



# Report

---

January 2010

Vol. 20, No. 1

## New Strategic Analysis

# THE CURRENT RECESSION AND BEYOND: MEDIUM-TERM PROSPECTS FOR THE U.S. ECONOMY

DIMITRI B. PAPADIMITRIOU, GREG HANNSGEN, and GENNARO ZEZZA

December 2009

A year ago, the U.S. economy was in severe crisis. Now, after unprecedented efforts by the Federal Reserve (Fed) and Congress, and the adoption of “big government” policies, the financial system is more stable but the official unemployment level is 10.2 percent—and rising. According to President Dimitri B. Papadimitriou and Research Scholars Greg Hannsgen and Gennaro Zezza, the nascent recovery is still very fragile, so a good policymaking strategy will require a clear assessment of U.S. economic prospects over the medium term (i.e., six years).

Using the Levy Institute’s macro model, the authors review the three key financial balances of the U.S. economy: the private sector, government, and current account. They focus on the current account balance according to (1) a baseline scenario predicated on average projections of fiscal policy and future exchange rates; (2) scenario 1, which assumes a stimulative fiscal policy; and (3) scenario 2, which assumes an 11.9 percent devaluation of the dollar combined with a modestly stimulative fiscal policy.

The most dramatic sign of the recession’s severity is the state of the labor market. The employment rate has tumbled (from 65 to 59 percent), the unemployment rate stands at 17.5 percent if one includes discouraged and part-time workers who

# Contents

---

## **NEW STRATEGIC ANALYSIS**

- 1 The Current Recession And Beyond: Medium-term Prospects for the U.S. Economy

## **NEW PUBLIC POLICY BRIEFS**

- 4 It Isn't Working: Time for More Radical Policies
- 5 Can Euroland Survive?

## **NEW POLICY NOTES**

- 6 Banks Running Wild: The Subversion of Insurance by "Life Settlements" and Credit Default Swaps
- 6 Fiscal Stimulus, Job Creation, and the Economy: What Are the Lessons of the New Deal?

## **NEW LEVY INSTITUTE MEASURE OF ECONOMIC WELL-BEING (LIMEW)**

- 7 Has Progress Been Made in Alleviating Racial Economic Inequality?

## **NEW WORKING PAPERS**

- 7 The Unequal Burden of Poverty on Time Use
- 8 Securitization, Deregulation, Economic Stability, and Financial Crisis, Parts I and II
- 9 A Critical Assessment of Seven Reports on Financial Reform: A Minskyan Perspective, Parts I–IV
- 9 Market Failure and Land Concentration
- 10 A Financial Sector Balance Approach and the Cyclical Dynamics of the U.S. Economy
- 10 Explaining the Gender Wage Gap in Georgia
- 11 Money Manager Capitalism and the Global Financial Crisis
- 11 A Perspective on Minsky Moments: The Core of the Financial Instability Hypothesis in Light of the Subprime Crisis
- 12 An Alternative View of Finance, Saving, Deficits, and Liquidity
- 13 Lessons from the New Deal: Did the New Deal Prolong or Worsen the Great Depression?
- 13 Minsky Moments, Russell Chickens, and Gray Swans: The Methodological Puzzles of the Financial Instability Analysis

## **INSTITUTE NEWS**

### **Upcoming Events**

- 13 The 19th Annual Hyman P. Minsky Conference on the State of the U.S. and World Economies, April 14–16, 2010
- 13 The Hyman P. Minsky Summer Seminar, June 19–29, 2010

## **PUBLICATIONS AND PRESENTATIONS**

- 14 Publications and Presentations by Levy Institute Scholars

---

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

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

Editor: W. Ray Towle

Text Editor: Barbara Ross

To be placed on the *Report* mailing list, order publications, or inquire about or comment on research and events, contact the Levy Institute:

Levy Economics Institute of Bard College, Blithewood, PO Box 5000, Annandale-on-Hudson, NY 12504-5000

Tel: 845-758-7700, 202-887-8464 (in Washington, D.C.); Fax: 845-758-1149; E-mail: [info@levy.org](mailto:info@levy.org)

All publications are available on the Institute's website ([www.levy.org](http://www.levy.org)).

want full-time work, and the real wage growth rate is negative. These statistics add up to a picture of hardship for many Americans, and to weak consumer demand. And according to common measures of the housing market, there are no grounds for a robust recovery, since investment has collapsed.

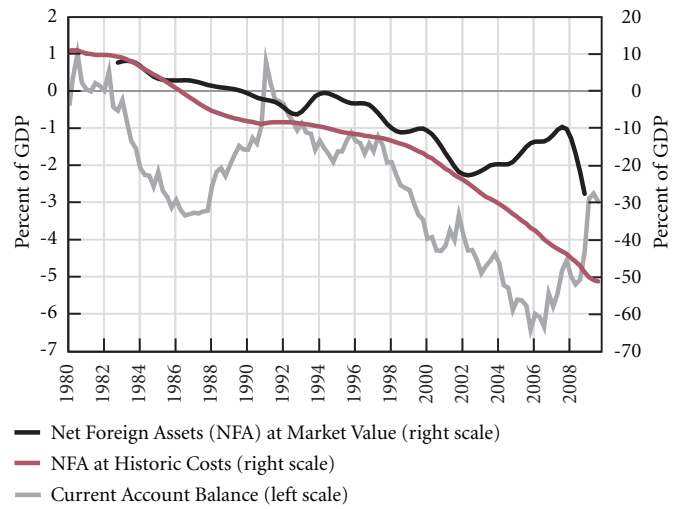
Current readings of U.S. net foreign assets (NFA) warrant deep concern (Figure 1). A further slowdown in the buildup of debt to foreigners will reduce debt-financed spending by U.S. businesses, households, and governments. If substantial current account deficits persist and reduce NFA, there is increased risk of a catastrophic drop in the dollar exchange rate. If policymakers succeed in staving off serious financial turmoil and controlling the dollar's decline, the current account balance may improve.

Dollar devaluation has been a main tool to reduce the trade deficit. However, the “terms-of-trade effect” reduces the effectiveness of this policy instrument, since Americans spend more on imported goods and services when prices rise. This perverse relationship suggests a departure from exchange-rate devaluations in favor of policy responses to large international imbalances, including measures such as energy conservation to reduce the demand for imported goods.

Using International Monetary Fund GDP projections, Papadimitriou, Hannsgen, and Zezza devise a baseline scenario that shows world output growth returning to trend in 2011 without replenishing the net loss in output as a result of the current recession. Using Congressional Budget Office projections, the authors verify the consequences of an end to the government’s fiscal stimulus (from 11.2 percent of GDP to 3 percent by 2012), in association with a rise in income tax revenues and a steady increase in outlays related to servicing the debt. The baseline scenario implies that real GDP growth will resume but remain sluggish, staying well below the rate required to push unemployment back to a more acceptable level (Figure 2). It is clear that the fiscal stimulus has strongly supported aggregate demand without lowering unemployment.

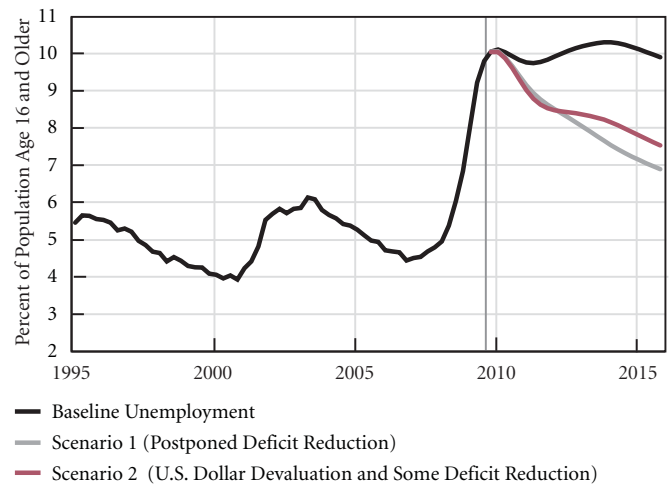
In scenario 1, the authors assume that the government maintains its current fiscal policies, postponing measures to address the deficit. Government expenditures and transfers are kept at the prerecession trend in nominal terms, and the Bush tax cuts are extended. Unemployment falls below 7 percent and

**Figure 1 U.S. Net Foreign Assets and Current Account Balance**



Sources: BEA; International Monetary Fund (IMF); authors’ calculations

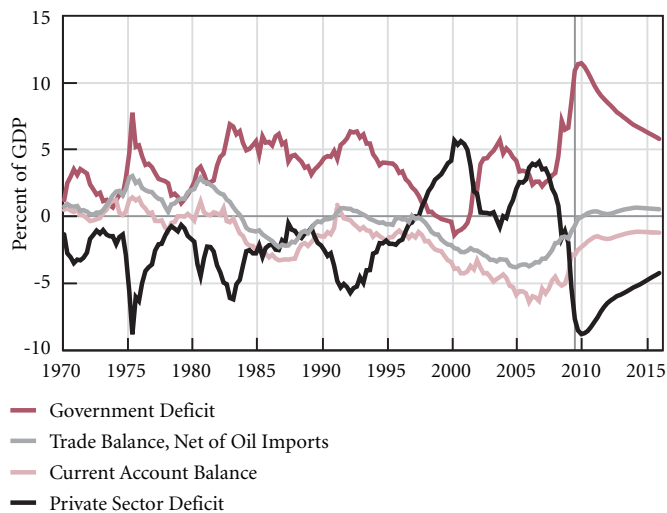
**Figure 2 Unemployment in Three Scenarios**



Sources: BLS 2009b; authors’ calculations

GDP growth rates average above 3 percent, but these rates are not high enough to close the output gap. The government deficit declines very slowly, government debt exceeds that in the baseline scenario, and the current account deficit widens. Thus, any policy that sustains growth in order to reduce unemployment is likely to reignite the current account imbalance problem.

**Figure 3 Main Sector and Trade Balances in Scenario 2, U.S. Dollar Devaluation and Some Deficit Reduction**



Sources: BEA; authors' calculations

In scenario 2, dollar devaluation raises the cost of oil imports but increases net exports and aggregate demand, thus permitting tighter fiscal policy than in scenario 1. Unemployment drops below 7.5 percent, the government deficit falls faster than that in scenario 1 (to 5.6 percent of GDP in 2015), and the current account deficit stabilizes at 1.3 percent of GDP (Figure 3). Thus, a modest dollar devaluation could be a very effective pro-employment policy, while directly addressing the medium-term threat posed by large imbalances.

Since market forces may not achieve an orderly dollar devaluation, the authors favor a multilateral agreement between the Fed and the central banks of major surplus countries. Failure to do so could lead to adverse consequences, such as a sudden collapse of the dollar and a return to financial fragility. It is also important to pursue an international pact to support efforts to develop alternative energy sources.

*For the complete text, go to [www.levy.org/pubs/sa\\_dec\\_09.pdf](http://www.levy.org/pubs/sa_dec_09.pdf).*

## New Public Policy Briefs

### It Isn't Working: Time for More Radical Policies

ÉRIC TYMOIGNE and L. RANDALL WRAY

Public Policy Brief No. 105

The Obama administration has implemented several policies to “jump-start” the U.S. economy. Two core premises are that monetary measures are required to strengthen the financial system before the rest of the economy can recover, and that most major banks have only a temporary liquidity problem induced by malfunctioning financial markets. The administration's efforts have largely focused on preserving the financial interests of major banks.

Research Associate Éric Tymoigne and Senior Scholar L. Randall Wray believe that maintaining the status quo is not the solution, since it overlooks the debt problems of households and nonfinancial businesses. They recommend a more radical policy agenda, such as federal spending programs that directly provide jobs and sustain employment, thereby helping to restore the creditworthiness of borrowers, the profitability of firms, and the fiscal position of state and federal budgets.

Leveraging of income and equity is the underlying cause of the crisis. Since leverage is highly procyclical, an unconstrained financial system will tend toward explosive growth during a boom. The notion that legislated capital requirements (such as those inherent in the Basel agreements) can constrain growth and risk is, therefore, flawed. And the argument that the U.S. government had to inject capital and get the bad assets off the books in order to encourage banks to lend again is nonsensical, the authors say. The public scolding of banks for “not providing credit” is misplaced, since the “shadow” sector is shrinking balance sheets and cutting off credit. The market wants more deleveraging because of solvency risks, not liquidity problems, so there will be no sustainable recovery until these debts are reduced and incomes begin growing again.

While Washington's focus is on the staggering government debt and unsustainable fiscal deficits, the real concern should be the debt level of the private domestic sector. It is important to recognize that government debt is low relative to the size of the U.S. economy, say the authors, and deleveraging in the private sector cannot happen without an expansion of the government deficit.

The current approach of the financial institutions that created the mess is to discourage loan renegotiations because preventing resolution is more profitable, based on the money to be made by squeezing debtors with fees and penalties. This explains why current policies have failed to keep people in their homes. And the promise to create three million new jobs when there are already 9.5 million fewer jobs than at the start of the downturn indicates that current efforts are grossly insufficient. The financial bailout has crowded out more sensible spending policies.

Tymoigne and Wray maintain that the government's programs will not work unless they deal with the core issue: many financial institutions are probably insolvent and should not be saved because they form a barrier to sustainable recovery. Policy should downsize the trade- and fee-driven financial sector, reduce monopoly power, increase supervision and regulation (and restore proper underwriting), and favor small, independent financial institutions. Policy should also support countercyclical government employment programs such as those created under the New Deal, help families restructure their finances and remain in their homes, and reallocate commitments that favor the financial sector.

*For the complete text, go to [www.levy.org/pubs/ppb\\_105.pdf](http://www.levy.org/pubs/ppb_105.pdf).*

## **Can Euroland Survive?**

STEPHANIE A. KELTON and L. RANDALL WRAY  
Public Policy Brief No. 106

The controversial title of this brief is based on a belief that the nature of the euro itself limits Euroland's fiscal policy space. The nations that have adopted the euro face "market-imposed" fiscal constraints on borrowing because they are not sovereign countries. Research Associate Stephanie A. Kelton and Senior Scholar L. Randall Wray foresee a real danger that these nations will be unable to prevent an accelerating slide toward a depression that will threaten the existence of the European Union (EU).

Economic performance throughout Euroland has converged to one that is uniformly poor for all members (i.e., chronically high unemployment and slow growth). Moreover, bond yield spreads between member governments have widened during the downturn, indicating that liquidity and default risks are expected to rise, and that national defaults are plausible.

The U.S. Federal Reserve (Fed) is lending to foreign central banks via swap lines and acting as the global lender of last resort. Its actions have been a form of life support for Euroland. The question is whether there is sufficient political will for U.S. policymakers to continue this support as the Fed's financial services explode.

The authors outline how fiscal policy operates in a sovereign nation that issues its own currency. There is no reason for rating agencies to downgrade sovereign government debt since it is debt with no default risk. Moreover, a sovereign government can bail out its state and local governments. But this option as it relates to the European Parliament is unknown, since the European Central Bank is practically prohibited from taking over the debts of member states.

The only way out of this crisis, then, is to use sovereign power and ramp up government spending. Nearly half of all member states are projected to breach the 3 percent deficit-to-GDP limit—debt that has to be purchased in (substantially tightened) private capital markets. Some states may simply abandon the euro in response to the threat of budgetary-related penalties by the EU's executive arm.

When a nation is perceived to be a "weak" issuer, the markets can effectively shut down its ability to stabilize conditions within its borders, a fundamental flaw that the authors have warned about since the euro zone's inception. Unless these nations can avert such financial constraints—for example, by establishing a sizable EU budget and giving the European Parliament fiscal authority on par with that of the U.S. Congress—prospects for stabilizing the euro zone appear grim. Such measures are likely to be politically, culturally, and socially difficult, so a trend toward dissolution remains a possibility.

*For the complete text, go to [www.levy.org/pubs/ppb\\_106.pdf](http://www.levy.org/pubs/ppb_106.pdf).*

## New Policy Notes

---

### **Banks Running Wild: The Subversion of Insurance by “Life Settlements” and Credit Default Swaps**

MARSHALL AUERBACK and L. RANDALL WRAY

Policy Note 2009/9

Wall Street is looking for the next asset bubble by securitizing life insurance policies and creating huge financial incentives in favor of personal calamity; that is, by making bets on the death of human beings.

Marshall Auerback, RAB Capital PLC, and Senior Scholar L. Randall Wray argue that credit default swaps (CDSs) give participants a vested interest in financial instability by generating perverse incentives. They believe that most of the problems seen in the securitized mortgage business will be re-created in the market for securitized life insurance policies. Worse, securitization of these policies creates incentives to ensure that our medical system does not provide the healthiest outcomes and that people die younger (e.g., an alliance of Big Pharma and Big Finance could increase health care costs and enhance the policies’ value). The authors call for the banning of CDSs and so-called “life settlement” securities since they operate against the public interest. In essence, they say, this is financial engineering run amok.

The authors propose that all bank assets and liabilities be brought onto balance sheets and made subject to reserve and capital requirements, and to the normal oversight of appropriate regulatory agencies. They also propose that all CDSs be bought and sold on regulated exchanges, and that securitization of products such as life insurance policies be prohibited (unless approved by Congress). The FDIC should unwind all CDS contracts between the largest insured banks in order to reduce systemic risk and identify and resolve the insolvent banks, avoiding resolution methods that favor large institutions. *For the complete text, go to [www.levy.org/pubs/pn\\_09\\_09.pdf](http://www.levy.org/pubs/pn_09_09.pdf).*

### **Fiscal Stimulus, Job Creation, and the Economy: What Are the Lessons of the New Deal?**

GREG HANNSGEN and DIMITRI B. PAPADIMITRIOU

Policy Note 2009/10

A group of academics disputes the notion that President Roosevelt’s fiscal and job creation programs helped end the Great Depression. However, Research Scholar Greg Hannsgen and President Dimitri B. Papadimitriou believe that the success of the New Deal strengthens the case for the effectiveness of fiscal policies and jobs programs. They recommend a permanent employer-of-last-resort (ELR) program, as proposed by Hyman P. Minsky, to mitigate the effects of today’s Great Recession.

The period between the Great Crash in 1929 and the beginning of Roosevelt’s first term in 1933 offered little evidence that the economy could recover on its own. When Washington sharply increased spending (1933–36), growth surged following a rapid rise in the deficit, but the country slipped back into recession when the deficit declined significantly. The persistence of mass unemployment throughout the 1930s should be blamed on the enormity of the task at hand and Roosevelt’s reluctance to run deficits, say Hannsgen and Papadimitriou. The number of jobs created by the Works Progress Administration and other federal agencies was perhaps more important than the size of the fiscal stimulus. And many New Deal programs created jobs indirectly (e.g., by making mortgages more affordable and bringing electricity to rural areas).

The authors suggest that the most pressing need today is to deal with unemployment (there are currently six job seekers per opening). There is good reason to believe that what worked during the Great Depression will work again, they say. An ELR program would provide cost-effective and noninflationary insurance against unemployment, and allow the government to cut spending on other safety-net programs (since some types of stimulus are more effective than others in creating jobs).

*For the complete text, go to [www.levy.org/pubs/pn\\_09\\_10.pdf](http://www.levy.org/pubs/pn_09_10.pdf).*

# New Levy Institute Measure of Economic Well-Being (LIMEW)

## Has Progress Been Made in Alleviating Racial Economic Inequality?

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

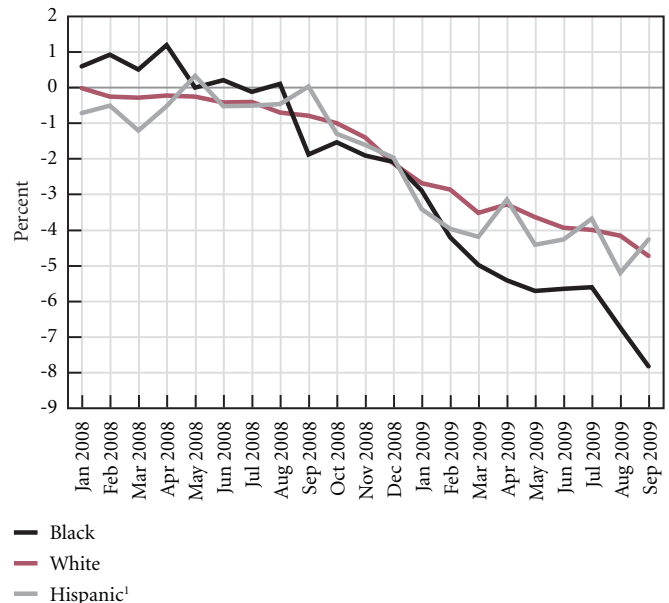
The authors examine trends in economic well-being between 1959 and 2007 based on the race/ethnicity of households. They find that the level of racial disparity in economic well-being has stagnated over the past 40 years. Changes in household wealth and net government expenditure are the key elements in the story that unfolds about racial differences.

The gap between white and nonwhite households showed a relatively small increase over the period (from \$26,100 in 1959 to \$30,600 in 2007). However, this increase conceals a significant deterioration in the well-being of blacks and Hispanics relative to whites due to the influence of the Asian group, which has the highest average income of all the groups surveyed. It also obscures the large decrease in the gap that occurred in the 1960s, when nonwhites benefited from an improvement in base income and net government expenditures (transfers and public consumption).

The introduction of Medicaid and increased public spending on education and infrastructure went a long way toward alleviating racial inequality in economic well-being. The 1990s saw a significant reversal, with nonwhites' pervasive disadvantage in asset accumulation leading to a widening gap. As a result, the average net worth of blacks relative to whites remained essentially unchanged at 19 percent between 1983 and 2007, while that for Hispanic households rose from only 16 percent to 26 percent. These observations are particularly significant in the context of the current economic downturn. Employment losses have been especially severe among blacks, and foreclosure rates have been much higher among black and Hispanic households (Figure 1), indicating that the asset gap has worsened.

The experience of the 1960s, which includes poverty alleviation, public education, affirmative action, and increased public sector employment for nonwhites, shows that government policy can be instrumental in diminishing racial inequality.

**Figure 1** Change in Monthly Employment Relative to Prerecession Employment by Race, January 2008 – September 2009 (in percent)



— Black  
— White  
— Hispanic<sup>1</sup>

<sup>1</sup>“Hispanic” can be of any race.  
Source: Authors’ calculations based on Bureau of Labor Statistics Table A-4, “Employment Status of the Civilian Noninstitutional Population by Race, Hispanic or Latino Ethnicity, Sex, and Age, Seasonally Adjusted,” <http://ftp.bls.gov/pub/suppl/empst.cspsee4.txt> (accessed October 8, 2009).

ity. Therefore, it is imperative to contemplate serious policy initiatives to address this issue, such as a proactive strategy that combines elements of both asset building and job creation.

For the complete text, go to [www.levy.org/pubs/limew\\_nov\\_09.pdf](http://www.levy.org/pubs/limew_nov_09.pdf).

## New Working Papers

### The Unequal Burden of Poverty on Time Use

BURCA KIZILIRMAK and EMEL MEMIS

Working Paper No. 572

Widespread income poverty has been a major challenge in postapartheid South Africa, and little attention has been paid to the linkages between poverty and time-use patterns. Using the 2000 time-use survey for South Africa, Burca Kizilirmak,

Ankara University, Turkey, and Research Associate Emel Memis analyze the impact of income poverty on time-use patterns. They find that poverty and marriage increase women's time spent on unpaid work but not that of men's, while higher education increases (decreases) the time spent on social care by men (women). As a result, governments should consider gender inequalities in time-use patterns when designing antipoverty policies and promoting gender equality.

The authors document the social structure of income poverty with respect to household size, number of children, employment, marital status, and residential location. In 2000, 59 percent of South Africa's population was living in poverty. More women were poor than men (62 versus 55 percent), and the ex-homeland areas had almost twice the poverty rate as the urban formal residential areas (82 versus 42 percent). Sixty percent of the poor lived in urban areas. While three quarters of the unemployed were poor, half of those employed were also poor, raising a serious issue about the sufficiency of wage levels.

The analysis reinforced most of the authors' a priori expectations: women's unequal burden in terms of unpaid work (4.4 versus 1.5 hours for men); the effect of poverty on increasing the time spent by women on unpaid work (e.g., water and fuel collection); and urban women's spending relatively less time on unpaid work than those in more rural areas. By comparison, poverty is not significant in terms of time spent on unpaid or paid work by men. The results confirm the traditional division of work within the domestic sphere, where women do the unpaid work and men assume the role of breadwinner. In opposition to expectations, young children do not significantly impact the time spent on unpaid work.

The authors disaggregate the time spent on unpaid work into different housework categories and find that (1) the impact of poverty on time-use patterns varies within a household; (2) marriage or cohabiting increases women's time spent on unpaid work but decreases that of men; and (3) more schooling decreases women's time spent on unpaid care and increases men's time spent on social care. They propose further research in order to fully account for household inequalities between members, including children's time-use patterns.

*For the complete text, go to [www.levy.org/pubs/wp\\_572.pdf](http://www.levy.org/pubs/wp_572.pdf).*

## **Securitization, Deregulation, Economic Stability, and Financial Crisis, Parts I and II**

ÉRIC TYMOIGNE

Working Paper Nos. 573.1–.2

Research Associate Éric Tymoigne analyzes the trends in the U.S. financial sector over the past 30 years and argues that unsupervised financial innovations and lenient government regulation are at the root of the current financial crisis and recession. He blames an economic setup that requires Ponzi processes for enduring economic expansion, and a regulatory system that is unwilling to recognize the intrinsic instability of market mechanisms. We need to change our approach to regulating financial institutions, says Tymoigne, and recognize the interests of the socioeconomic system (i.e., financial and systemic stability) rather than the interests of Wall Street or Main Street.

The first part of this detailed study assesses the evolution of securitization and how it contributed to Ponzi processes in the mortgage industry and other sectors. The second part focuses on the regulatory changes that contributed to the worst financial crisis of the past 80 years. Tymoigne argues that regulation and supervision should be oriented toward managing the growth of systemic risk at all levels through an analysis of creditworthiness that includes the detection of Ponzi financial practices. In addition, the government should put in place an industrial policy that limits mergers and acquisitions, counters the Ponzi tendencies of market mechanisms, and manages financial innovations.

The intent of securitization has changed over time. More recently, it has concerned financial claims in secondary rather than primary markets, so that risk is transferred off the balance sheet of the claim's originator (servicer). Securitization allows the servicer to reduce the amount of capital required and create a new source of revenue. As a result, there has been an unprecedented redistribution of profitability away from Main Street and toward Wall Street. Rather than fulfilling social needs, Wall Street used securitization for its own interests—for example, innovative financial instruments in the mortgage market (backed by artificial assets) created the housing boom. All sectors affected by securitization engaged in Ponzi processes, and there was strong sociopolitical pressure to let these processes go unchecked.

The U.S. government should motivate financial firms to innovate and ensure that the country has a sound and reliable



financial system, says Tymoigne, even if short-term profitability suffers. Two central criteria for judging innovations should be safety and the capacity to improve a society's standard of living.

The crisis shows that there is a need to understand and measure systemic risk, and to reprioritize the goals of the central banks. Subprime lending, speculation, and greed were contributing factors in the crisis, but the main factor relates to Hyman P. Minsky's insight that "stability is destabilizing." A means of promoting financial stability (the social interest) is a regulatory and supervisory framework oriented toward analyzing cash flows at the individual, sector, and systemic levels, and discouraging Ponzi practices—that is, changing the economic paradigm.

*For the complete texts, go to [www.levy.org/pubs/wp\\_573\\_1.pdf](http://www.levy.org/pubs/wp_573_1.pdf) and [wp\\_573\\_2.pdf](http://www.levy.org/pubs/wp_573_2.pdf).*

### **A Critical Assessment of Seven Reports on Financial Reform: A Minskyan Perspective, Parts I–IV**

ÉRIC TYMOIGNE

Working Paper Nos. 574.1–4

This four-part study critically analyzes reports dealing with U.S. financial system reform. It uses Hyman P. Minsky's analytical framework and focuses on the implications of Ponzi finance for regulatory and supervisory policies. The main conclusion is that all of the reports fail to deal with the socioeconomic dynamics that emerge during periods of economic stability, and therefore their proposals are unlikely to limit financial fragility. Any meaningful systemic and prudential regulatory changes should analyze cash flows rather than capital equity, and prevent Ponzi processes whether they are legal or not (see also, Working Paper Nos. 573.1–2).

The reports evaluated by Tymoigne include the Department of the Treasury's *Blueprint for a Modernized Financial Regulatory Structure* (2008); the Counterparty Risk Management Policy Group III's *Containing Systemic Risk: The Road to Reform* (2008); the *Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience* (2008); the Group of Thirty's *Financial Reform: A Framework for Financial Stability* (2009); the *OECD Strategic Response to the Financial and Economic Crisis* (2009); the Government Accountability Office's *Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System* (2009); and the International Center

for Monetary and Banking Studies' *Fundamental Principles of Financial Regulation* (2009).

*For the complete texts, go to [www.levy.org/pubs/wp\\_574\\_1.pdf](http://www.levy.org/pubs/wp_574_1.pdf); [wp\\_574\\_2.pdf](http://www.levy.org/pubs/wp_574_2.pdf); [wp\\_574\\_3.pdf](http://www.levy.org/pubs/wp_574_3.pdf); and [wp\\_574\\_4.pdf](http://www.levy.org/pubs/wp_574_4.pdf).*

### **Market Failure and Land Concentration**

FATMA GÜL ÜNAL

Working Paper No. 575

According to conventional theory, perfectly competitive markets allow the full utilization of land, labor, and capital, as well as their efficient allocation across alternative uses. This paper by Research Associate Fatma Gül Ünal studies the link between land ownership inequality and the functioning of rural factor markets in Turkey. Her analytical method of measuring the relationship between market malfunctioning and asset distribution contributes to the dialogue on why free-market policies fail and fills an important empirical gap in the development literature.

In the developing world, there is an inverse relationship between farm size and yield per acre, so the unequal distribution of land as a major productive asset results in the overutilization of land and underutilization of labor. Ünal's investigation supports the claim that factor markets are structurally limited in reducing inequalities as a result of landownership concentration. Rural factor markets have a tendency to perpetuate rather than ameliorate land-related inequalities, resulting in a failure to distribute economic opportunities.

The paper's general hypotheses are that Turkish labor is not fully utilized because of malfunctioning markets, which are connected to land ownership inequality, and that any improvement in market functioning reduces income inequality. The main argument is that, while factor markets diminish inequality, the extent of the reduction depends on how well the markets function and is structurally limited. The author determines that rural factor markets, when left on their own, are ineffective in achieving allocative efficiency, thus adding to rural unemployment as well as to income and asset inequality.

*For the complete text, go to [www.levy.org/pubs/wp\\_575.pdf](http://www.levy.org/pubs/wp_575.pdf).*

## A Financial Sector Balance Approach and the Cyclical Dynamics of the U.S. Economy

PAOLO CASADIO and ANTONIO PARADISO

Working Paper No. 576

Paolo Casadio, Intesa Sanpaolo Bank, and Antonio Paradiso, University of Rome La Sapienza, develop a small-scale econometric model of the U.S. economy based on a financial balances model by Goldman Sachs (2003) that was inspired by the works of Distinguished Scholar Wynne Godley. Their analysis includes the private and external sectors of the economy, and introduces the idea of financial fragility in capitalist economies that was originally developed by Hyman P. Minsky.

The authors find that the financing gap—the difference between internal funds and the business investments of nonfinancial firms—is a leading indicator of business cycles, while business investment is a lagging indicator. They also find that all sector balances depend on asset market variables, and discrepancies from equilibrium affect the growth in output (e.g., a negative financial balance has a negative effect on GDP, while a negative household balance has a positive effect).

It is important to understand the cyclical nature of the financing gap because it plays a crucial role in determining business-cycle phases, in accordance with Minsky's theory of financial fragility. The authors find that, at a disaggregated level, the financing gap is a leading (by five quarters) procyclical variable of the GDP cycle.

The authors explain the pattern of the financing gap—that is, the underlying forces driving the sector balances and the correlation of those balances with output. In general, profits and output have a common dynamic and are driven by common factors. In the first phase, the financing gap is positive because corporations wait to invest. In the second, corporations push investment beyond internal funds as GDP growth is fueled by business investment and optimism spreads, leading to a financial imbalance (and a negative financing gap) à la Minsky.

*For the complete text, go to [www.levy.org/pubs/wp\\_576.pdf](http://www.levy.org/pubs/wp_576.pdf).*

## Explaining the Gender Wage Gap in Georgia

TAMAR KHITARISHVILI

Working Paper No. 577

Research Associate Tamar Khitarishvili assesses the economic dimension of gender inequality in Georgia during the 2000–04 period. The study aims at establishing a baseline for the analysis of the impact of recent gender-targeted policies by the Georgian government. The gender wage gap was found to be substantial as a result of factors such as occupational differences. Female employment is concentrated in industries with the lowest mean wages—education, health care, and culture—but there are indications that women are increasingly engaged in high-skilled sectors such as finance, manufacturing, and energy.

The Georgian government's steps aimed at advancing the cause of gender equality have not translated into any plan of action for internalizing the gender framework into political, social, and economic decision making. It appears that gender equality, as a societal goal, is perceived to be an external (foreign) concept that is threatening the country's traditional way of life.

Khitarishvili determines that the labor force participation rate for men is 7 percentage points higher than that for women and the female unemployment rate is significantly higher than that for men. On average, women earn approximately 57 percent of what men do, and the situation appears to have worsened during the 2000–04 period. Her findings are consistent with the literature, such as higher returns to education for women than for men (although these returns are low compared to those in other countries). Marriage is a key variable in determining the probability of employment, while the presence in the household of children under six has a negative effect on the probability that women will be employed.

Sample selection bias was shown to be significant for men but not for women (contrary to previous studies of transition countries). Men are more likely than women to accept jobs with wages in the lower segment of their wage-offer distribution (due to women's primary caretaking responsibilities). This result is important, says Khitarishvili, because it indicates that the reasons for entering the labor force differ by gender. Correcting for sample selection bias increases the gender wage gap.

An important avenue for future work includes investigating the differences between income groups and the need to pay attention to self-employment.

*For the complete text, go to [www.levy.org/pubs/wp\\_577.pdf](http://www.levy.org/pubs/wp_577.pdf).*

## **Money Manager Capitalism and the Global Financial Crisis**

L. RANDALL WRAY

Working Paper No. 578

The economic crisis cannot be explained within the context of a “Minsky moment” because it represents a slow transformation of the financial system and economy toward fragility. Basing his arguments on Hyman P. Minsky’s financial instability hypothesis, Senior Scholar L. Randall Wray blames “money manager capitalism,” which is an economic system characterized by highly leveraged funds seeking maximum returns in an environment that systematically underprices risk. He suggests that the money manager phase of capitalism may be ending.

The trend has been toward more severe and frequent crises. The current crisis is a natural outcome of an unsustainable boom in real estate prices, mortgage debt, and leveraged positions in collateralized securities, in conjunction with an equally unsustainable boom in commodity prices. Wray proposes policy responses such as regulatory constraints and new standards to prevent boom/bust cycles; massive fiscal stimulus to allow growth without relying on private sector debt; mortgage relief; higher wages; greater employment; and revised monetary policy.

Wray outlines the long-term transition away from tightly regulated banking and toward “market-based” financial institutions, including securitization. Ironically, the creation of international standards as adopted by the Basel agreements encouraged this transition, which greatly increased systemic risk. Since the financial markets required much lower spreads and the Federal Reserve pursued a low interest rate policy, banks and thrifts were allowed to earn fee income for loan origination and move mortgages off their books to escape reserve and capital requirements, and to restore profitability. Instead of a closely regulated industry, home finance became an unsupervised and highly leveraged speculative activity. When the subprime market unraveled, it enveloped the whole money manager

system: by January 2009, U.S. financial institutions had written off \$1 trillion in bad assets.

Wray also proposes that Congress ramp up global food aid, subsidize alternative energies, enforce new regulations and standards for mortgage originators, and discourage the consolidation of financial institutions. And since commodities represent the latest asset class to be targeted for exploitation by money manager capitalism, it is necessary to close the loopholes that allow commodities speculation to escape regulation and oversight.

The current crisis represents a failure of the Big Government/neoconservative model that promotes deregulation, reduced supervision, privatization, and consolidation of market power. Monetary policy’s proper role is to stabilize interest rates, to direct credit controls and prevent runaway speculation, and to supervise markets.

*For the complete text, go to [www.levy.org/pubs/wp\\_578.pdf](http://www.levy.org/pubs/wp_578.pdf).*

## **A Perspective on Minsky Moments: The Core of the Financial Instability Hypothesis in Light of the Subprime Crisis**

ALESSANDRO VERCELLI

Working Paper No. 579

Alessandro Vercelli, University of Siena, Italy, provides a rigorous definition of a “Minsky moment” based on a restatement of the core of Hyman P. Minsky’s financial instability hypothesis (FIH). He perceives a Minsky moment to be the starting point of a Minsky process, and suggests an alternative to Minsky’s threefold taxonomy (hedge, speculative, and Ponzi units) that classifies a unit’s financial conditions based on continuous measures of liquidity and solvency.

Vercelli believes that Minsky’s narrow, threefold classification has likely hindered the development of analytical models of the FIH. For example, all units (including Ponzi) are considered solvent, since insolvent units would become bankrupt. However, an insolvent unit may be rescued by a bailout or by adopting extraordinary measures. In the case of “big banks,” bankruptcy does not fully discontinue a unit’s economic and financial consequences. As observed during the subprime collapse, the economic impact of virtually insolvent units may be particularly important in a financial crisis (when opinion favors their rescue) due to contagion (e.g., Lehman Brothers). Therefore,

the dynamic behavior of distressed financial units is crucial when analyzing a financial crisis and choosing policy strategies that will bring the crisis under control.

Vercelli applies his classification to all economic units, including households. He notes that units have different degrees of liquidity (or illiquidity), so a unit's net worth is measured in association with its solvency index. Using this approach, he breaks down Minsky's three-tier classification into six financial postures: hyperhedge, hedge, hyperspeculative, speculative, distressed, and highly distressed.

A Minsky moment begins when a substantial number of economic units suffer from both liquidity and solvency problems (and try to deleverage all at the same time). This progression need not degenerate toward a Minsky meltdown if, for example, the monetary authorities create a sufficient amount of liquidity or introduce safety margins such as compulsory illiquidity and leverage caps. However, mitigating a Minsky process requires (government) intervention long before the process begins.

To understand and control financial crises, says Vercelli, we need a comprehensive vision of the workings of a sophisticated financial economy that avoids any form of reductionism. A few policy insights on how to mitigate the financial cycle and stabilize the economy include stricter capital requirements and well-designed constraints on the units' illiquidity and indebtedness. The financial authorities should enforce these rules irrespective of the phase of the economic cycle.

*For the complete text, go to [www.levy.org/pubs/wp\\_579.pdf](http://www.levy.org/pubs/wp_579.pdf).*

## **An Alternative View of Finance, Saving, Deficits, and Liquidity**

L. RANDALL WRAY

Working Paper No. 580

According to orthodoxy, the current crisis is a result of excessive liquidity and a euphoric real estate boom. Senior Scholar L. Randall Wray believes that the crisis stems from the long-term transformation of the global financial system by "money managers" who control huge pools of institutional funds. The liquidity crisis could have been resolved very quickly, says Wray, if the Federal Reserve (Fed) had immediately opened the discount window to all financial institutions. The unrecognized problem is that gross insolvencies at the larger financial insti-

tutions are the result of unprecedented fraud rather than subprime loans. Moreover, the planned fiscal stimulus will fall far short of what is needed, despite the fact that the United States can financially "afford" to resolve the crisis.

The conventional view on the causes of the global financial crisis includes excessive U.S. trade deficits, the Fed's low interest rate policy, and a rapid increase in the demand for commodities. Solutions to the crisis include balancing the U.S. current account, fiscal responsibility, and higher interest rates. Otherwise, there is the threat of dollar devaluation, inflation, and national insolvency.

Wray counters with an in-paradigm view based on a stock flow-consistent balances approach initiated by Distinguished Scholar Wynne Godley. Deficit spending by one sector generates the surplus (saving) of another, so deficit spending by the government provides the income that allows the nongovernment sector to accrue an equal amount of saving. Government spending comes first by crediting bank accounts, so this process reverses the orthodox causal sequence.

It is not possible for federal government deficits to exceed nongovernment saving (domestic plus the rest of the world). A similar accounting identity holds for the domestic and external sectors: the domestic private sector balance plus the government balance equals the external sector balance. A government deficit (surplus) adds (subtracts) private sector net financial wealth. Portfolio adjustments affect prices and returns on financial assets, which in turn affect future spending and saving decisions. When the rest of the world is added to the model, its net accumulation of dollar-denominated financial wealth is equal to the U.S. current account deficit. In this case, portfolio adjustments also affect the exchange rate, which can impact future production, consumption, and saving decisions.

It is unlikely that the crisis will lead to another Great Depression, says Wray, because we now have a "big government" and a "big bank," a floating exchange rate, and the ability to act as lender of last resort (to financial institutions) and run very large budget deficits. A sovereign government can always afford to lend without limit and cover losses on deposits, so the United States has the domestic policy space to deal with the crisis.

Recovery will require the resolution of insolvent financial institutions and a large fiscal stimulus package, but the Obama government's efforts fall far short of what is needed in terms of total spending, number of jobs created, and sectors covered.

According to Wray, “too big to save” is a better doctrine than “too big to fail” if we’re to close down Ponzi schemes and focus efforts on saving the small-to-medium-size financial institutions that are necessary for economic recovery. He also favors household tax relief through a payroll tax holiday, as well as a universal job guarantee through a permanent employer-of-last-resort (government) program.

*For the complete text, go to [www.levy.org/pubs/wp\\_580.pdf](http://www.levy.org/pubs/wp_580.pdf).*

### **Lessons from the New Deal: Did the New Deal Prolong or Worsen the Great Depression?**

GREG HANNSGEN and DIMITRI B. PAPADIMITRIOU

Working Paper No. 581

This working paper forms the basis for Public Policy Brief No. 104, which is outlined in the October 2009 *Report* (p. 6), and Policy Note 2009/10 (see p. 6).

*For the complete text, go to [www.levy.org/pubs/wp\\_581.pdf](http://www.levy.org/pubs/wp_581.pdf).*

### **Minsky Moments, Russell Chickens, and Gray Swans: The Methodological Puzzles of the Financial Instability Analysis**

ALESSANDRO VERCELLI

Working Paper No. 582

This companion paper discusses methodological issues of a heuristic model based on Hyman P. Minsky’s financial instability hypothesis (FIH) that was developed by Vercelli in Working Paper No. 579 (see p. 11). Following Minsky, Vercelli concurs that the crucial factor in a financial system is the periodic increase in financial instability that gradually emerges in periods of tranquility. The interaction between liquidity and the solvency conditions of financial units brings about persistent fluctuations that do not have an *intrinsic* tendency to change over time. Change depends on factors that are exogenous to the FIH. Moreover, the role of shocks in Minsky’s theory is very different from that in conventional models of the business cycle. In a fragile system, even a “slight disturbance” may precipitate a financial crisis.

According to the FIH, we cannot rely on traditional probability and decision theories unless we are in a period of tran-

quility. Rather, we should expect the periodic emergence of financial fragility and the risk of recurrent crises—unless we take structural measures to mitigate them. Moreover, the relationship between microeconomics and macroeconomics is much more complex than in conventional economics. A unit’s financial behavior is heavily influenced by the behavior of all units, as expressed by aggregate indexes.

Vercelli points out that Minsky’s contributions are topical as a result of his underlying vision concerning the workings of a sophisticated monetary economy rather than his analytical constructs. The FIH’s relevance for mitigating financial crises has increased with time and will continue to do so if we update and develop Minsky’s insights in an effort to understand his powerful methodological approach.

*For the complete text, go to [www.levy.org/pubs/wp\\_582.pdf](http://www.levy.org/pubs/wp_582.pdf).*

## **INSTITUTE NEWS**

---

### **Upcoming Events**

---

#### **The 19th Annual Hyman P. Minsky Conference After the Crisis: Planning a New Financial Structure**

April 14–16, 2010

Ford Foundation, New York City

The focus of the Levy Institute’s 19th Annual Hyman P. Minsky Conference will be post-recession exit strategies and the new financial architecture. Complete program information will be posted on our website, [www.levy.org](http://www.levy.org), as it becomes available.

#### **The Hyman P. Minsky Summer Seminar**

June 19–29, 2010

Blithewood

Annandale-on-Hudson, N.Y.

The Levy Economics Institute is pleased to announce that it will hold The Hyman P. Minsky Summer Seminar in June 2010. The Seminar will provide a rigorous discussion of both theoretical

and applied aspects of Minsky's economics, with an examination of meaningful prescriptive policies relevant to the current economic and financial crisis. The Seminar will consist of a Summer School from June 19 to 26, followed by an International Conference on June 27, 28, and 29, both to be held at the Levy Institute in Annandale-on-Hudson, N.Y.

For more information, visit [www.levy.org](http://www.levy.org).

## PUBLICATIONS AND PRESENTATIONS

---

### Publications and Presentations by Levy Institute Scholars

**RANIA ANTONOPOULOS** *Research Scholar and Program Director*

**Presentations:** "Government Policy in the Midst of Crisis: What Constitutes a Progressive Agenda from a Gender Perspective?" Annual International Meeting of the National Council for the Prevention of Discrimination, Government of Mexico (CONAPRED), Mexico City, Mexico, September 29 – October 1; "The Current Economic and Financial Crisis: A Gender Perspective," 13th Conference of the Research Network Macroeconomics and Macroeconomic Policies (FMM), "The World Economy in Crisis—The Return of Keynesianism?" Hans Böckler Stiftung, Berlin, Germany, October 30–31.

**PHILIP ARESTIS** *Senior Scholar*

**Publications:** "Price and Wage Determination and the Inflation Barrier: Moving Beyond the Phillips Curve" (with M. Sawyer), in G. Gnos and L.-P. Rochon, eds., *Monetary Policy and Financial Stability: A Post-Keynesian Agenda*, Edward Elgar, 2009; "New Consensus Macroeconomics and Keynesian Critique," in E. Hein, T. Niechoj, and E. Stockhammer, eds., *Macroeconomic Policies on Shaky Foundations: Wither Mainstream Macroeconomics?* Metropolis, 2009; "The New Consensus in Macroeconomics: A Critical Appraisal," in G. Fontana and M. Setterfield, eds., *Macroeconomic Theory and Macroeconomic Pedagogy*, Palgrave Macmillan, 2009; "The Future of Public Expenditure" (with M. Sawyer), *Renewal*, Vol. 17, No. 3 (Autumn).

**Presentations:** "New Consensus Macroeconomics and Keynesian Critique," and "Current Financial Crisis and Regulatory Implications," 7th International Summer School of History of Economic Thought, Lucca, Italy, September 9–12; "New Consensus Macroeconomics and Inflation Targeting: Relevance to CAREC Countries," "Economic Policies after the New Consensus Macroeconomics," and "Economic Policies after the New Consensus Macroeconomics," CAREC Institute Workshop, organized by the Asian Development Bank, Almaty, Kazakhstan, October 21–24.

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

**Presentations:** "The Financial Crisis—An American Perspective," conference on "Nykkredit Financial Sustainability 2009: A Global Perspective," Copenhagen, Denmark, September 29; "The Great Crisis and the Dismal Science," Royal Society at King's College—University of Cambridge, England, October 7; "The Predator State and the Great Crisis," conference on "The Economics of Peace," sponsored by Praxis Peace Institute and RSF Social Finance, Sonoma, California, October 18–23; "The Great Crisis and the Predator State," The Holland Lecture Series, sponsored by the First Unitarian Church of Omaha, Nebraska, October 20; "No Return to Normal: The Great Crisis, the Dismal Science, and the Exit Strategy Illusion," conference on "From Crisis to Opportunity: Investing for a Sustainable Economy," for the 20th Annual SRI in the Rockies, Tucson, Arizona, October 25–28.

**JAN KREGEL** *Senior Scholar and Program Director*

**Publication:** "A Crise Global e as Implicações para os Países Emergentes: O B de BRICs se Justifica?" in J. P. dos Reis Velloso, ed., *A Crise Global e o Novo Papel Mundial dos BRICS*, Olympio Editora, 2009.

**Presentations:** "Financial Markets and Specialization in International Trade: The Case of Commodities," presented at "Consultation on Financial Crisis and Trade: Toward an Integrated Response in Latin America and the Caribbean," Sistema Económico Latinoamericana y del Caribe (SELA), Caracas, Venezuela, September 1; "The U.S. Financial Crisis and Its Global Implications," Pontifical Catholic University, Porto Alegre, Brazil, September 8; "Basic Principles for Formulating Crisis Policy," 2nd International Conference of the Associação Keynesiana Brasileira, Porto Alegre, September 9; "How to Reregulate in Light of Past Experience," workshop on "Financial

Crises and Regulation: Experiences and Perspectives in Europe and the U.S.,” University of Siena, Italy, September 18; “Testimonial,” presented at “Academic Actus in Honor of Carlota Perez,” Tallinn University of Technology, Estonia, September 21; “Is Reform of the Regulation of the Financial System an Oxymoron?” The 4th Bi-annual Cross-border Post Keynesian Conference, State University of New York at Buffalo, October 9; “Causes and Effects of the Current Crisis—The Work of the Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System,” Norwegian Financial Crisis Commission, Oslo, October 14; “The Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System: The Vision, the Process, the Results,” conference on “The Other Canon,” Tallinn University of Technology, Estonia, October 15; “Is This the Minsky Moment for Reform of Financial Regulation?” 13th Conference of the Research Network Macroeconomics and Macroeconomic Policies (FMM), “The World Economy in Crisis—The Return of Keynesianism?” Hans Böckler Stiftung, Berlin, Germany, October 30–31; “A Crise e as Transformações Internacionais: Um Novo Paper do Brasil no Cenário Global?” Seminario Internacional INCT-PPED, “Promovendo Respostas Estratégicas a Globalização,” Instituto de Economia, Universidade Federal do Rio de Janeiro, Brazil, November 3.

**DIMITRI B. PAPADIMITRIOU** *President*

**Presentations:** interview regarding the expiration of the Treasury guarantee for money market mutual funds with Paul Davis, *American Banker*, October 8; interview regarding Treasury pricing on gold with Martha C. White, *Slate.com’s: The Big Money*, October 8; interview regarding employer-of-last-resort programs with Paul Glastris at *Washington Monthly*, October 16; interview regarding the influence of Hyman Minsky with Michael Hirsh at *Newsweek*, October 26; “Addressing Global Imbalances after the Economic Crisis” (with G. Zezza), 13th Conference of the Research Network Macroeconomics and Macroeconomic Policies (FMM), “The World Economy in Crisis—The Return of Keynesianism?” Hans Böckler Stiftung, Berlin, Germany, October 30–31; “Global Imbalances after the Economic Crisis,” conference on “Financial Globalization: Culprit, Survivor or Casualty of the Great Crisis?” Yale Center

for the Study of Globalization, New Haven, Connecticut, November 12–13; roundtable, “Is There Still a Paradigm for Monetary Policy Today?” Euro50 Group Meeting, Paris, France, November 19; seminar on “The ‘Great Recession’ and Beyond: Economic Outlook for the U.S. and Global Economy,” University of Athens, Greece, November 24.

**JOEL PERLMANN** *Senior Scholar and Program Director*

**Publication:** “Secularists and Those of No Religion: ‘It’s the Sociology, Stupid (Not the Theology),’” *Contemporary Jewry*, August 24.

**Presentations:** “Evaluations of *A Just Zionism* by Chaim Gans,” Annual Meeting of the American Political Science Association, Toronto, Canada, September 3; “Ethnic Intermingling through Four Generations: A Preliminary Report Based on the Forward Linkages of NAPP and IPUMS Data,” 34th Annual Social Science History Association Meeting, Long Beach, Calif., November 12–15.

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

**Presentation:** “Trends in American Living Standards, 1959–2004,” Columbia University Center for the Study of Wealth and Inequality Seminar Series, New York, N.Y., October 8.

**GENNARO ZEZZA** *Research Scholar*

**Presentations:** “The Current Crisis Through the Lens of a New ‘New Cambridge’ Model,” 50th Meeting of the Italian Economist Society, Università Luiss, Rome, Italy, October 23–24; “Addressing Global Imbalances after the Economic Crisis” (with D. B. Papadimitriou), 13th Conference of the Research Network Macroeconomics and Macroeconomic Policies (FMM), “The World Economy in Crisis—The Return of Keynesianism?” Hans Böckler Stiftung, Berlin, Germany, October 30–31.

**Levy Economics Institute of Bard College**

Blithewood

PO Box 5000

Annandale-on-Hudson, NY 12504-5000

*Address Service Requested*

**NONPROFIT ORGANIZATION**

**U.S. POSTAGE PAID**

**BARD COLLEGE**