend that developed in the aftermath of the Asian crisis. In this working paper, Research Associate Jörg Bibow argues that the cost of this scheme is too high for developing countries, and suggests that managed, rather than liberalized, capital markets are a more beneficial alternative for financing economic development.

Mainstream economists view current account surpluses as representing a "saving glut" generated by developing countries because they do not possess established financial markets of their own, and hence seek secure investment of their savings in advanced market economies. This view also regards the conversion of savings into foreign financial assets as posing no cost to the developing countries, since, lacking viable financial markets, they would gain nothing from their surpluses if the savings were not invested abroad. Moreover, to sustain this financial mechanism, the developing countries must adopt capital accounts convertibility (i.e., liberalization). Bibow, however, offers a different, "dollar glut" interpretation of the paradox, which he regards as resulting from dollar liquidity based on U.S. credit creation. Moreover, he argues that while the private cost of capital exports may be negligible, this is not so from a public (national) point of view. The relevant measure for this purpose is to compare the private sector's cost of short-term borrowing abroad with the yield that a developing country's central bank earns on its liquid foreign assets—by one estimate, about 1 percent of the developing countries' GDP. The spread between the two is what Bibow defines as an "intermediation loss"—a loss from the perspective of the developing country, but a gain from the perspective of the provider of international liquidity services. The author also proposes capital accounts management to prevent such losses. In this alternative to convertibility, the developing country selects the composition of capital flows so as to match the external technological or business expertise with its national development goals, and to maintain policy space (e.g., in the event of a need to decouple from external macroeconomic shocks).

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

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

JULIA S. PERELSTEIN

Working Paper No. 554

The current U.S. financial crisis has exposed the weaknesses in international trade that make the rest of the world so vulnerable to instability in the U.S. economy. The emphasis of this working paper by Julia S. Perelstein, *Mandag Morgen*, Oslo, Norway, is on the vulnerability of emerging economies.

Perelstein notes that by the middle of this decade, household consumption in the United States had become the main engine of growth, accounting for 33 percent of GDP growth. Much of the spending was financed by debt secured on real estate. The reason for debt-driven consumption growth was that foreign export credits earned in U.S. dollars were used to buy U.S. national debt to finance the U.S. current account deficit. The author also believes this reinvestment in U.S. capital markets was due to inadequacies in the financial markets of emerging economies with current account surpluses. However, since the reinvestment led to massive liquidity in the system, the excess funds were driven to one asset market after another, finally moving to speculation in commodity futures and thus leaving millions of the world's poor struggling to secure adequate supplies of food and energy. Moreover, the author notes that while the decline in the value of the U.S. dollar would make debt repayment easier for some countries, there are others that are dependent on export earnings from the U.S. market in order to make payments on their debt, and these are facing a dire future. She concludes that the United States' macroeconomic imbalances cannot be resolved without gravely affecting the rest of the world.

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

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

EWA KARWOWSKI
Working Paper No. 555

In this working paper, Ewa Karwowski, School of Oriental and African Studies, University of London, takes a critical look at the theory and practice of Islamic banking, and examines claims that its operations avoid many of the conventional banking practices that have destabilized markets worldwide. She looks specifically at Malaysia, the world's largest provider of Islamic financial services.

Karwowski notes that in Islamic finance, profit (or loss) is shared at a predetermined ratio between the bank and the entrepreneur, and profits have to be generated by two alternative financing modes. Primary modes include profit-sharing arrangements such as partnerships and equity participation; secondary modes include mark-up pricing and leasing arrangements, with less emphasis on productive investment. However, while conventional Western banking differs from the primary (interest-free) modes, it is nonetheless reconcilable with the secondary financial modes that result in predetermined debt servicing. Indeed, the author notes that secondary modes constitute the majority of Islamic banking transactions, especially in Malaysia. This feature provides the context for assessing perhaps the most important claim made for Islamic banking; namely, that it is a stabilizing form of finance.

The principal measure employed by the author is the calculated percentage of banking and financial assets as a share of total liabilities. She notes that Malaysian firms hold a significant share of their liabilities in financial and banking assets; the typical Malaysian firm is overcapitalized. Karwowski examines the balance sheets of the country's major Islamic banks and finds that, on the liabilities side, nonfinancial companies with earnings obtained from non-Islamic businesses, rather than households, are the major depositors; on the assets side, some of the banks focus on noncommercial companies, but most of those examined provide a significantly larger share of total loans to individuals (e.g., for the purchase of residential property and transport vehicles). Thus, she argues, there is convincing evidence that Islamic banks in Malaysia channel funds from the overcapitalized noncommercial corporate sector toward household investing in housing and durables. Just like conventional banks, they contribute to the creation of financial bubbles, and are far from exercising a stabilizing effect on the economy. The author concludes that it is hard for Islamic banking to retain its distinct features when operating in an interdependent environment dominated by large conventional banks, particularly in a country well integrated into the global economy.

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

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

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

This working paper forms the basis for the February 2009 LIMEW reports outlined above. It includes extensive appendices concerning the key techniques of statistical matching that were used to identify and analyze the long-term trends of economic well-being. An area of the paper not already covered in the reports is the section on economic inequality. Authors Wolff, Zacharias, and Masterson review aggregate income by quintile and find that the middle three quintiles were lower in 2004 than in 1959 according to the LIMEW and the two official measures, gross money income (MI) and extended income (EI). The change in the division of the economic pie favored the top quintile far more than the bottom quintile in the LIMEW and MI distributions.

Time trends also vary among the measures. LIMEW shows an increase from 1972 to 1982, no change from 1982 to 1989, and then a surge from 1989 to 2000, reflecting the large increase in income from wealth, which is highly concentrated at the top of the distribution. This was followed by a significant decline in inequality due to the decline in the value of financial assets between 2000 and 2004. The Gini index indicates higher inequality in 2004 than in 1959, an increase of 6.2 Gini points for MI, 5.1 points for LIMEW, and 2.1 points for EI. The report also provides estimates for the decomposition of inequality by income component, a rough guide to the components' inequality-enhancing and -reducing effects. Decomposition analysis showed that base money income (consisting mainly of earnings) and income from wealth contributed positively to the increase in inequality between 1959 and 2004 in all three measures. The principal factor behind the increase in inequality in LIMEW was the rising contribution of income derived from nonhome wealth, while for MI and EI this role was played by base income.

Net government expenditures contributed negatively to the increase in inequality between 1959 and 2004 in all of the measures. The 2000–04 period is again particularly interesting. The large decline in income from nonhome wealth (15 percent in LIMEW and 43 percent in EI) was the main factor accounting for the reduction in inequality in both LIMEW and EI. The report concludes by noting that the reduction in measured inequality between 2000 and 2004 appears to be a result of the boom and bust of financial markets rather than a reduction in earnings inequality or the result of changes in government redistributive policies.

For the complete text, go to www.levy.org/pubs/wp_556.pdf

Levy Institute News

2008 Economists for Peace and Security Conference: The Financial Crisis, the U.S. Economy, and International Security in the New Administration

The 2008 Economists for Peace and Security (EPS) conference took place at the Schwartz Center for Economic Policy Analysis, New School University, in New York City on November 14. Cosponsored by EPS, The Levy Economics Institute, the Schwartz Center, and the Charles Léopold Mayer Foundation Initiative for Rethinking the Economy, the conference covered a range of analyses and policy proposals on maintaining financial security in the current crisis.

Senior Scholar James K. Galbraith argued that housing constitutes the main asset of most households, and in the current state of the housing market, many households have no asset against which to borrow even if credit started flowing again. He suggested establishing a body similar to the Home Owners' Loan Corporation of the 1930s to renegotiate and reset sustainable mortgages. He also pointed out that, given the drastic fall in the value of pensions, there is a need for a program of support to prevent the elderly from falling below the poverty line, for which Galbraith proposed an across-the-board increase in Social Security benefits.

The inadequacy of the Bush/Paulson stimulus plan was an extensively discussed conference topic. Joseph E. Stiglitz, Columbia University, argued that the current crisis is a problem of global deficiency in aggregate demand caused by countries with massive current account surpluses (i.e., they export far more than they import), and suggested a penalty scheme to encourage the expenditure of those surpluses. His recommended short-term policies included a conversion of the current tax reduction on housing purchases, amounting to an approximate 50 percent reduction of mortgage interest and property taxes, into a tax credit for poor households. He also proposed federal mortgage subsidies for the long-term unemployed, as in the United Kingdom. Stiglitz concluded by noting that finance is supposed to be a means to an end—namely, the smooth functioning of the real economy—but has instead become an end in itself, as is evident from the enormous size of the U.S. financial sector, raising again the important issue of regulation.

John Eatwell, University of Cambridge, spoke of the need for an institution to deal with the risks posed to the global financial system. He examined the notion that risk management techniques can reduce the risks involved in global finance, and argued that it does not take into account the problem of systemic risk. For example, a run on a bank in poor financial health can erode confidence in the banking system as a whole, resulting in a run on a perfectly sound bank as well. Therefore, current risk assessment methods and technologies fail to price in the externality cost to the system, and hence cannot price systemic risk correctly. Eatwell argued that the only way to avoid risk assessment's adverse effects on the global financial system is to enlist international institutions as system regulators. The major problem, he noted, is the near absence of international regulation, since at present regulatory actions are confined by national boundaries.

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

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

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

The program of events, along with audio recordings of the speakers' presentations, is available at www.levy.org.

Publications and Presentations

Publications and Presentations by Levy Institute Scholars

RANIA ANTONOPOULOS *Research Scholar*

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

PHILIP ARESTIS *Senior Scholar*

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

Presentations: "New Consensus Macroeconomics and Keynesian Critique," 12th Conference of the Research Network Macroeconomics and Macroeconomic Policies, "Macroeconomic Policies on Shaky Foundations—Whither Mainstream Economics?" Berlin, Germany, October 31–November 1, 2008;

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

JAMES K. GALBRAITH *Senior Scholar*
Publications: "James K. Galbraith Says Predator State Hit Wall: Year in Review," *Bloomberg.com,* December 31, 2008; "We Are All Keynesians Again," *The Washington Monthly* (January–February); "A Biophysical Approach to Production Theory" (with J. Chen), UTIP Working Paper No. 55, February 1; "The Generalized Minsky Moment" (with D. Munevar Sastre), UTIP Working Paper No. 56, February 2; "The Evolution of Economic Inequality in the United States, 1969–2007" (with J. T. Hale), UTIP Working Paper No. 57, February 2.
Presentations: "The Johnson Legacy and the Obama Challenge," panel on "Employment, Cities, and Housing," "Lyndon B. Johnson Centennial Symposium: Policy Challenges for the New President and the LBJ Legacy Meeting," Lyndon B. Johnson School of Public Affairs, Austin, Tex., December 4, 2008; "Inequality, Unemployment, and Growth," panel on "Inequality: Economic, Fiscal, Financial, and Societal Dimensions," Allied Social Science Associations (ASSA) Annual Meetings, San Francisco, Calif., January 3–5, 2009; "Inequality, Unemployment, and Growth: New Measures for Old Controversies," panel on "Understanding the Persistence of Inequality: Toward the Development of New Analytical Approaches," ASSA Annual Meetings; "Earnings Inequality in the United States," panel on "The Persistent Problem of Inequality: A Roundtable on Policy Advice for the Next Administration," ASSA Annual Meetings; "The Crisis and the Road Ahead," Americans for Democratic Action conference, Washington, D.C., January 20; "The Financial Crisis and the Economy Looking Forward," Metropolitan Breakfast Club, Austin, Tex., February 18.

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

FERIDOON KOOHI-KAMALI *Research Associate and Editor*
Presentation: "Intrahousehold Inequality and Child Gender Bias in Ethiopia," Eastern Economic Association Annual Conference, New York, N.Y., February 27.

THOMAS MASTERSON *Research Scholar*
Publication: Review of *The World Bank, A Critical Primer* by E. Toussaint, *Labour/Le Travail*, Vol. 62 (Fall 2008).
Presentation: "Long-Term Trends in the Levy Institute Measure of Economic Well-Being (LIMEW), United States, 1959–2004," Allied Social Science Associations Annual Meetings, San Francisco, Calif., January 3–5.

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

EDWARD N. WOLFF *Senior Scholar*

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

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

GENNARO ZEZZA *Research Scholar*

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

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