



Report

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18th Annual Hyman P. Minsky Conference on the State of the U.S. and World Economies

MEETING THE CHALLENGES OF FINANCIAL CRISIS

A conference organized by The Levy Economics Institute of Bard College with support from the Ford Foundation

On April 16 and 17, 2009, more than 150 policymakers, economists, and analysts gathered at the headquarters of the Ford Foundation in New York City to offer their insights into and policy guidelines for 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.



18th Annual Hyman P. Minsky Conference, Ford Foundation, New York City

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

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Welcome and Introduction

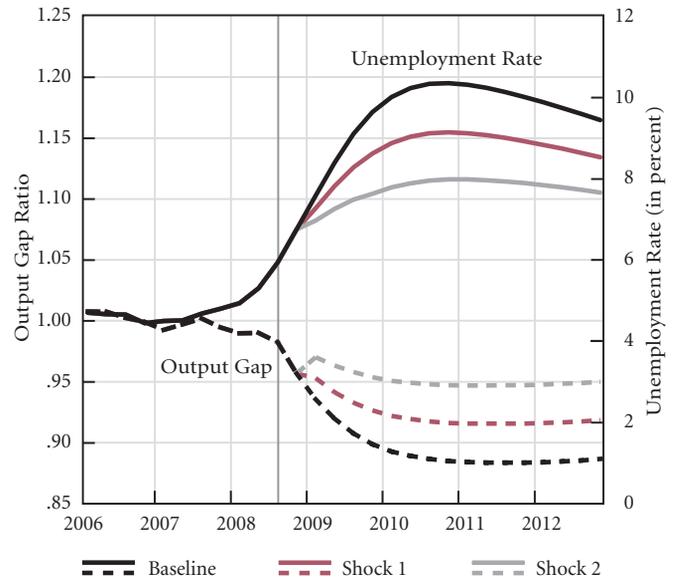
MAYA HARRIS, PEACE AND SOCIAL JUSTICE PROGRAM,
FORD FOUNDATION

DIMITRI B. PAPADIMITRIOU, LEVY INSTITUTE

Harris noted that the current financial crisis reflected the Ford Foundation’s mission, which is to tackle the most pressing challenges, issues, and concerns of the day. In terms of the financial crisis, the issues relate to how global financial governance and stability impact poverty reduction and social justice. A crisis of this magnitude presents the chance to redefine the debate and agenda on global financial governance, with bold new thinking on policy, regulation, and reform.

Papadimitriou thanked the Ford Foundation for its financial support and for hosting the conference. He devoted his introductory remarks to an elaboration of the issues discussed in the Institute’s latest Strategic Analysis reports, *Recent Rise in Federal Government and Federal Reserve Liabilities: Antidote to a Speculative Hangover* (see p. 20) and *Prospects for the United States and the World: A Crisis That Conventional Remedies Cannot Resolve* (summarized in the April 2009 issue of the *Report*, pp. 1–3). He noted that the United States could not have maintained its prerecession growth unless it had been happy to encourage (or at least permit) the private sector, particularly the personal sector, to borrow on such an unprecedented scale. Between 2000 and 2007, U.S. private sector borrowing and debt accelerated sharply; growth suddenly ceased in the first quarter of 2008, and then began to fall. The borrowing flows between the third quarter of 2007 and the third quarter of 2008 dropped by a dramatic 13 percent. Papadimitriou argued that the unprecedented cut in interest rates by the Federal Reserve (Fed) will not be able to reactivate standard lending practices unless business confidence in future profits and income growth is recovered. With borrowing out of the picture, private net saving (i.e., the difference between income and expenditure) is likely to remain positive for years, as households pay down debt. He then examined the effects of U.S. government outlays on GDP with different econometric simulations obtained from the Levy Institute’s macroeconomic model of the U.S. economy for 2009–12. As shown in Figure 1, even with the application of government outlays assumed equal to 2.5 percent (shock 1) and 5.3 percent (shock 2) of GDP, output will not increase sufficiently to

Figure 1 Output Gap and Unemployment



Sources: Federal Reserve and authors’ calculations

prevent unemployment from continuing to rise through the next two years. It seems unlikely that larger budget deficits of the order of 8–10 percent of GDP to resolve the unemployment problem through the next two years would be tolerated. Therefore, fiscal policy alone cannot resolve the current crisis. A solution that ensures sustained growth with full employment would require both fiscal expansion and a rapid acceleration in net export demand, Papadimitriou observed. Such a resolution of the strategic problems now facing the U.S. and the world economies can probably be achieved only by an international agreement that would change the international pattern of aggregate demand combined—a significant rebalancing that cannot occur without dramatic changes in the institutions responsible for running the global economy.

Keynote Speaker: BRUCE KASMAN, JPMORGAN CHASE & CO. In Kasman’s view, there is reason for short-term optimism regarding financial market stabilization but a poor medium-term outlook for unemployment. He argued that instability produces very powerful business cycles, not just on the downside but also on the upside. He noted that despite the dependence of world growth on easy credit and a surge in inflation due



Bruce Kasman

to higher food and energy prices during 2008, the United States' growth performance has held up in relative terms, and its GDP was in the middle of the range for world economies throughout last year. He attributed this outcome to three factors: (1) weak demand prior to the recession, reflected in a 5 percent current account deficit; (2) the Fed's easing of policy rates last year in response to the credit crisis, when policy rates rose outside the United States to counter inflationary concerns; and (3) the relatively smaller gap between U.S. inventories and sales. This suggests that the American consumer and the U.S. business sector have already made the adjustments necessary for stabilization—though this is unlikely to produce an expansion of the kind observed in the years prior to the recession. Europe and Japan have lagged in making this adjustment, whereby businesses have cut back on spending and employment in order to lower their costs and inventories, and will have a weaker performance in the coming quarters as a result. Nonetheless, Kasman maintained, global order-to-inventory ratios and consumer spending will improve, since much of the stimulus spending entering the world economy will only be felt in the second and third quarters of the year. However, he warned that short-term improvements in these areas will not be matched by improvement in the employment situation. According to Kasman, we are in the midst of a fundamental shift in global macroeconomic performance following three decades of improving labor market conditions, globalization, disinflation, and the increased

prominence of market-oriented systems. He examined the extent of economic growth required to return to the “normal” labor market conditions of recent decades, when unemployment rates hovered around 5–6 percent. Based on a peak unemployment rate of 8.5–10.5 percent for this recession, a return to the normal rate would require the U.S. economy to perform “miracles,” sustaining well over 5 percent GDP growth for three years running. Kasman concluded by observing that the U.S. economy will come out of a major disruptive shock only to be stuck in low growth and high unemployment in the medium term.

Session 1. Assessment of Fed/Treasury Response to Crisis

Moderator: GREG HANNSGEN, LEVY INSTITUTE

Speakers: WILLIAM KURT BLACK, UNIVERSITY OF MISSOURI-KANSAS CITY; MARSHALL AUERBACK, RAB CAPITAL PLC; JANE D'ARISTA, POLITICAL ECONOMY RESEARCH INSTITUTE, UNIVERSITY OF MASSACHUSETTS AMHERST; THOMAS FERGUSON, UNIVERSITY OF MASSACHUSETTS BOSTON

Black, a white-collar criminologist, examined the responses of the U.S. government to “controlled” financial frauds—that is, the use of a seemingly legitimate corporation or governmental agency as a weapon to defraud. He noted that accounting control fraud is a certainty during the expansion phase of a financial bubble. A firm can grow extremely rapidly by making bad loans and through massive leverage, enabling it to report, in terms of accounting, earnings that make it appear highly profitable. Black also pointed out the limited attention given in economics to fraud, even though fraud-based economic principles are frequently employed to analyze financial crime—for example, the market for “lemons” (in secondhand cars) based on asymmetric information. Fraud, said Black, is all about increasing asymmetry of information and using it to victimize others. Another issue is the moral hazard involved in guaranteeing firms support in case of failure. Moral hazard leads not only to excessive risk but also to fraud, yet virtually all economic treatises simply exclude fraud and address only excessive risk. And then there is Gresham's law: if fraud creates a competitive advantage, then market discipline will drive honest firms out of the marketplace. Moreover, Black drew attention to the magnitude of financial crime, citing the FBI's warning, in September 2004, that there was an “epidemic” of fraud in the mortgage



Greg Hannsgen, William Kurt Black, Marshall Auerback, and Jane D'Arista

industry, 80 percent of which was induced by lenders, not borrowers. He argued that this is likely to be an underestimation, in part because only about 34 percent of all mortgage frauds are ever discovered before the loans are made.

Auerback examined the historical evidence for the economic benefits of an activist government. He noted that many Asian economies (e.g., Japan, Korea, and Thailand) sustained the greatest quantum leap in living standards in the shortest recorded time in history—about 30 years—and did so largely through significant state intervention to create above-market returns for sectors regarded essential for development. The United States had a similar experience with its canal-building programs in the early 19th century; President Eisenhower's interstate highway construction program, begun in the 1950s; and, of course, the New Deal. Auerback took issue with the current government view that unblocking credit channels will lead to renewed growth, and noted how this policy failed in Japan in the 1990s due to a lack of demand for borrowing: increased growth came only after the government introduced fiscal stimulus. The notion that the government that governs best governs least is misconceived, Auerback remarked, and we should actually welcome a return of the state. As an example, he noted that the United States spends twice as much on health care (as a percentage of its GDP) as other advanced nations, yet generally achieves inferior results compared to countries such as France or Germany, whose health care systems have a substantially smaller private sector component.

D'Arista took issue with the government's policy of handing out money to troubled financial firms as a means of resolving the crisis. She argued that losses to creditors should be a part of any durable solution, citing the Fed's handling of the Long-Term Capital Management case in 1998, whereby a small number of firms were left to resolve it for themselves at their own expense, rather than using public funds to cover the losses. Another area of inadequate response has been the levying of capital adequacy requirements against some 19 vulnerable individual institutions rather than focusing on the financial system as a whole, with capital provided only by the taxpayer. D'Arista pointed out the contradiction in using banks instead of regulation to govern the expansion and contraction of credit, given that the banking sector, in terms of the amount of credit outstanding, accounts for only 25 percent of the financial system. She also addressed the issue of inadequate capital cushions. She noted that in the early 1950s, U.S. banks had 65 percent of credit market assets in the reserve accounts held by the Fed, but by the early 2000s, these holdings amounted to less than .02 percent; reserve requirements were ultimately abolished altogether. When Fed officials decided there was a use for reserve accounts, they petitioned Congress and received an interest payment on these accounts, which now sit on the asset side of the balance sheet and are as good as gold. This policy encourages the hoarding of reserves over lending. Hence, the banks' earnings from reserve accounts increased from \$67 billion in September 2008 to a peak of \$900 billion in January 2009. D'Arista proposed a cushion for the financial system (i.e., "liability reserves") based on the fund requirements of the Fed to improve the central bank's influence over credit, during both expansions and contractions. According to this plan, the Fed would create reserve accounts for all financial institutions and put them on the liability side of balance sheets. The virtue of this proposal is that it would create an imbalance in an institution's balance sheet (by replacing an asset with a liability), thus giving it every incentive to fill in the gap by buying a new asset or making a new loan.

Ferguson discussed the Fed and Treasury responses to the financial meltdown as a series of major errors that began with the "shadow bailout" in August 2007, when it became evident that the U.S. financial market was in deep trouble. The bailout was effectively an effort by the Fed and the Treasury to table the whole question of financial reform until after the election, and to avoid an economic collapse in the middle of a presidential

election. The basic mechanism that they used was to hand enormous amounts of money out to banks through channels like the Federal Home Loan Bank System, whose outstanding debt exploded in 2007. Therefore, any chance of nipping the recession in the bud by sweeping bad assets into a single “bad bank” (as in Sweden in the 1990s) was lost. The second error, argued Ferguson, was the Bear Stearns bailout without any provision for return of the public funds provided. Right after the bailout, JPMorgan’s stock shot up and financial stocks rallied, but the public had no share of those gains. The mistake here was that the intervention led to the belief that the Fed and the Treasury would honor a policy of “too big to fail,” which was followed by a great reversal in September when Lehman Brothers was allowed to fail, leading to the widespread sense that nobody was safe. More recently, Henry Paulson and Ben Bernanke have said that Lehman did not have sufficient collateral but Bear Stearns did. Ferguson disputed this reasoning, because after Lehman went broke, the Fed made two enormous loans to the firm—and its collateral could not have been any better after Lehman went broke than it was before. Yet another error, he maintained, was Paulson’s advice to Freddie Mac and Fannie Mae to expand their lending at precisely the moment the rest of the mortgage sector was contracting. The result was a run on Freddie and Fannie debt, leading to collateral calls and the partial collapse of the Carlyle hedge fund in Amsterdam—of which Bear Stearns was a huge creditor. The bailout of Bear Stearns marked the end of the shadow bailout.

Keynote Speaker: DENNIS P. LOCKHART, FEDERAL RESERVE BANK OF ATLANTA

Lockhart focused on the challenges of building a new regulatory framework once recovery from the current financial crisis is under way. He argued that securitization has brought benefits to consumers (e.g., lower mortgage rates and affordable homeownership) that cannot easily be matched by a bank that originates a loan to hold. However, the lack of transparency regarding the value of the securities and the financial condition of the banks holding them were central factors in the financial turmoil of the last 18 months. Going forward, Lockhart argued, markets and investors will show a new risk awareness that will provide incentives for the creation of simpler and more transparent securitization structures. Hence, he expected the U.S.



Dennis P. Lockhart

securitization system to be reformed but not replaced. Imposing a set of rules about what behaviors are prohibited is almost certain to amount to fighting the last war, since, he maintained, it is not easy to anticipate where the next source of stress in financial markets will arise. Therefore, the post-crisis environment will require flexible responses to allow for the failure of interconnected complex institutions. Large banks and other highly leveraged financial institutions are involved in an intricate network of two-way short-term funding arrangements; as a result, the failure of a large interconnected financial institution threatens the funding of its counterparties, which then threatens their counterparties, and so on. Any robust resolution process must come to grips with the potential for these sorts of network spillovers, said Lockhart, and include mechanisms for short-circuiting the potential cascade of counterparty failures when a lead domino falls. He also noted that the resolution of a large, globally integrated and diversified financial institution is new territory for regulators. The challenge is that such institutions are not just domestic entities but also a collection of institutions with cross-border connections in many jurisdictions. This suggests that resolution planning should be a continuous effort on the part of regulators. Lockhart suggested that practices might include “what if” consultations with national authorities where the biggest offshore operations are located, and working with institutions and host governments to achieve cleaner and simpler legal structures that are “resolution ready.”

Keynote Speaker: JAMES GRANT, GRANT'S INTEREST RATE OBSERVER

Grant focused on the similarities and differences between the current crisis and earlier ones in the United States, particularly that of the debt-financed real estate bubble in Kansas, Nebraska, and the Dakota Territory in the late 19th century. He noted that around the time of the Civil War, the U.S. government turned over vast tracts of public lands to the railroads, turning these transportation companies into real estate companies. The railroads needed settlers and the settlers needed credit, so the railroads furnished the credit. The result was a nationwide surge in real estate mortgages around the 1880s—a big boom in lending and borrowing that would shortly end in drought and falling grain prices. Mortgage money dried up as Eastern investors refused to place more money in the West. Congress responded by forming a committee to conduct an investigation into possible courses of action; some of its members saw the boom and bust as a result of the radical and disruptive innovations of the time (e.g., the telegraph, the steam engine, the mechanical reaper), which brought great benefits but also displaced labor and destroyed old wealth; for example, the opening of the Suez Canal in 1869 reduced the need to maintain large inventories and led to the disappearance of a vast (and vastly profitable) system of warehousing and distribution. Grant noted that there was no public policy response to this crisis, as most policymakers regarded it as progress. He singled out this lack of a response as the most important difference between earlier crises and the current one. He pointed out that in the postwar period, the average federal response to an economic slump—defined as fiscal balance (or imbalance) plus expansion in the Fed's balance sheet—was 2.9 percent of GDP. By contrast, the current projected decline in the fiscal balance is 19 percent of GDP; the authorized increase in the size of the Fed's balance sheet over the next year or so could push this to 29 percent of GDP—exactly 10 times the magnitude of the average postwar governmental response to a recession. Grant concluded that the principal cause of this tenfold increase was the degree of leverage in the system, observing that the debt-to-GDP ratio more than doubled between President Reagan's entry into the White House and today.



Edward Chancellor and James Grant

Session 2. Proposals on Alternative Financial Regulation

Moderator: JANE D'ARISTA, UNIVERSITY OF MASSACHUSETTS AMHERST

Speakers: ALAN S. BLINDER, PRINCETON UNIVERSITY; CHRISTINE M. CUMMING, FEDERAL RESERVE BANK OF NEW YORK; MICHAEL GREENBERGER, THE UNIVERSITY OF MARYLAND SCHOOL OF LAW; MARTIN MAYER, THE BROOKINGS INSTITUTION

Blinder discussed several reforms of the financial regulatory system. First on the list were current (temporary) policies that, he argued, should not be made permanent. Nationalized or semi-nationalized entities such as Fannie Mae, Freddie Mac, AIG, and the Federal Deposit Insurance Corporation (FDIC) should revert to the private sector once the economy recovers. Second were policies aimed at improving the existing regulatory structure, especially international regulation. Institutions may be global, Blinder said, but regulation and supervision are national—a problem that can be solved through better communication and closer collaboration among national regulators. Cross-border bank regulation is difficult because it involves standardizing regulations across many countries. In terms of extending regulation into new domains, Blinder supported the idea of the central bank (rather than a new agency) acting as a systemic regulator since it is also the lender of last resort. He also argued that there should be a cost to institutions classified as “too big to fail”—for instance, higher FDIC premiums. Blinder also discussed the



Jane D'Arista, Christine M. Cumming, Michael Greenberger

necessity of a regulator having oversight of hedge funds and the derivatives market in order to monitor systemic risk; in addition, the markets for derivatives should be pushed into either organized exchanges or clearinghouses. The emphasis, he said, should be on regulatory transparency. He observed the need for a new regulatory entity to hold mortgage brokers responsible, just as stockbrokers recommend stocks to clients at their own legal peril, and outlined a number of major corporate governance issues that apply to all corporations, financial or otherwise. These include inadequate board oversight, a faulty risk management structure, and a compensation system that encourages risky behavior. Risk managers have been subordinate to the business line managers, which has led many firms to catastrophe. The consequences are not just internal to institutions, said Blinder, but also have huge externalities for the rest of the economy.

Cumming discussed three notions currently at the center of the discussion of regulatory reform—namely, a systemic risk regulator, a clearinghouse for settlement, and resolution and insolvency. She noted that throughout the 1990s the primary focus was the domino theory: banks lent to one another, and there was a risk of contagion if something should happen to any one bank. The focus later shifted to common risk practices associated with sales, and investor and consumer protection. She also noted that the locus of the contagion issue has shifted away from interbank lending to regulation of the clearance and settlement system for a wide range of transactions. The latter

offers an opportunity to have centralized risk controls, and more potential transparency about what the exposures actually are. Cumming also examined ways to shed light on the insolvency of international institutions, since these institutions operate against a backdrop of local regulations. The evolution of our global financial institutions has confounded the regulatory structure, since the nature of their activities was fundamentally changed by the inclusion of trading and derivatives. She noted the very rapid decay of such assets once an institution is declared insolvent. A major challenge for the insolvency process is how to quickly move the instruments from a failing institution to one that can actually manage them. She also added that the galvanizing force of the current crisis would help bring about regulatory change more quickly and effectively.

Greenberger singled out the completely unregulated credit default swaps market as the engine that created a false sense of security among lenders (if everything went wrong, they were hedged with insurance). The originators of collateralized debt obligations (CDOs) said these products were swaps, not insurance, since they were not overseen by state insurance regulators, which have capital reserve requirements. These products were deregulated in 2000 under the new Commodity Futures Modernization Act, which SEC Chairman Christopher recently called a “horrific regulatory black hole.” Greenberger argued that there is little doubt that such over-the-counter derivatives products would have to be regulated; the debate is whether the regulation should be handled by private clearing operations or by exchange trading (favored by Greenberger), which provides public transparency and has a stronger capital adequacy format. In an exchange-trading environment, all positions are marked to market twice a day; hence, there is published information on what the price of the exposure is, limiting the possibility of fraud or manipulation. Greenberger noted that two of the main players in this market, the International Swaps Dealers Derivatives Association and a group called the Coalition for Business Reform (i.e., JPMorgan, Goldman Sachs, and Citibank, among others), do not want mandatory clearing and standardization, which doesn’t allow for detailed over-the-counter derivative products (one-offs) for companies such as Exxon Mobil. Greenberger observed that unregulated one-off contracts to avoid basis risk lead to systemic risk, which is worse. Furthermore, a systemic regulator cannot regulate bubbles because it cannot identify excessive leverage or overexposure.



Alan S. Blinder

The best way is to regulate a guarantee for a credit default swap in the same way as in the equity markets (i.e., transaction by transaction), where companies have to meet net capital requirements, post margin, and mark to market every day.

Mayer focused on the consequences of financial market liberalization, and noted that the Fed for many years worried much more about the profitability and survival of the banking industry than the maintenance of ethical or even practical standards. He also pointed out how the crisis was made worse by the official panic and incoherent performance in September 2007: first, Fannie Mae and Freddie Mac were nationalized; then Lehman was allowed to fail; and then AIG was rescued, even though some fraction of its activities were fraudulent. Mayer thought the notion that rating agencies should evaluate risk on behalf of the seller has an incentive structure that reinforces instability, and that payment for ratings by buyers, not sellers, would result in a less risky environment. He examined the need for narrow banking, and pointed out that the logic behind the Glass-Steagall Act was the incompatibility of commercial and investment banking activities. He suggested that some activities that have recently been folded into the bank holding company do not go well with banking practice and should be separated; for example, the insurance of financial instruments must be regulated separately from banking, and have its own dedicated capital requirements. Mayer concluded by noting that the next year offers unprecedented opportunities for regulatory

reforms. The entire finance sector is now a ward of the state, he said, since only federal insurance makes the liabilities of the sector salable. Telling banks what they can and cannot do with insured deposits is now the name of the game.

Session 3: Levy Institute–Ford Project Proposals on Regulation of the Financial System

Moderator: GREG HANNSENGEN, LEVY INSTITUTE

Speakers: JAN KREGEL, LEVY INSTITUTE;

C. P. CHANDRASEKHAR, JAWAHARLAL NEHRU UNIVERSITY; MARIO TONVERONACHI, UNIVERSITY OF SEINA;

ÉRIC TYMOIGNE, LEVY INSTITUTE

Kregel began by discussing Minsky's view of banks, and went on to examine how best to regulate commercial and investment banking activities in separate spheres. He noted that the banking system is not engaged in taking money from households and then lending it out, but rather in a completely reverse procedure of lending money first and then seeking to fund its loans. The problem of financial stability, then, is how to cover the short cash position in the financial sector. The instability comes from the fact that business firms and financial institutions cannot create cash. There is only one institution that can create cash, and that is basically the government, through the central bank. One implication of this, Kregel noted, is that the government does not have to borrow in order to do its spending. Indeed, it represents the ability to create the liquidity that is required in order to allow financial institutions to meet their cash commitments on a continuous basis. To fulfill this function, the government must by definition run a fiscal deficit over time. If it runs a surplus, it automatically drains liquidity from the system, creating instability.

Kregel also examined two basic changes in the U.S. financial structure: the Glass-Steagall Act of 1932 (regulation by function) and the Financial Modernization Act of 1999. In the former, commercial banks were not permitted to engage in investment banking activities through affiliates. In the latter, the decision was made to adopt a bank holding company structure whereupon it would be necessary to mix the deposit banking structure with investment banking. He noted that Minsky favored small, local banks that accept and buy loans from clients, which requires the banks to check the creditworthiness of borrowers—something that no longer occurs under the originate-and-distribute system. Minsky also favored the bank holding

company model in the 1990s because he believed “a failure of a particular subsidiary would not impair the capital and ability of other subsidiaries to operate.” Today, Kregel said, it is impossible to believe that. Since it is unlikely that we can return to Glass-Steagall, he recommended a de facto separation of the deposit and investment functions within the bank holding company system, while retaining the system’s structure. The aim would be to limit each type of holding company to a range of activities that were sufficiently linked to their core function and to ensure that each company was small enough to be effectively managed and supervised.

Chandrasekhar examined how the changing structure of India’s financial markets has rendered its economy more vulnerable to the current global recession. He pointed out that the recession has affected emerging countries through reversals in flows of portfolio capital, among other channels. He noted that there is a tendency toward capital reversals in times of crisis because institutions and firms, which have invested in the emerging countries and are facing problems at home, need to sell assets to cover their losses and meet commitments. However, the adverse effects of the reversals for receiving countries can become extremely significant if they occur within the context of surging capital inflows, as is the case for India. Foreign investment flows into India in the late 1990s stood at \$5 billion. These inflows reached about \$30 billion in 2006–07, then more than doubled, to approximately \$62 billion, in 2007–08—approximately 9 percent of GDP. Chandrasekhar noted that the flow of capital into India in the form of debt has been very significant. Facilitated by liberalization of a kind that involved removing caps on external borrowing by Indian corporations, a substantial part of the surge has gone to finance domestic investment. Given such a high degree of dependence on outside debt-financing, the impact of the reversal is likely to be highly damaging. Chandrasekhar remarked that in the year ending in January 2009, roughly \$24 billion in foreign institutional investment left India—a quarter of the capital in its stock market. He argued that capital inflows employed as credit for debt-financing has also transformed India’s growth path, from one dependent on state expenditures and exports to one reliant on credit-financed consumption and investment. He noted that the ratio of outstanding bank credit to GDP rose from about 30 percent in 1997 to 60 percent by the end of 2008, and warned that India is likely to see its own subprime bubble burst.



Janet L. Yellen

Tonveronachi contended that regulatory changes since the mid-1980s comprise one of the main causes of the accumulation of fragility in financial systems—changes that allowed financial intermediaries to take huge risks. He also argued that the focus on capitalization has led to a disregard for traditional tenets of banking (i.e., liquidity and provisioning), and the approach to regulation has been unduly market-friendly, giving more discretionary power to supervisors—as permitted under the Basel construction. A new outlook on the financial system requires the abandonment of the Basel rules, said Tonveronachi, together with overregulation for at least the next 10 to 15 years, along with simplified regulations and a reduction in supervisors’ discretionary powers. He also outlined measures to avoid hard-to-value risks, to develop margins of safety for liquidity and provisioning, and to redirect incentives toward financing of the real economy. He proposed regulatory agreement on an explicit list of financial instruments and institutions, exclusion of hard-to-value and hard-to-manage instruments and intermediaries; extending common rules to all leveraged financial firms; and prohibiting regulated institutions from having direct or indirect interactions with countries that lack a similar homogenous regulatory structure. Included among his other proposals was a ban on leveraged institutions’ entering into securities and derivatives contracts that are traded outside the organized secondary markets; criminal prosecution for providing false information to the supervisory authorities, and other corporate fraud; and the

separation of leveraged financial firms from collective investment schemes, pension funds, insurance companies, and commerce. The proposed scheme would impose limits on leverage ratios, with a lower maximum leverage for the trading book relative to that for the banking book; and ensure that liquidity requirements were met with cash and/or risk-free assets.

Tymoigne examined two alternative approaches to banking regulation: the “bad bank” (traditional) approach and Minsky’s own analysis. In the former, bank failures result from specific conditions inside isolated banks, leading to fraud or mismanagement. The regulatory goal here is really to train supervisors to detect fraud. Incentives should be set to foster proper behaviors, norms established that define what is imprudent and what is prudent in risk management, and the financial sector allowed to innovate and the “market” to identify the “good” innovations, so that maximum competition and self-regulation are encouraged. The problem with this approach is that it ignores systemic risk, focusing instead on the detection of “bubbles” and mispricing—not only difficult but also highly unpopular. Furthermore, it is both too permissive (e.g., if the regulatory ratios are met then the financial institutions are assumed to be prudently managed) and too rigid (e.g., it does not account for financial innovations and may set up overly stringent regulatory standards that constrain economic growth). Regulators should be concerned when everything appears to be “normal,” said Tymoigne.

He then drew attention to the three types of financial positions in Minsky’s analysis—hedge, speculative, and Ponzi—and pointed out that not all Ponzi processes are illegal. Minsky argued that, over time, more stable positions develop into a Ponzi position of having to refinance continuously, especially during long-lasting economic expansions. These suggest a need to focus on detecting the sensitivity of balance sheets to adverse changes in asset prices, expectations, interest rates, aftertax revenues, and, especially, cash flows; there is also a need to detect financial interdependence leading to systemic risk and detect, discourage and eliminate Ponzi finance, both legal and illegal. Market forces may drive even the most altruistic and conservative economic units into Ponzi finance if their survival is threatened. In terms of the policy implications of the Minskyan approach, all financial institutions need to be regulated, independent of their size; even a small (unregulated) lender may fall victim to a Ponzi process, as observed during the U.S. mortgage crisis. A cash-flow accounting method should be developed at

the macroeconomic level, since cash flows are central to detecting Ponzi processes and position-making needs. Also, there needs to be government oversight of the approval process for financial innovations, just as for new pharmaceutical products; a good innovation should not be judged by its profitability. Finally, there should be a patent regime for financial innovations as a means of promoting higher quality over greater numbers.

**Keynote Speaker: JANET L. YELLEN, FEDERAL RESERVE
BANK OF SAN FRANCISCO**

Yellen discussed the pros and cons of policies aimed at counteracting bubbles. She noted that the conventional view (also held by the Fed) is that monetary policy should respond to an asset price, but only to the extent that it will affect the future path of output and inflation. However, other observers argue that monetary authorities must consider responding directly to an asset price bubble when one is detected; monetary policy is hard pressed to respond effectively after the fact. The result, of course, is that output and employment would be reduced in the near term—the price of mitigating the risk of serious financial and economic turmoil later on.

Yellen outlined the issues separating these two approaches. For example, the effects of booms and busts and asset prices sometimes show themselves only after a significant lag, and in those cases, conventional policy approaches can be effective. Fluctuations in equity prices generally affect wealth and consumer demand gradually; a central bank might then adjust short-term interest rates after the bubble bursts, in order to counter the depressing effects on demand. Yellen noted that, even though this stance fit the 1990s tech-stock bubble well, some bursting asset price bubbles are more virulent than others. The current recession is a case in point. As house prices have plunged, the turmoil has been transmitted to the economy much more quickly and violently than interest rate policy has been able to offset. It follows that policymakers should intervene only in those cases that seem especially dangerous, and that conventional interest rate policy actions may not be the best (i.e., tighter monetary policy could have an unacceptably depressing effect on the overall economy). For these reasons, central bankers may be better off avoiding monetary strategies and instead rely more on targeted and lower-cost alternative approaches to manage bubbles, such as financial regulatory and



Norbert Walter

supervisory tools—though not, Yellen added, as a regular practice. However, regardless of how well micro regulations are designed, they cannot protect the macro economy. In principle, many individual institutions could be managing risk reasonably well, while the system as a whole remains vulnerable, due to interconnections among financial institutions that could lead to contagious cycles of loss and illiquidity. Yellen also noted that most proposals for regulatory reform would impose higher capital requirements on systemically important institutions and design them to vary in a procyclical way. This pattern would counteract the natural tendency of leverage to amplify business cycle swings, serving as a kind of automatic stabilizer for the financial system.

Keynote Speaker: ROBERT J. BARBERA, ITG

Barbera discussed the importance of expectations, particularly in Minsky's analysis, and some "self-evident truths" about expectation in that analysis. The first issue is how people come to create an opinion about the future—how they form a consensus expectation about tomorrow. Barbera noted that since forecasting the future is very hard, most forecasts are based on the recent past. The consensus expectation for the next six months invariably bears a rough approximation to the last three or four: yesterday informs our opinion about tomorrow. The second issue is how those expectations change over time. Given

the record from many countries over many decades showing a recession after an expansion in every seven to 10 years, one would expect anxious rather than confident expectations after a boom lasting several years. Barbera argued that this is not how expectations change; rather, they change because, given a string of benign yesterdays, one begins to believe that tomorrow will be benign as well. As confidence rises, some will find ways to make large bets on a benign outcome. Overconfidence then gives rise to the aggressive use of leverage as the business cycle matures, leading gradually to a superleveraged state and a financial system that is very much at risk, because a small disappointment can have profound consequences. This suggests that expectations are formed adaptively rather than rationally: since they are backward looking over the course of a cycle, there is a predisposition to excess.

Keynote Speaker: NORBERT WALTER, DEUTSCHE BANK

Walter spoke about the effects of the financial crisis on the European economies, and the policies that have been adopted to counter them. He noted that the subprime crisis was the first transmission channel to hit Europe, through highly toxic commercial paper. Prior to the crisis, European financial institutions had a great deal of deposits on hand and little business to finance, so they bought triple-A-rated securities from the United States. The crisis in U.S. financial markets hit so fast, some of these banks were wiped out; others were in deep trouble and needed to be recapitalized. This, of course, had considerable implications: the banking sector began to shrink. In addition, there was the role played by heavily leveraged mergers. Walter noted that over the past two and a half years, several European institutions that used leveraged finance in order to acquire an "interesting target" destroyed themselves in the process (e.g., the Royal Bank of Scotland's attempted takeover of ABN Amro). A second transmission channel was the lack of prudence in macroeconomic policy, particularly monetary policy that allowed the excessive expansion of liquidity. This policy created bubbles in several asset classes—most prominently, real estate. Essentially, greed, fed by macro policy, produced a housing market that is now in need of correction. For instance, Spain's construction sector has to be cut to less than half its current size in order to return to normal conditions. Walter also noted trade as another channel through which the recession is



Jan Kregel

hitting Europe. As exports collapse, so does the investment activity of exporters—a serious problem for Italy, Japan, Germany, and Slovakia, all of which rely on producing cars for the international market (e.g., 90 percent of the cars manufactured in Slovakia are destined for foreign markets). Walter also discussed how the impact of the crisis varies across Europe. Central and Eastern Europe are very inhomogeneous. Such institutional differences are of dramatic importance for the way in which the countries in these regions are affected by the international downturn (e.g., some have their own central banks, others do not). Walter also rejected the belief that helping a few smaller states would bankrupt the European Union, noting that the cost of Germany's unification—75 percent of GDP over the past 18 years—has not led to a high risk premium for German government assets. He concluded with a warning about the dangers of protectionism in the current climate, in which the instinct of politicians is to save ailing domestic companies and protect jobs in their home country, and that this could translate into protectionism at a time when recovery demands trade expansion.

Session 4: The Institutional Shape of the Future Financial System

Moderator: JAN KREGEL, LEVY INSTITUTE

Speakers: RICHARD BOOKSTABER, AUTHOR AND FINANCIAL ECONOMIST; ALEX J. POLLOCK, AMERICAN ENTERPRISE INSTITUTE; WALTER F. TODD, AMERICAN INSTITUTE FOR ECONOMIC RESEARCH

Bookstaber examined the dynamics that lead to market crises. He noted that leverage in a market in the grip of a liquidity crisis amplifies the shock to that market. Such a crisis would force highly leveraged institutions to sell assets in order to finance positions in a market already under stress, driving prices down further. An example of the liquidity crisis cycle dynamic is Long-Term Capital Management (LTCM), which was destroyed when Russia defaulted. The company did not have a lot of exposure in Russia but other participants in the market did, and they held instruments in the same markets as LTCM. Highly leveraged participants had to liquidate their positions, so the impact was felt from one market to the next. Thus, a prudent investor or bank may be unable to understand or avoid the implications of systemic risk.

The government is the only entity that can oversee the entire marketplace and maintain confidentiality, observed Bookstaber. The first task for a systemic risk would be data collection—what portfolios institutions hold, how they are leveraged, and what might drive them to the exits—at least for the top 20 banks and hedge funds. The second task would be to hold accountable the chief risk officers of banks, including the investment banks; the risk manager at the government level should act as an ombudsman that oversees these chief risk officers. The third task would be to enable the regulator to examine the safety of an institution's financial instruments before they are put on the market; there is a need for the equivalent (at the regulatory level) of the National Transportation Safety Board and Consumer Product Safety Board to examine the instruments before implementation. The fourth task would be to provide an environment that is more open in terms of information flows and manned by people who understand what is going on in terms of the markets, the types of instruments and risks, and imbalances related to incentives. Therefore, said Bookstaber, it is advisable to bring expertise and talent from the private sector into the regulatory sector, and to make the necessary adjustments in terms of incentives and pay scales. The cost would be far less than a trillion-dollar loss.

Pollock discussed the limits to the effectiveness of regulators to prevent financial crises. He noted that financial cycles are followed by political cycles, and politicians respond to crisis with reorganization and increased regulation, claiming it will never happen again—a repeating pattern. He also questioned whether the development of financial fragility is preventable, since it reflects human nature; as Minsky put it, when everybody makes money for an extended period, “short-term financing of long positions becomes a normal way of life.” When markets are stable, leverage appears safe, but a highly leveraged financial system will always collapse from time to time.

Pollock observed that correctly forecasting and controlling the financial future is an impossible task: the application of mathematics to finance does not make it a scientific process. He also argued that the Fed would be too conflicted between its monetary and regulatory duties to serve as systemic risk regulator; moreover, a money-printing central bank in a fiat money regime is a huge source of systemic risk. He therefore rejected the idea of a risk regulator in favor of an extremely competent advisory body with an international membership. Such a body ought to be in close communication with important financial actors, as well as politicians and central bankers, looking out for a buildup of hidden leverage and whether short-term funding was becoming a “normal way of life.” It also ought to look for inevitable points of concentrated potential failure—for example, the contribution of Fannie Mae and Freddie Mac, as big investors, to the housing market bubble.

Todd pointed out the lack of official interest in the history of past financial crises, and argued that these hold important lessons for the errors that led to the current crisis—and for its resolution. He discussed the approach to stress-testing U.S. banks in the 1930s, and noted how banks were classified into three groups: A, B, and C. “A” banks were judged adequately capitalized and allowed to operate without further federal assistance. “B” banks were those whose capital was heavily impaired but with enough positive net worth to allow deposits to be paid off in full. “C” banks were institutions with marked-to-market value assets equal to at least 90 percent of their liabilities. These banks obtained assistance from the Reconstruction Finance Corporation, typically in the form of preferred stock purchases with warrants for common stock that were convertible after five or 10 years. Todd noted that both Japan and Sweden used the 1933 U.S. model in recent applications of the stress test to their



Alex J. Pollock

financial institutions—in both cases because federal regulators would not face up to the inherent insolvency of banks.

The answer to why Washington does not want to revisit the U.S. model in the 1930s may be related to the question “How big is too much?”—a reference to the Fed’s “too big to fail” policy. Todd argued that the Fed has embarked on a policy course that has no exit strategy, because drawing back all the liquidity it has pumped into the system would require raising interest rates so high that it would seriously damage the rest of the economy. He also opposed the view that the Fed should issue its own liability instruments to mop up the excess liquidity, but argued that if this has to be done, each reserve bank must be made individually responsible for the liability notes that it has issued, without loss-sharing among the reserve banks.

Session 5: Current Conditions and Forecasts

Moderator: AJIT ZACHARIAS, LEVY INSTITUTE

Speakers: DEAN MAKI, BARCLAYS CAPITAL; JAMES W. PAULSEN, WELLS CAPITAL MANAGEMENT; LAKSHMAN ACHUTHAN, ECONOMIC CYCLE RESEARCH INSTITUTE

Maki outlined Barclays’ U.S. economic forecast for 2009. He noted that real GDP declined by 6.3 in the fourth quarter of 2008 and by 5.5 in the first quarter of 2009 but is expected to fall by only 2 percent in the second quarter, and to return to 1 percent positive growth in the third quarter and to 2 percent

growth in the fourth. Headline inflation is expected to be negative for most of 2009, mainly due to declining energy prices (the U.S. economy is a net importer of energy). Maki noted that these forecasts are not particularly optimistic, since the unemployment rate is expected to rise over this period—from 6.1 percent in the third quarter of 2008 to 9.5 percent in the fourth quarter of 2009. Moreover, the records of past deep recessions in the United States indicate an 8 percent GDP growth rate for at least a couple of quarters after each recession ended. Maki observed that falls in energy prices mean consumers have more to spend elsewhere. Moreover, the adopted policies of lowering the withholding tax threshold and providing a \$250 check to every Social Security recipient in May 2009 mean that disposable income in the second quarter of 2009 will be strong. The extent of the decline in inventories (the degree to which production falls below consumption) indicates a rise in manufacturing output, and the second quarter will likely see the largest inventory decline on record. In the past, this feature has always indicated the end of a recession. Once inventories hit the desired level, production simply has to pick up to match the pace of final sales, which is expected by the third quarter. In terms of housing, inventories of new homes are currently falling at the fastest rate on record, and the projected surge in housing expenditure that follows usually adds a full 1 percent to GDP. Another factor is that mortgage rates are at record lows, and the housing affordability index is even higher than it was during the real estate boom. Finally, there are the policy effects. The federal budget deficit in 2009 will approach 14 percent of GDP (\$2 trillion) and includes the largest stimulus package in the postwar period (5.6 percent of GDP), which has not yet hit the economy in full force. The expansion of the Fed balance sheet will also push GDP growth into positive territory.

Paulsen contended that evidence from a number of related areas suggests that the recession will end soon. His forecast was based on a massive policy stimulus, the effect of buying power on the sidelines, and a “healthy player” thaw. Even before the Obama stimulus packages, there was huge growth in the inflation-adjusted total money supply and in federal government deficit spending. When real GDP growth is compared with the fiscal-adjusted money supply growth rate, the latter leads the former by six months. Therefore, this crisis is not lacking fiscal stimulus but rather the patience for the stimulus to work. He pointed to the large private cash holdings of households and



Dean Maki

companies as evidence of hidden consumer power, and noted that it will take a year for the stimulus to fully impact the economy. He expressed support for policies that will revive the confidence of consumers with jobs and safe homes (who constitute the vast majority) and encourage spending. Public debate about bank nationalization was a mistake, Paulsen said, as it led to a needless run on the banks' stocks earlier this year. He observed that there is rising confidence that the economy is close to ending its free-fall, and maintained that the banking crisis will fade away once it is possible to forecast with accuracy the peak unemployment rate and the bottom of the housing market. He argued that a great deal of our current financial problems have to do with a lack of enforcement of monopoly laws (a lack of competition rather than regulation). All sorts of rationalizations were put forward for mergers (e.g., achieving economies of scale), but after 30 years of allowing the practice, we are paying the price. The growth in monopolies has created banks that are “too big to fail.” This lack of enforcement led to grotesquely inflated CEO salaries, and to a widespread tendency to overlend. Monopolies may have goals other than profit maximization (e.g., securing a larger market share), leading to overlending in the short run to gain market share, even if it means taking short-term losses. Markets are also more likely to become illiquid when dominated by large players controlling substantial portions of the assets, unlike markets comprised of small investors with little influence over asset prices.



Joseph E. Stiglitz and Dimitri B. Papadimitriou

Achuthan examined forecasts for the growth rate cycle upturn in the U.S. economy. He noted that a business cycle consists of expansion occurring at about the same time in many economic activities, followed by similarly general recessions, contractions, and revivals that merge into the next expansion phase of the next business cycle. From fluctuations in activity in the course of the cycle one obtains the growth rate cycle, with its highest point corresponding to the steepest upward slope in activity, and its trough, to the steepest decline in activity. He noted that 90 years of U.S. business cycle history indicate that in all recessions but one (the Great Depression), a peak in the growth rate cycle can occur long before a recession actually begins (sometimes, recession doesn't materialize at all). However, when the cycle reaches its trough, it is almost always followed, within a short time, by an end to recession. If that pattern were to be followed once again in the current recession, the trough would likely be reached in a very short time, as growth rate cycle upturns are followed by business cycle upturns in a matter of months, not years. He noted that, ever since the late 1930s, recessions have ended in less than four months after the growth rate cycle trough was reached, and maintained that there is a great deal of evidence that we are at that point in the U.S. cycle. He concluded by observing that the business cycle can be a much more powerful force in overcoming our current financial problems than some suspect. It can in fact overwhelm them—as it did, for example, in the Great Depression, producing a huge four-year expansion.

Keynote Speaker: HENRY KAUFMAN, HENRY KAUFMAN & COMPANY, INC.

Kaufman argued that the current crisis could have been avoided if the Fed had measured up to its supervisory responsibilities. He noted that U.S. financial markets have changed dramatically since World War II, when most of the country's financial structure was under the purview of the central bank, yet the authority and structure of the Fed remained basically unchanged for decades. When the Federal Reserve System was established in 1913, total debt outstanding amounted to only \$62 billion, compared to \$33 trillion today. In 1912, commercial banks were the dominant financial institutions; their relative importance in the financial system has since diminished. Moreover, huge financial conglomerates now dominate the markets. Today, the 10 largest U.S. financial institutions hold more than 50 percent of U.S. financial assets, up from only 10 percent in 1990. The 20 largest institutions hold more than 70 percent of U.S. financial assets, compared with 12 percent at the start of 1990. Kaufman wondered what policymakers did to prevent, or at least mitigate, the current crisis, and noted that the Fed failed to recognize in time the dimensions of the credit crisis, believing that the subprime mortgage problem was well contained—although it acted forcefully, once it began, to revive the credit market. Nonetheless, the Fed's role in creating the current recession was, he argued, considerable. Official policymakers actually encouraged huge financial institutions to merge in order to avoid insolvency and market disruptions. Nor did the Fed recognize the crucial role that the large financial conglomerates have played in changing the public's perception of liquidity. Traditionally, liquidity was an asset-based concept. But in recent decades this shifted to the liability side, as liquidity came to be virtually synonymous with easy access to borrowing. Kaufman argued that the Fed's economic libertarianism explains the absence of its opposition to abandoning Glass-Steagall, which led to the creation of institutions "too big to fail" and diminished its supervisory role. The same philosophy underlined its view that credit bubbles cannot be identified until they burst, even though they are detectable in a number of ways (e.g., very narrow yield spreads between high- and low-quality debt). Kaufman suggested the creation of a centralized oversight authority that would work together with the Fed, but he opposed the idea of an independent risk regulator because effective regulation must also be linked to the Fed's control over the growth of money and credit.



Dimitri B. Papadimitriou, James K. Galbraith, Warren Mosler, Robert W. Parenteau, and L. Randall Wray

Keynote Speaker: JOSEPH E. STIGLITZ, COLUMBIA UNIVERSITY

Stiglitz expressed pessimism for the U.S. economy's prospects for recovery. He assessed the government's plan for the "cleanup" of toxic assets and the lessons the crisis holds for the economics profession. He noted that what had sustained the global economy was the housing bubble, and one of the reasons behind it was the Fed's desire to keep interest rates low. Low interest rates should be the foundation of a dynamic economy, but U.S. financial markets channeled the available capital into leveraged, unproductive investment. The bubble pushed the U.S. savings rate down to zero, but given the extent of the destruction to people's wealth and the markets' strict limits on borrowing, the savings rate will almost surely move up to 4, 5, or 6 percent—perhaps even higher, said Stiglitz. This suggests there will be a deficiency in aggregate demand just at a time when demand expansion is critical for recovery.

On bank restructuring, Stiglitz disagreed that the current set of proposals constitutes a public-private "partnership," since the taxpaying public, through a variety of institutional arrangements, guaranteed 92 percent of the money used to bail out Wall Street, with the private sector putting up the remaining 8 percent; however, the latter receives 50 percent of the profits, whereas the public bears almost all of the losses. In addition, public guarantees to the private sector encourage moral hazard, creating perverse incentives for bad behavior and leading to undesirable outcomes—in this case, to toxic assets. Stiglitz noted

that the government tried to describe its assets plan as motivated by a problem of liquidity in the U.S. financial system, but he pointed out that if that had been the motivation, the government could have provided the liquidity, along with an equal share in the profits as well as the losses. He outlined an alternative plan that avoids the creation of perverse incentives to prevent bad outcomes, and subjects the financial system to the principle that the polluters (i.e., the big banks) must pay the costs of cleaning up the mess.

Stiglitz also examined how economic theory views the current crisis, noting that the advocates of free markets believe that financial crises are rare events. In the aftermath of the Great Depression, the so-called "neoclassical synthesis" came to be accepted, according to which, once markets were restored to full employment, neoclassical principles would again apply: the economy would be efficient. Yet, large market failures have become increasingly more common on a global scale. The current crisis is just the largest and most recent in a series of financial crises that have occurred since the U.S. savings-and-loans debacle of the 1980s, including all of those bailouts with country names—Mexico, Brazil, Korea, Indonesia, Argentina, Thailand, Russia—that were really bailouts of Western lenders as a result of the inadequate assessment of creditworthiness.

Session 6: Alternative Stimulus and Bailout Proposals

Moderator: DIMITRI B. PAPADIMITRIOU, LEVY INSTITUTE

Speakers: JAMES K. GALBRAITH, LEVY INSTITUTE;
WARREN MOSLER, VALANCE COMPANY, INC.; ROBERT W. PARENTEAU, LEVY INSTITUTE; L. RANDALL WRAY, LEVY INSTITUTE

Galbraith discussed the Keynesian case for a relatively rapid economic recovery, which begins with the argument that recessions are largely self-limiting through the inventory cycle: liquidation is followed by growth because the cutback in consumption is always less than the cutback in production, and therefore merchants run out of stock and have to reorder. In addition, the current administration moved quickly to propose a substantial fiscal expansion package that is both larger and longer lasting than all comparable expansion packages in the postwar period. However, Galbraith did note some pessimistic perspectives on a Keynesian rebound. First, the household sector is intent upon paying down their debts from the extraordinarily high levels that they reached

in recent years; that pay-down will continue for some time, depressing household expenditures. Second, if the inordinately large destruction of U.S. capital were followed by a relatively larger share of overseas production (and higher U.S. imports than in the previous business cycle), it would result in an unbalanced recovery, with a lower propensity to create jobs in the short run.

Galbraith also discussed the character of the recovery should the news in the next few months prove comparatively good. First, unemployment will be slow to follow the turnaround in production and output. Moving from monthly job losses of 600,000 to gaining that many requires the addition of 1.2 million jobs per month for an extended period—something unlikely to happen anytime soon. Second, it is obvious that the government is in the process of adopting a plan to save the large financial institutions; large losses that remain unrecognized or ignored may well be transferred to the taxpayer through the device of the public-private partnership, under the assumption that these assets will regain in value, when the reverse is more likely. Finally, it is quite possible that commodity prices will go up in the early phase of the recovery, causing problems for the sustainability of the expansion. Similarly, the Fed's expansionary fiscal policy stance may be abandoned in the early phases of a recovery in favor of a return to the conventional orthodoxy of a balanced budget and debt reduction. If policymakers do indeed take that position before the private sector is able to sustain growth on its own—and that may be quite a long time, said Galbraith—then the United States may experience a replay of 1937–38, with a temporary (sharp) reversal in economic recovery.

Mosler noted that the establishment of the Fed in 1913 was in part a solution to the severe gold panic of the time. However, the United States' later abandonment of the gold standard freed the U.S. economy from a self-imposed constraint on the supply side of its currency. He argued against the view that recovery requires first helping the banks to lend again: the private sector cannot act in a countercyclical manner. However, the federal government can immediately restore nominal aggregate demand by making the correct entries on its balance sheet—a course not available to it under the gold standard. Seen as a data-entry problem, the budget deficit can be employed in various ways to expand demand. In this respect, Mosler proposed federal funding for a program that provides an \$8-per-hour job creation for anyone willing and able to work that includes federal health-care benefits—an employer-of-last-resort scheme à la Minsky

that represents an excellent transition mechanism and bottom-up approach.

Mosler also suggested regulating banks by allowing unlimited access to federal funds while maintaining control over what the banks can do with them, their assets, and their capital ratios. The Fed should lend without collateral, he said (since the FDIC already insures the loans) and permanently set all risk-free rates at zero as a deflationary and stabilizing measure. Banks should not be allowed to lend against financial assets. He also proposed an alternative to the Geithner plan for a public-private investment partnership to aid failing banks, such as selling FDIC-backed credit default insurance to any member bank that wants to protect its toxic assets. In terms of government purchases of financial assets, Mosler suggested moving TARP (Troubled Asset Relief Program) and other new Treasury financial asset purchases to the Federal Reserve, since these transactions are in the realm of the Fed and are about price (interest rates), not quantity. He also suggested that the Treasury should cease all issuance of securities, which move income away from the real producing sectors.

Parenteau contrasted Irving Fisher's and Minsky's views on the possibility of debt deflation. Fisher believed that paying down debt in a recession forces the distress selling of assets, causing falling prices, raising the real burden of debt, and leading to the collapse of profitability and production. Parenteau cited supporting evidence from the current crisis on falling asset prices and private incomes, and the paying down of debt by households, but so far, there is no evidence that debt is being liquidated or paid down on the nonfinancial corporate side. He noted that Minsky believed there are three "guardrails" against a debt deflation occurring again: (1) monetary policy, whereby monetary stimulus based on lowering interest rates would tend to stabilize asset prices, (2) fiscal stimulus (i.e., deficit spending) that is directed toward stabilizing private incomes, and (3) a government that plays an active role in the orderly winding down of failing institutions that pose a risk to the system as a whole. However, debt deflation did indeed happen in the Asian crisis of 1997–98, and may again in the United States (and perhaps in other countries) as the current crisis plays out. This is evident in the sharp turnaround in the household sector, which after more than a decade of deficit spending has dramatically reversed course and is now a net saver—a recessionary adjustment that has put enormous pressure on Minsky's debt inflation

guardrails. At the aggregate level, if one sector becomes a net saver, another has to be a deficit spender. In this case, the U.S. government must deficit-spend on a massive scale in order to match the rise in private net saving and thus avoid a collapse in incomes. This is in stark contrast to the current policy debate, with its emphasis on getting the banks to begin lending again to the private sector. Parenteau also argued against the view that expansion of the Fed's balance sheet is going to create an exit-strategy problem—inflation—when the recovery begins. He pointed out that many of the Fed's lending facilities are short term oriented; that is, they will roll off as the private marketplace comes back. So there will be an endogenous self-liquidation, and the Fed's balance sheet will not be as much of an overhang as some expect.

Wray contrasted pre-1930s finance capitalism in the United States with its second emergence beginning in the early 1950s, and suggested short- and long-term policies to mitigate its destabilizing effects on the economy (see also, Public Policy Brief No. 99, *The Return of Big Government*, summarized on p. 5 of the April 2009 issue of the *Report*). He noted that the first version of finance capitalism occurred in the presence of a small-government, laissez-faire economy, and it failed decisively in the 1930s. It was replaced by the New Deal, which created a paternalistic, “Big Government” form of capitalism. This new form produced a high-wage, high-consumption society, with unions protecting workers and welfare protecting others. Growth occurred on the basis of leveraging Treasuries, so that much of the finance was internal to firms or leveraging a very safe asset. By the early 1950s, however, gradual deregulation removed the New Deal constraints and financial innovations increased, along with an appetite for risk that permitted fragility to grow over time. This second version of finance capitalism is distinguished by complex, long-lived capital assets that are too expensive to be financed out-of-pocket, and so it requires external finance that is actually a prior commitment of future earnings.

Wray also reviewed a “shopping list” of short- and long-term policy proposals for economic recovery and financial stability. The short-term proposals included increasing government lending to financial institutions without limit or collateral while abandoning the policy of “too big to fail”; an immediate payroll tax “holiday”; and fiscal stimulus, in addition to mortgage relief and the serious governmental pursuit of financial fraud at all levels—right up to the top. For the medium and long terms, he suggested that

payroll tax reform would encourage work and employment, and that containing inequality by promoting industry over finance would weaken the forces that keep wages stagnant. He also discussed a public works program that would maintain job stability and full employment without being inflationary. All of these proposals are affordable, said Wray, because the government can afford to buy anything for sale in its own currency.

New Strategic Analyses

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

JAMES K. GALBRAITH

In this new Strategic Analysis, Senior Scholar James K. Galbraith observes that two ingrained thinking habits are responsible for the slowness of policy responses to the current financial crisis. The first is the belief that economies will eventually return to normal on their own, despite economic news that is consistently worse than the expected forecasts. The second is the idea that recovery runs through banks rather than around them, because credit is “blocked” and needs to “flow” again. Credit cannot flow when there are no creditworthy borrowers and no profitable projects, maintains the author. Galbraith proposes several measures to deal with these problems. First, economic forecasts should be realistic, and fiscal expansion should be geared to the actual scale of the crisis, rather than limited by an arbitrary belief that it will be shallow and short. Second, new, competent regulators should replace the management of troubled banks. Third, tax havens should be abolished, and trade in foreign-currency-linked instruments, restricted. Fourth, either foreclosures should be stopped or foreclosed homeowners permitted to convert to rentals under public management, with an option to repurchase later on. And finally, the author notes that the crisis is a major blow to the elderly in every aspect of their private wealth—home values, stock market values, and interest income. Therefore, he argues for an increase in public retirement benefits, particularly, in social security benefits.

For the complete text, go to www.levy.org/pubs/sa_apr_09.pdf.

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

DIMITRI B. PAPADIMITRIOU and GREG HANNSGEN

Recent Federal Reserve (Fed) flow-of-funds data show that federal government liabilities rose sharply in 2008. In this new Strategic Analysis, President Dimitri B. Papadimitriou and Research Scholar Greg Hannsgen argue that the rise is unlikely to cause excessive inflation, and focus on its positive effect in providing a much-needed improvement to private sector balance sheets. The authors note that the liabilities of the federal government are mostly in the form of securities issued by the Treasury Department, and have been growing at an accelerated rate mainly because of rising deficit spending. As the Fed begins its recently announced purchases of longer-term Treasury bonds this spring, rising deficits will probably be partly reflected in further increases in Fed liabilities, rather than in Treasury securities alone. Given the current weak demand for goods and services, the authors believe a sudden rise in prices is unlikely. Yet the rise in liabilities offers crucial help to sectors that have seen the value of their portfolios shrink dramatically, and they note in this regard that the U.S. private sector's net wealth fell by nearly \$8 trillion over the last year. However, federal government liabilities are necessarily assets of either the U.S. private sector or other countries; and in the current climate of risk aversion, the safety of U.S. securities is an attraction. Thus, not only are U.S. households building up a reserve of safe assets, but the rest of the world's economies, particularly China, have also been big net buyers of U.S. securities over the past two years. Other buyers include domestic life insurance companies and money market mutual funds, whose shares, in turn, are bought by households and nonfinancial businesses. Thus, many of the new government bonds are flowing to sectors where they are badly needed for their ability to stabilize net worth, either directly or through money market mutual funds.

Papadimitriou and Hannsgen also examine the main sources of growth in the Fed's liabilities, and note that while currency in circulation rose steadily over the past year, bank reserves jumped by over \$650 billion, beginning last fall as the Fed battled the financial crisis. The authors argue, however, that this is unlikely to boost inflation, because any plausible scenario in which the excess reserves somehow caused a surge in infla-

tion would involve vastly increased bank lending, which is doubtful to occur in a recessionary environment: both the banks and potential borrowers will be wary of new debt as long as the economy is so weak. The authors conclude that concerns about inflation distract attention from the most important effects of increased deficits—including impacts on balance sheets. It will take some time for the private sector to rebuild its balance sheets, and putting the brakes on either government spending or intervention in the financial sector would only inhibit that effort.

For the complete text, go to www.levy.org/pubs/sa_apr_09_2.pdf.

New Public Policy Brief

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

JAN KREGEL

Public Policy Brief No. 100

Why is it that the bailout of U.S. banks has not increased bank lending? Examining similar past attempts provides some insight. In this working paper, Senior Scholar Jan Kregel argues that prior experiences of bank bailouts have not successfully expanded lending because they did not address the revival of depressed household and bank incomes, which remains critical to a successful bailout policy. Kregel discusses the so-called "liquidity trap" approach, adopted as a finance recovery policy during the Great Depression and, more recently, in response to the Japanese recession of the 1980s. This is a zero-interest-rate policy (ZIRP) intended to induce and boost lending by banks through massive increases in bank reserves. The Bank of Japan (BoJ) introduced ZIRP in 1999. However, the policy resulted in Japanese banks' simply accumulating reserves without further lending, and in falling incomes due to the virtual disappearance of interest income from postal savings accounts (a basic source of income for seniors and retirees). The author notes that the policy of reflation through monetary expansion, advocated by Irving Fisher during the Great Depression, also failed, because the banks were not eager to expand lending when there were

few qualified borrowers and lower interest rates eroded their major source of income. The policy was suspended after a short time, allowing interest rates to rise in order to support bank incomes. The Fed responded to the current crisis by introducing ZIRP more rapidly than the BoJ; but in the absence of eligible borrowers, the only impact of lower interest rates has been lower household and bank incomes.

Financial intermediation, introduced in the United States by the Financial Modernization Act of 1999, resulted in banks' minimizing loans held at risk on their balance sheets in order to conserve capital and increase pure intermediary activities by maximizing fee and commission incomes. Therefore, it is not surprising that U.S. bank lending has not lately increased, because banks had already ceased to lend in the new system. The fact that capital markets stopped buying the loans originated by banks because of a lack of transparency concerning risk meant that credit ceased for the entire system. As the liquidity cushion disappeared, lending came to a halt—not only private sector lending but also lending amongst financial institutions. The current problem is not that the banks are not lending, says Kregel; it is that they are now lending only to the Fed. He argues that the movement of loans off the banks' balance sheets reduced the capital backing outstanding loans, and also eliminated the liquidity cushion behind the loans. The author concludes by pointing out that only when Keynesian-style deficit spending was adopted under the New Deal was there an improvement in economic conditions in the United States. The initial focus of government expenditures should, therefore, be on income expansion, and on covering losses sustained by banks and households. Indeed, Kregel notes, the current financial crisis could have been avoided if increased household consumption had been financed through wages increases rather than increased borrowing, and financial institutions had used their earnings to augment bank capital rather than employee bonuses.

For the complete text, go to www.levy.org/pubs/ppb_100.pdf.

New Policy Notes

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

PHILIP ARESTIS and ELIAS KARAKITSOS

Policy Note 2009/2

There is understandable unease about bailing out asset speculators, but as custodians of the financial system, central banks are responsible for its effective operation. In this new Policy Note, Senior Scholar Philip Arestis and Elias Karakitsos, Guildhall Asset Management and Centre for Economic and Public Policy, Cambridge, U.K., argue that policies targeting the net wealth of the personal sector are far better than a bailout.

Net wealth is defined as (financial and tangible) assets less personal sector liabilities, including mortgage debt and consumer credit. The authors note that, even though a boost in house or equity prices will increase gross wealth, this is not a one-to-one relationship. For example, if an increase in gross wealth is matched by a corresponding increase in debt, net wealth will not increase. Indeed, in the last two years of the housing bubble, gross wealth increased, yet net wealth decreased. Targeting net wealth can also avoid the weakness of inflation-targeting policies. The experience of many countries, including the United States, shows that successful control of CPI-inflation does not guarantee control of asset price inflation. However, net wealth is an ideal variable to monitor (and control) bubbles because it is at the heart of the transmission mechanism between asset prices and debt, and consumption. Since the end of World War II, average net wealth in the United States has been approximately five times annual disposable income. Thus, the authors recommend that the Fed should maintain a target ratio of net wealth to disposable income in the range of, say, 4.3–5.3. However, they warn that overly zealous enthusiasm for wealth targeting might cause instability and a deeper recession than mild wealth targeting with smaller declines in profits and interest rate cuts. Large swings in interest rates, combined with lags in the effects of monetary policy and the quick response of demand and wealth to profitability, would create volatility, destabilizing the economy and leading to a prolonged recession.

For the complete text, go to www.levy.org/pubs/pn_09_02pdf.

An Assessment of the Credit Crisis Solutions

ELIAS KARAKITSOS

Policy Note 2009/3

Economic recovery is contingent upon resolving the financial crisis, and differences in policy responses relate to two different views on its cause. In this new Policy Note, Elias Karakitsos, Guild Asset Management and Centre for Economic and Public Policy, Cambridge, U.K., examines each of these views, and evaluates their associated policy responses.

There are two current policy stances with regard to asset recovery: the “business as usual” and “good bank” models. According to the former, financial sector assets are undervalued but will regain their worth as the economy recovers, as a result of new policy measures. According to the other, the assets are worthless and the banks are insolvent; therefore, recovery requires preventing the consequences of their insolvency from spreading to the entire economy. Wall Street prefers the bailout solution offered by the business-as-usual model, which requires a government bailout by (1) guaranteeing (or insuring) the assets or liabilities of the banks; (2) placing the bad and toxic assets in a “bad bank” that is capitalized by public and private money; or (3) temporarily nationalizing the banks. The banks would not bear the cost of their actions, and they would continue to do business as usual. The losses from the bad and toxic assets, however, may be too big to bear: in the United States, the cost of a bailout using taxpayer money may exceed by trillions the original estimate of \$700 billion, and may not prevent the bankruptcy of financial institutions.

The alternative solution is to create a “good bank” from each old bank, its assets consisting of the good assets of the old bank, and its liabilities, the deposits and secured debt of the old bank. This solution allows credit to flow once again and is fair to the taxpayer. Its drawback is that the removal of sound assets will enhance the old banks’ probability of failure; thus, it carries a risk that the entire economy may sink into a depression worse than that in the 1930s. The risk lies in the cross holding of assets and liabilities within the financial and personal sectors (e.g., by pension funds and federally-related mortgage pools). Karakitsos suggests the separation of cross-holdings held by these sectors. The government could then insure the personal sector against reasonable exposure to the bad and toxic assets of the old financial sector, or, alternatively, allow the personal sector to bear the

first 10 percent of the loss and guarantee the remainder. This “modified good bank” solution would shield the economy from depression should the old banks become insolvent.

For the complete text, go to www.levy.org/pubs/pn_09_3pdf.

A Crisis in Coordination and Competence

MARTIN SHUBIK

Policy Note 2009/4

The ad hoc emergency approach to the current economic crisis could waste billions of dollars by mismatching skills and needs. According to Martin Shubik, Yale University, we need to line up and coordinate at least four sets of talents—political, bureaucratic, financial, and industrial—for both a “quick fix” and longer-term solution. A healthy economy should dampen both the downward and upward swings in expectations because most Americans want stability, says Shubik. In principle, the government should not buy assets where it has neither the technical nor the administrative ability to manage them. The failure of financial institutions has a “fast network” (negative) effect on national and global financial markets. Therefore, these institutions cannot easily be placed in bankruptcy and must be reorganized, with the government taking a senior position in providing financial guarantees at a potential profit. Management must also be reorganized, with the more egregious “masters of the universe” fired but many mid- and upper-level managers retained. In every instance, two questions must be asked: Is the firm sick or healthy from the viewpoint of its ability to produce a saleable product? Is it healthy from the viewpoint of its financial structure? Firms that are healthy by both measures need no help. Those that are unhealthy by both measures should be left to liquidate, and firms that have a healthy business but a bad financial structure should be helped to reorganize. Those with a record of imperceptive management (such as General Motors) should be allowed to either manage their own reorganization or go bankrupt. In addition, bankruptcy measures should be decisively employed. That the bankruptcy of large firms will cause massive layoffs is a myth. Shubik argues that the reverse is often true: upper management is fired, and the firm, along with many of its other workers, is taken over by new, more efficient management.

For the complete text, go to www.levy.org/pubs/pn_09_04.pdf.

A Proposal for a Federal Employment Reserve

Authority

MARTIN SHUBIK

Policy Note 2009/5

There are occasions when the financial control mechanisms of a society are not sufficient to prevent serious damage to the fundamental economy they are meant to protect. Therefore, the system requires a fail-safe mechanism that comes into play when the financial brakes do not work. In this new Policy Note, Martin Shubik, Yale University, argues for a new government agency, similar in power and structure to the Fed, designed to keep a socially acceptable index of unemployment below a specified level. This agency—a Federal Employment Reserve Authority, or FERA—would be devoted to monitoring the “natural rate of unemployment,” which is “natural” in the sense that it is dependent on society’s existing institutions, laws, customs, and technology. As a permanent body it would be a vast improvement over a last-minute, temporary disaster-relief program such as the Depression-era Works Progress Administration. An agency such as FERA more logically calls for a central or controlling authority in Washington and a branch in each of the 50 states. Each state branch would have a board of governors split among business and labor representatives, as well as academics and federal and state representatives. Each branch would monitor unemployment within its state. It would also maintain a list of potential public works projects, with priorities and potential revenue-generation possibilities noted. The priority would be self-liquidating projects where some portion of the revenues would flow back to either the state or the federal government. Shubik outlines the basic principles that should guide the agency: (1) it should never own assets that it does not have the capability to evaluate, (2) its role should be coordination and stimulation of employment generating activities, not to employ individuals directly, (3) its evaluations and sources of information must be made transparent, and (4) once unemployment goes above a fixed level of, say, 6 or 7 percent, the agency would put out bids for projects in coordination with federal and state funding authorities.

For the complete text, go to www.levy.org/pubs/pn_09_05.pdf.

The “Unintended Consequences” Game

MARTIN SHUBIK

Policy Note 2009/6

In troubled times, it is the government that changes the rules of the game. In the United States today, such a change is required to protect new legislation on finance against abuse. In this new Policy Note, Martin Shubik, Yale University, observes that, once the legislation has been passed, the entrepreneurs and their lawyers move in to exploit the loopholes. While the broad print of the legislation satisfies the public, a skilled drafter of legislation can put in the appropriate fine print to take care of special-interest groups, secure in the knowledge that the public has neither the time nor the ability to read it. Shubik’s solution is to create within the Department of Justice a small operational “war gaming group” for all major new legislation. He notes that virtually every army or navy of any significant size has had a war-gaming facility to check out and stress-test its plans and strategies. This technique can be applied to lawmaking. A game is designed around a new piece of legislation, and a first prize of, say, \$1 million is awarded to the competing lawyer or team of lawyers who finds the most egregious loophole. The competition is open to any lawyer. The “war gaming group” sponsors the scenario, running a series of games for 10 or 20 players selected by a panel chosen by an institution such as the American Bar Association. A prize of a million dollars or so is enough to attract young lawyers or students, both for the money and the prestige, but it is not enough to attract many established law firms—which stand to make tens or even hundreds of millions if the loopholes remain.

For the complete text, go to www.levy.org/pubs/pn_09_06.pdf.

“Enforced Indebtedness” and Capital Adequacy Requirements

JAN TOPOROWSKI

Policy Note 2009/7

International banking regulations have enshrined the notion that an individual firm can choose the structure of its financial liabilities without affecting the financial liabilities of other firms. In this new Policy Note, Jan Toporowski, School of Oriental and African Studies, University of London, and the Research Centre

for the History and Methodology of Economics, University of Amsterdam, argues that capital adequacy regulations for banks force nonfinancial companies into debt, and increase instability.

The author argues that the process of issuing capital or liabilities is subject to two constraints. The first is the balance sheet constraint—that is, one bank's (or firm's) liability is another bank's (or firm's) asset. Secondly, there is no guarantee that the assets of the banks will generate sufficient income to allow each individual bank or firm to make the payments on the liabilities they wish to maintain. Given a certain capacity on the part of other, nonbank financial intermediaries for purchasing equity, a regulatory requirement to increase bank capital reduces the amount of capital available to nonfinancial firms. If these firms are unable to secure the amount of equity capital they need, they are obliged to raise capital through the issue of debt instruments in the form of corporate bonds or company paper. This means that, when recession comes, it is made worse by the greater indebtedness of companies, thus increasing the financial fragility of the economy. Toporowski contends that, for an internationally integrated financial system, banks and economies would be much more effectively stabilized if cross-border lending to the private sector were matched by a commitment to lend, in the domestic currency of the bank, to the government of the country in which that private sector is based, in the event that lending to that country were reduced. If, for example, a bank located in the United Kingdom were to lend to companies in South Africa, the bank would commit itself to lend to the South African government the equivalent of any reduction in lending by the bank to those companies. In this way, capital outflows would be matched by new capital inflows to governments, which would then be in a position to stabilize the foreign borrowing of banks and companies in their respective countries. *For the complete text, go to www.levy.org/pubs/pn_09_7.pdf*

New Working Papers

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

JAN KREGEL

Working Paper No. 557

U.S. financial regulation extends the same prudential regulations applied to deposit takers to investment banks and broker-dealers, creating regulatory gaps of the kind that contributed to the current financial crisis. In this working paper, Senior Scholar Jan Kregel argues that the history of financial regulation in the United States suggests that this response has not proved durable, nor capable of providing financial stability. He maintains that regulation of financial firms by either their function or their product would provide greater market stability.

Kregel notes that national banks in the 1920s were suffering from falling profitability and declining loan applications as the expansion of free banking led to overbanking. At the same time, the 1920s stock market boom brought with it the possibility for national banks' commercial clients to fund their short-term financing needs through longer-term capital market issues. Banks were allowed to solve their need for additional sources of revenue by engaging in a broader range of financial activities. However, the Great Depression produced a strong regulatory response in the form of the Glass-Steagall Act, which limited the activities of deposit-taking commercial banks to short-term commercial lending and establishing a direct correspondence between the definition of a regulated institution and its function in providing deposits, excluding investment banks from this activity.

However, the strict identification of financial institutions with their function gradually broke down, as commercial banks began to lose private household deposits to thrifts and brokerage houses, and Treasury bills became more attractive than regulated deposits for the management of liquidity by business firms. Thus, between 1956 and 1981, the fee income of insured commercial banks rose from 11.3 percent of operating income net of interest expense to 19.5 percent. Recovery in commercial bank profitability was thus linked to reducing the Glass-Steagall regulations. Bank holding companies could thus be created with

affiliates that were able to offer consumer finance and mortgage services, and avoid restrictions. Restrictions on branching and deposit interest rates were either reduced or eliminated completely. Hence, the 1999 Financial Modernization Act produced the same solution of restoring a mixture of commercial and investment banking functions. But financial innovation has led not only to the commingling of commercial and investment banking but to a series of new capital market institutions. In particular, hedge funds and private equity funds have taken on both traditional investment banking functions, as well as commercial banking functions—without the regulation of either.

The author notes that Germany's experience provides an alternative. Germany rejected the separation of commercial and investment banks after the 1930s banking crisis, and maintained universal banking. Its regulators now operate a system in which the bank's balance sheet is effectively split into short-term commercial banking activities and capital market activities requiring long-term maturity matching. This is equivalent to extending commercial bank regulation to investment banks, while recognizing that the regulations must differ. During the U.S. Congress's deliberation of the Financial Modernization Act, the German system was reviewed but ultimately rejected in favor of the bank holding company model. Given its disappointing performance, the author suggests that it is perhaps time to return to a discussion of universal banks—not as a banking model, but as a model for regulation.

For the complete text, go to www.levy.org/pubs/wp_557.pdf.

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

JAN KREGEL

Working Paper No. 558

International financial flows are the propagation mechanism for transmitting financial instability across borders. They are also the source of unsustainable external debt. In this working paper, Senior Scholar Jan Kregel analyzes instability not only in domestic and international markets but also in the structure of the international financial system as a whole, and examines proposals to increase its stability.

Kregel notes that under the Bretton Woods regime, the ability of countries to accumulate external debt was limited

because lending was undertaken by national governments. Debtor nations could obtain short-term outside loans from the International Monetary Fund (IMF) only on the condition they adopt dollar-devaluation as a corrective measure to increase the inflow of funds from export earnings. Consequently, the external debt of most countries remained low, resulting in relative stability for the international economic system. Such a regime promoted “hedge” financing profiles, since it ensured that exogenous changes in cash commitments were matched by changes in cash inflows to meet them. It also ensured that countries hit by external shocks that transformed their financing profiles from “speculative” to “hedge” were able to return quickly to hedge financing rather than being pushed into a Ponzi financing position.

However, it is impossible to maintain a hedge profile through external surpluses for all countries at the same time: at least one country must have a Ponzi financing position by the accounting identity that net saving and dissaving (the use of savings to meet current expenses) balance in the aggregate. The author notes that in the present global context, it is the United States—the required deficit country—that is operating a type of Ponzi scheme. In the absence of any IMF capital controls, such a scheme leads to global instability. He also notes the increasing importance, since the 1970s, of private international capital inflows as a more significant source of instability. The new system allocated funds on the basis of the highest returns rather than in interest of market stability, as debtor nations sought to attract funds by opening their internal markets and deregulating their capital accounts—the predominant source of crises in the last quarter of a century.

Kregel maintains that the operation of such an international market requires a commodity that is sufficiently homogeneous to allow competitive pricing in exchange; as far back as the 17-century theorist William Petty, economists have recognized the importance of homogeneous commodities as a prerequisite for the operation of competitive markets and the role of prices in providing market information. However, the evaluation of the financial products in this market does not depend on the performance of the borrower's future income, as was the case with traditional financial instruments; rather, it relies on the future movement in a specified price from which the return on the contract is derived. The evaluation is reduced to the instruments' risk characteristics to meet investment objectives.

Thus, the homogeneous commodity required for the efficient operation of the market mechanism has become risk itself: it is risk that is being traded, not cash flows. Yet, by reducing everything to a single, similar characteristic, this method abrogates the very diversity upon which stability of the financial system depends, undermining the effectiveness of any strategy to provide risk reduction.

Kregel concludes that, if there is no coherent way to measure risk, then the domestic financial system will always be a source of potential international disturbance—unless there are international measures to dampen the transmission mechanism or measures are taken to return financial systems to credit assessment rather than risk arbitrage.

For the complete text, go to www.levy.org/pubs/wp_558.pdf.

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

SERGIO DESTEFANIS and GIUSEPPE MASTROMATTEO

Working Paper No. 559

Research on the European labor market has focused on strong unions, restrictive employment protection legislation, generous social safety nets, and large tax wedges. Indeed, labor market rigidities are widely held to play a key role in Europe's poor employment performance in the 1980s and 1990s. In this working paper, Sergio Destefanis, University of Salerno, Italy, and Giuseppe Mastromatteo, Catholic University of Milan, note that the flexibility of the U.S. labor market was explicitly taken as a benchmark for most of the reforms recommended for the European Union. However, much of the evidence is based on bivariate relationships between selected policy reform indicators and unemployment/employment rates, suggesting a direct link between structural reform and labor market outcomes. Nonetheless, the authors' evaluation reveals that such empirical support is less clear-cut in leading academic papers, most of which are based on increasingly complex multivariate analyses.

Destefanis and Mastromatteo formulate a new approach for assessing differences across labor markets in Organisation for Economic Co-operation and Development (OECD) countries. Rather than relying on complex multivariate models where possible misspecifications are hard to detect, they assess the robustness of the claims made in the most recent bivariate

OECD study within a very similar cross-country setup and highlight the impact of unobserved heterogeneity. They employ a sample of observations from 1994 to 2004 comprising 21 longstanding member countries of the OECD. To this sample they apply three different equations. In the first, the differences in unemployment rates between 1994 and 2004 are defined as functions of policy change. For policy change, the authors employ the aggregate index of the intensity of reform policy (for social security and benefit system, employment protection legislation, and so on), computed by others for the above period. They first report a correlation between the composite policy change indicator and rates of employment and unemployment: 0.61 and -0.53, respectively. However, they note that there are differences across the countries in their sample that affect their results. When labor market performance is bad, some governments may be more willing to implement policies aimed at increasing market flexibility. On the other hand, other governments may respond with policies that have little to do with enhancing flexibility, such as wage agreements. The authors also find strong negative correlations once the relationships include the initial year's employment and unemployment rates. In order to control for all these factors, they add the estimates of the 1994 rates to their basic equation. Furthermore, changes in industrial structure could also impact labor market performance (e.g., job prospects in manufacturing are more limited than in services, which have acted as the mainspring of job creation in recent times). To deal with the effect of the latter on employment, the authors add a further variable to their basic equation, using changes in construction employees' share of total employment as a proxy for external shocks.

The first result of applying this approach is that the composite reform policy indicator loses significance once other variables (initial-year rates and shocks) are added to the equation. The second is that past labor market performance matters. The lagged-level variable is always significant, and its inclusion affects policy coefficients, generally decreasing their significance. Similarly, changes in the share of construction employees are very significant, although their influence on the policy coefficients is arguably weaker. The authors therefore conclude that earlier OECD findings on labor market performance are sensitive to changes in its basic analysis framework.

For the complete text, go to www.levy.org/pubs/wp_559.pdf.

The Social and Economic Importance of Full Employment

L. RANDALL WRAY

Working Paper No. 560

John Maynard Keynes regarded unemployment as a principle fault of capitalism, yet misinterpretation of his views on employment policy and job creation is quite common. In this working paper, Senior Scholar L. Randall Wray contends that employment policy as advocated by Keynes differs in important respects from the commonly held view of “pump-priming,” and can be designed to avoid inflationary job expansion.

Wray points out that Keynes did not regard unemployment as resulting from labor market failure (e.g., “sticky” wages). Even if unemployed labor bids down wages, this often will not induce firms to hire more labor beyond the level needed to meet expected demand for their output. Indeed, there is no automatic market process to eliminate unemployment, since firms produce only the quantity of output they expect to sell. Many followers of Keynes have seen the solution to unemployment as various demand stimulating policies: more government spending, lower taxes, lower interest rates to encourage private spending, and, most prominently, investment. Clearly, when aggregate output is far below potential—as it was in the 1930s—raising aggregate demand is called for. However, as an economy gets closer to full employment, it becomes far less clear that policy should aim to raise aggregate demand. The main objection is that if unemployment gets too low, inflation will result, since firms will start bidding up wages to hire the more desirable. Since 1960, this fear—represented by the supposed Phillips curve trade-off (lower unemployment can only be purchased through higher inflation)—has, perhaps, been the major barrier to achieving full employment.

The author notes that Keynes was well aware of this problem. Indeed, Keynes believed that the lower limit to unemployment that could be achieved by raising aggregate demand would probably be about 5 percent; trying to reduce unemployment below that level through the use of general macroeconomic policy would be likely to generate inflation. For this reason, he rejected general “pump priming” (e.g., policies to raise aggregate demand through a combination of tax cuts, government spending increases, or lower interest rates) in favor of “targeted” spending programs.

Wray also discusses a targeted employment guarantee program for which government acts as the employer of last resort (ELR). In its most general version, the ELR proposal would provide a universal job guarantee in which government offered a job to anyone willing and able to work, at a uniform wage rate. The perceived advantage of the uniform basic wage is that it would limit competition with other employers, since workers could be drawn out of the ELR program by wage offers slightly above the minimum wage. For this reason, an ELR scheme would not be in competition with the private sector for any workers except those with the lowest skills and work experience.

Critics contend that a job guarantee would be inflationary, using some version of a Phillips curve argument (i.e., there is an inverse relationship between the rate of inflation and the rate of unemployment). Some contend that an ELR program would reduce the incentive to work, raising private sector costs, since workers would no longer fear job loss. However, Wray notes that such criticisms do not differentiate between general demand pumping and targeted spending, and fail to recognize that the ELR wage floor only prevents wages from falling but cannot cause private sector wages to rise.

For the complete text, go to www.levy.org/pubs/wp_560.pdf.

The Return of the State: The New Investment Paradigm

MARSHALL AUERBACK

Working Paper 561

The U.S. recession has shifted the debate on the public/private sector balance; in particular, the view that “big state” intervention can foster economic development is gaining ground. In this working paper, Marshall Auerback, RAB Capital PLC (U.K.), examines the role of the state at crucial stages of transition (from communism to capitalism) in the light of the interventionist paradigm—actually an old investment model. He notes that state-driven capitalism has provided the basis for a successful pattern of economic development, even in countries traditionally perceived as “laissez-faire,” for a long time. The United States adopted a protectionist policy for its young manufacturing industry until it grew sufficiently strong to compete with British and German products in international markets. A somewhat similar result can be seen in the transitional economies of Russia and China: Russia chose rapid, “shock therapy” privatization, with

catastrophic economic results; while China's gradual liberalization and privatization resulted in excellent economic performance. The author also cites other studies that highlight the role played by creating "rents" (above-normal market returns) by "distorting" markets through state interventionist policies. Such policies were employed by the East Asian capitalist countries to induce more-than-free-market return on investment in activities that the government regarded as important for the economy's transformation. He notes that the private sector in the recession-hit U.S. economy is already adapting to this new paradigm. For example, 14 U.S. technology companies are joining forces in seeking \$1 billion in federal aid to build a plant to make advanced batteries for electric cars, in a bid to catch up to Asian rivals that are far ahead of the United States.

For the complete text, go to www.levy.org/pubs/wp_561.pdf.

The Current Economic and Financial Crisis: A Gender Perspective

RANIA ANTONOPOULOS

Working Paper 562

The contraction in international trade has severely affected those sectors and activities in the developing world on which women and the poor rely for income (i.e., agriculture, textile, remittances, tourism, and informal employment) or that serve an important social function (i.e., unpaid work, including unpaid care work). In this working paper, Research Scholar Rania Antonopoulos examines how the recession has affected the poor and women in these areas, and suggests counter policies to mitigate their impact. The author notes that the projected global unemployment rate for women will range from 6.5 to 7.4 percent in 2009, compared to 6.1–7.0 percent for men. The economic crisis is expected to increase the number of unemployed women by up to 22 million worldwide by the end of the year. The concern is all the more grave due to the recent concentration of job growth for women in exports and tourism, sectors marked by extreme procyclical fluctuations. Textiles are a highly female-intensive industry, the author notes. For example, in Malaysia and Bangladesh, women constitute 78 percent and 85 percent of this workforce, respectively. As demand for export manufacturing is declining dramatically in the current consumption/demand glut, women can expect severe impacts in employment and household income.

Agriculture is still the most important sector of women's employment. Globally, the share of women employed in agriculture stands at 35.4 percent, as compared to 32.2 percent for men. This proportion rises to more than 65 percent in sub-Saharan Africa, where almost seven out of 10 women work in the agricultural sector. Women agricultural workers are responsible for about half of the world's food production; they are the main producers of staple crops such as rice, maize, and wheat, accounting for 60–80 percent of the food intake in most developing countries. These trade-oriented sectors face the most immediate impact of the crisis. The author notes that of the 51 economies reporting fourth-quarter data for 2008, 36 show double-digit declines in exports as compared to a year ago.

Informal (unprotected, unregulated, low-pay) work has grown in developing countries such as India, paralleling high growth rates. The share of women in informal-sector employment in sub-Saharan Africa is 84 percent, compared to 63 percent for men; this proportion is 58 to 48 in Latin America, and roughly equal in Asia. Female labor also accounts for the majority of unpaid work (e.g., home care, cooking, cleaning, and the collection of water and fuel). How much unpaid work women undertake depends on the existence of physical infrastructure and availability of public goods and services. If the current crisis results in the tightening of (fiscal) policy space, the first items to go will once again be public expenditures on health, early childhood development, sanitation, and the like, effectively shifting the burden of providing such services onto women and girls. In times of crisis, it is well known that, in many societies, men and boys are more likely to be fed first; when families have to make a choice about which of their children to keep in school, it is the daughters whose education will be sacrificed.

Antonopoulos notes that the de facto exclusion of poorer women from formal banking services turns microfinance into a lifeline for women. It is crucial that microfinance be protected during economic crises—for example, by demanding that commercial banks receiving liquidity support from central banks maintain, if not expand, precrisis levels of funding for microcredit. Moreover, public spending on social sector infrastructure and service delivery should also be maintained at precrisis levels, especially in the areas of nutrition delivery, health, sanitation, and education.

For the complete text, go to www.levy.org/pubs/wp_562.pdf.

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

GIUSEPPE FONTANA

Working Paper 563

The New Consensus Macroeconomics (NCM) has dominated macroeconomic policy since the 1970s. The NCM regards interest rate adjustment as the sole effective monetary policy tool, and rejects fiscal policy as ineffective. As a result, government has no role in the NCM model. This makes the NCM particularly problematic in terms of setting policy in the current crisis, since there is now broad agreement, even among many NCM economists, that government intervention through taxation and expenditure has become indispensable to economic revival.

In this working paper, Giuseppe Fontana, University of Leeds (UK) and Università del Sannio, examines how the fundamental NCM approach justifies the absence of government from its model, and provides rebuttals to the NCM arguments for eliminating all fiscal policy tools from that model. Fontana notes that the core NCM model consists of a three-equation system: (1) an output curve, defining the current gap of actual from potential output to be determined by lagged past, and forward-looking (expected) future output gaps, as well as the real interest rate; (2) a Phillips curve for the current rate of inflation that is determined by past and expected future inflation rates, and the current output gap; and (3) a monetary policy equation for the standard Taylor rule that explains the nominal interest rate in terms of the current output gap, the deviation of current inflation from its target, and the equilibrium real interest rate (defined as the long-run rate at which actual and potential output levels become equal). The central bank sets the short-run nominal interest rate, which affects consumption and investment components of aggregate demand by changing the real interest rate. However, those policy targets are subject to the central bank's other responsibility: achieving the desired long-run rate of inflation. Hence, it faces a short-run policy trade-off between inflation and output.

Fontana also discusses weaknesses of the NCM small model. Here, the author is mainly concerned with the model's focus on monetary policy to the exclusion of fiscal policy. One justification is based on "Ricardian equivalence." "Ricardian" consumers will save more now to compensate for current higher

taxes (in the case of tax-financed government expenditure) or future higher taxes (in the case of bond-financed government expenditure), as the government has to pay back its debts. Increased government spending is therefore exactly offset by decreased consumption on the part of private agents, with the result that aggregate demand does not change. This argument has been called into question, Fontana notes, on the grounds that it is based on unrealistic theoretical assumptions such as long time horizons, perfect foresight, perfect capital markets, and the absence of liquidity constraints, and is poorly supported by empirical evidence.

For the complete text, go to www.levy.org/pubs/wp_563.pdf.

New Consensus Macroeconomics: A Critical Appraisal

PHILIP ARESTIS

Working Paper 564

Over the past decade, the New Consensus Macroeconomics (NCM) has emerged as a dominant influence on macroeconomic thinking and policy, especially monetary policy. In this working paper, Senior Scholar Philip Arestis examines the features of NCM, along with some of its shortcomings.

The author notes that policy implications of the NCM paradigm have proved influential. Price stability is a major objective of monetary policy; it is based on controlling the changes in the rate of interest, and undertaken through inflation targeting. The monetary policy experience in the United States and other countries around the globe, following the abandonment of money supply rules in the early 1980s, indicates that NCM monetary policy has been an effective means of controlling inflation.

However, there are two important limitations to the NCM paradigm. First is the absence of banks and monetary aggregates in the NCM theoretical framework. Arestis contrasts the "standard" NCM model, with no banks or monetary aggregates (no role for fiscal and debt management policies), and a similar enlarged model, which is endowed by including banks that create deposits and make loans, and by giving fiscal policy some role, with agents using government bonds to manage their liquidity. He notes that a bond-financed change in government spending has a bigger and more persistent effect on inflation in the enlarged model than in the standard model.

The second limitation is the model's use of the equilibrium, or natural, rate of interest. The "natural" rate is the rate that equates saving with investment at a zero output gap. It is also consistent with full employment if wages are flexible. Under these assumptions, the reaction of the interest rate policy instrument to movements in the natural rate can ensure price stability. The problem is that the standard NCM model assumes a single interest rate: it does not recognize the effect of different interest rates on the determination of aggregate demand. For example, loan rates are important when bank credit is the main source of finance for firms. When the rate of interest on bank loans differs from the policy rate of interest, the natural rate may not be a useful indicator for monetary policy; in addition, it is not easily computable from observed data. The author concludes by noting that NCM is based on inconsistencies, and a great deal of "ad hocery."

For the complete text, go to www.levy.org/pubs/wp_564.pdf.

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

SANJAYA DESILVA and YUVAL ELMELECH

Working Paper No. 565

The U.S. homeownership rate reached its highest level in history, 69.0 percent, in 2004—a sharp increase from 63.9 percent in 1990 and a dramatic shift compared to the one percentage point increase in the homeownership rate experienced in the preceding three decades. Yet homeownership itself remained unevenly distributed, particularly along racial and ethnic lines. In this working paper, Sanjaya DeSilva, Bard College, and Research Associate Yuval Elmelech examine the trajectory into homeownership of black, Asian, white, and Latino households, and explore its various socioeconomic and demographic characteristics, as well as the distinct immigration experiences and spatial (locational) patterns that shape racial and ethnic inequality in homeownership in the United States.

In their study, the authors combine data from the 2000 Integrated Public Use Microdata Series and 2006 American Community Survey. Their findings from a multivariate analysis suggest that immigration, as well as spatial (region/location) attributes, remain key to an understanding of racial-ethnic

differences in homeownership. These effects, however, are not uniform, as they tend to vary by racial/ethnic origin. Examining the racial/ethnic groups separately, the authors find that the trajectory into homeownership is quite rapid among Asian immigrants, a pattern that signifies a high rate of assimilation. A related finding of this study is that residence in areas with a relatively large proportion of white residents seems to depress minority likelihood of homeownership. The results of the authors' decomposition analysis reveal some interesting findings regarding the probable sources of the white-minority homeownership gap. DeSilva and Elmelech show that most of the minority-white gap can be "explained" by and attributed to differences in immigration and spatial characteristics. Some researchers have attributed the unexplained gap to discrimination.

Three distinct models of minority trajectory into homeownership emerge in the study. The Asian-white inequality is unique in that it is relatively small; the gap can be entirely explained by the fact that human capital and the family attributes of Asian households resemble those of white households. The black-white pattern, based on the multivariate and decomposition analyses, reveals a more intricate picture: while the two racial groups tend to reside in zones that substantially differ in their racial, immigration, and economic contexts, these residential differences seem to explain a relatively small part of the (explained) white-black homeownership gap (10 percent). A substantial part of the black-white ownership gap is "unexplained," a finding that is in line with the persistent evidence on the distinct opportunity structure that black households face in the credit and housing markets. Finally, the Latino-white model is characterized by a more "balanced" pattern. The authors find some differences between the "Mexican and other Hispanic" category; for example, the economic and education characteristics of Mexican households have a more detrimental effect on the trajectory into homeownership.

For the complete text, go to www.levy.org/pubs/wp_565.pdf.

Caste and Wealth Inequality in India

AJIT ZACHARIAS and VAMSI VAKULABHARANAM

Working Paper No. 566

Caste is a persistent determinant of power, economic inequality, and poverty in contemporary India, yet economics literature on caste relations in India has been limited, with the

majority of evidence coming from consumption expenditure rather than surveys of household wealth. However, wealth (assets minus debt) inequality is an integral aspect of economic inequality, and can also translate into disparities in economic security. In this working paper, Senior Scholar Ajit Zacharias and Vamsi Vakulabharanam, University of Hyderabad, analyze the relationship between overall wealth inequality and caste divisions in India, using data from the two rounds of the All-India Debt and Investment Survey (AIDIS) conducted in 1991–92 and 2002–03.

Zacharias and Vakulabharanam examine the wealth-caste inequality relationship by decomposing the overall inequality into within-group and intragroup components. The main caste division, employed in both AIDIS samples, classifies the population into three groups: Scheduled Castes (SC), the so-called “untouchables”; Scheduled Tribes (ST), mostly rural, landless laborers living on the fringes of or outside the settled agricultural society; and everyone else, whom the authors group under Other Communities (OC). The 2002–03 survey introduced the additional category of Other Backward Classes (OBC). The authors cross-tabulated caste and religion to further separate OC into distinct groups, such as Hindus who are not SC, ST, or OBC — the so-called “forward castes” (FC). They note that the average SC/ST person in India has a substantial disadvantage in wealth relative to people from other groups in both AIDIS samples. Among these other groups, the FC Hindus are the clear leaders in median wealth in both rural and urban areas. In a worrisome trend, the relative median wealth of the rural and urban ST are, in fact, lower in 2002 than in 1991. The authors’ decomposition analysis shows that inequality between castes (between-group inequality) accounted for as much as 13 percent of overall wealth inequality in 2002. The major determinant of between-group inequality is the large gap between SC/ST groups (especially rural) and the forward castes (especially urban) in average wealth. The authors also find that three SC/ST caste groups—urban ST, rural ST, and urban SC—witnessed increases in within-group inequality between 1991 and 2002. This was especially striking for the ST groups. Given the relative deterioration of the group’s median wealth, the evidence suggests the possible emergence of a “creamy” (nouveau rich) stratum and growing income polarization within the ST groups. *For the complete text, go to www.levy.org/pubs/wp_566.pdf.*

Levy Institute News

Event: Conference on Employment Guarantee Policies

As the world financial crisis has turned into a global jobs crisis, addressing unemployment is becoming a strategic priority in both developing and developed economies. By mobilizing unused domestic labor resources, direct job creation can become an engine of pro-poor growth while also promoting gender equality and meeting social inclusion targets—key international development goals. Public works projects, employment guarantees, and employment of last resort strategies can play a crucial role in reducing unemployment and poverty, ameliorating distress migration, and delivering physical infrastructure and social services in ways that particularly benefit underserved communities.

On June 22 and 23, 2009, The Levy Economics Institute, in partnership with the United Nations Development Programme (UNDP), Regional Bureau for Latin America and the Caribbean and the Bureau for Development Policy, convened an international conference to present the merits and challenges of public job creation programs as a constitutive component of an economic recovery strategy. Titled “Employment Guarantee Policies: Responding to the Current Economic Crisis and Contributing to Long-Term Development,” the conference was held at Blithewood, the Institute’s main research and conference facility, on the campus of Bard College in Annandale-on-Hudson, New York. More than 30 top policy advisers, members of government organizations, academics, and international development specialists convened to analyze and exchange views on various public employment initiatives, drawing on existing research and the outcomes of country-level programs in South Africa, Argentina, India, Iran, and Chile, among others. Speakers included Rebeca Grynspan, assistant secretary general of the United Nations and Latin American regional director, UNDP; Selim Jahan, director of the Bureau for Development Policy’s Poverty Practice, UNDP; Senator Cecilia López of the Colombian Congress; and Santosh Mehrotra, head of the Development Policy Division of the Indian Planning Commission.

Events: Conference and Seminar on Gender and the Global Economic Crisis

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

Publications and Presentations

Publications and Presentations by Levy Institute Scholars

PHILIP ARESTIS *Senior Scholar*

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

Filho), *Economia e Sociedade*, Vol. 18, No. 1, April (in Portuguese).

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

JAMES K. GALBRAITH *Senior Scholar*

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

Presentations: “The Financial Crisis,” International Scene Lecture Series, Hofstra University, Hempstead, N.Y., February 24; “Comments on the Financial Crisis and Its Implications for Brazil,” seminar on “The Role of the State in a Post-crisis World and the Challenges for Brazil,” Council of Economic and Social Development, Brasília, Brazil, March 5–6; “Today’s Path to Growth: What Do the 1930s Tell Us about Now?,” symposium on “A Second Look at the Great Depression and New Deal,” Council on Foreign Relations, New York, N.Y., March 30; “Is the Stimulus the Solution?” panel on “The 2009 Stimulus Package: What’s in It (or Not) for Texas,” 24th Annual Public Conference, Texas Lyceum, Austin, April 3; “The Economic Crisis and Obama’s Response,” Clark University, Worcester, Mass., April 6; “Financial Crisis,” “The University of Chicago Conference on the Financial Crisis,” Chicago, Ill., April 10–11; guest speaker, “The Great Deleveraging,” organized by Meketa Investment Group, San Diego, Calif., April 20; “A New, New Deal,” “Hammer

Forum” series, The Armand Hammer Museum of Art and Cultural Center, University of California, Los Angeles, April 21; “The World Recession: Causes, Consequences, and Cures,” “The Predator State and the Free Market,” and “The Growing Divide Between Rich and Poor Worldwide,” The American University in Cairo, Egypt, May 11–14; “Transformational Times,” 154th ARL Membership Meeting, Association of Research Libraries, Houston, Tex., May 20; “Current Analysis of the Economic Situation, the Outlook for Jobs, and the Role of Policy so Far in the Crisis,” The Global Economic Crisis: Is the “New” New Deal in Sight, University of California Center, Sacramento, May 27; “The Great Transition—A Green New Deal?,” “Building Workforce Partnerships Conference 2009: The Great Transition,” San Jose, Calif., May 27–28.

GREG HANNSGEN *Research Scholar*

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

JAN KREGEL *Senior Scholar*

Presentations: “From Mortgage Crisis to Global Depression,” expert meeting on “Crises in Global Governance, Opportunities for Global Justice,” Brussels, Belgium, February 12; “Taming the Bond Market Vigilantes: Gaining Policy Space,” panel on From the Financial Crisis to the Global Economic Crisis: Impacts and Lessons, XI International Conference of Economists: Globalization and Development Problems,” Havana, Cuba, February 27; “Brazil and the Global Recession of the Twenty-first Century,” seminar on “The Role of the State in a Post-Crisis World and the Challenges for Brazil,” Council of Economic and Social Development, Brasília, Brazil, March 5; “Keynes, Liquidity Preference, and Bank Bailouts in the Subprime Financial Crisis,” 4th International Conference on Keynes’s Influence on Modern Economics, Sophia University, Tokyo, Japan, March 16–17; “Re-regulating Finance: Using Minsky to Learn from the Crisis,” IDEAS conference on “Re-regulating Global Finance in the Light of the Global Crisis,” organized by International Development Economics Associates (IDEAs), Tsinghua University, Beijing, China, April 9–12; “From U.S. Subprime Mortgage Crisis to Global Depression,” meeting sponsored by the Advisory Committee to the Carolyn Benton Cockefair Chair in Continuing Education, University of Missouri–Kansas City, April 23; “Global

Response to the Crisis and the President of The General Assembly of the United Nations’ Commission of Experts on Reform of the International Monetary and Financial System: The Economic Logic behind the Commission’s Major Proposals,” Regional High-Level Consultative Forum on the Impacts of the International Financial Crisis on the ESCWA Member Countries: The Way Forward, Damascus, Syrian Arab Republic, May 5–7; “The Economic Logic Behind the Commission’s Major Proposals,” thematic debate on “Principles of the Reform: Towards a New Bretton Woods?,” Parliamentary Conference on the Global Economic Crisis, organized by the Inter-Parliamentary Union, Geneva, Switzerland, May 7–8; “The Global Crisis and the Implications for Emerging Countries: Is the ‘B’ in BRICS Justified?,” National Institute of Advanced Studies XXI National Forum, “In the Midst of a World Crisis, the New Global Role of the BRICs (BRIMCs?) and Brazil’s Opportunities (Crisis as an Opportunity, Using the Action Plan),” The Brazilian Development Bank (BNDES), Rio de Janeiro, Brazil, May 18; “Minsky and the Regulation of the Financial System,” presentation at “The Global Crisis, the Financial System and its Regulation,” Center of Economics and Finance for Development of Argentina (CEFID-AR), National Bank of Argentina, Buenos Aires, May 20.

THOMAS MASTERSON *Research Scholar*

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

DIMITRI B. PAPADIMITRIOU *President*

Publications: interview regarding the latest version of TARP with Ron Fink, *Financial Week*, February 10; interview regarding the consequences of the crisis on consumption with Kay Glans, *Glasshouse Forums*, February 18; interview regarding AIG with Petra Boehm, Ard German TV, February 2; interview regarding international coordination on world recovery with Laurent Belsie, *Christian Science Monitor*, March 11; interview regarding perspective on TARP survey findings with Paul Davis, *American Banker*, March 27; interview regarding the future of the SEC on Rose Aguilar’s radio program *Your Call*, April 6; interview regarding the relationship of contingent workers to aggregate demand and profits with Peter Coy, *BusinessWeek*, April 8; interview regarding the difficulty in the banking sector and its implications for the economy with Paul Davis, *American*

Banker, April 9; interview regarding fiscal policy trends and the role of the state in the next 20 years with Giselle Machado, Kaiser Associates Latin America, April 9; interview regarding the 18th Annual Hyman P. Minsky Conference with Kathleen Hays, Bloomberg Television, April 16; interview regarding Minsky and his theories for the current crisis with Nikolaus Piper, *Süddeutsche Zeitung*, May 12.

Presentations: workshop organized by Socialist International on the global economic crisis, recovery, governance, and regulatory reform, March 31; “Full Employment Policy: Theory and Practice,” Global Foundation for Democracy and Development, Dominican Republic, April 27–28.

JOEL PERLMANN *Senior Scholar*

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

EDWARD N. WOLFF *Senior Scholar*

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

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

AJIT ZACHARIAS *Senior Scholar*

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

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

GENNARO ZEZZA *Research Scholar*

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

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Levy Institute Measure of Economic Well-Being

New Estimates of Economic Inequality in America, 1959–2004

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

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

THOMAS MASTERSON, EDWARD N. WOLFF,
and AJIT ZACHARIAS
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AJIT ZACHARIAS and VAMSI VAKULABHARANAM
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*Housing Inequality in the United States: A Decomposition
Analysis of Racial and Ethnic Disparities in Homeownership*

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