Remarks to the 18th Annual Conference Honoring Hyman Minsky
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Let me first congratulate Dimitri Papadimitriou and the Levy Economics Institute. Clearly the Minsky conference is the go-to event on these issues at this important moment.

The economist Dean Baker has a small book entitled *Plunder and Blunder*, in which he explains how he saw the housing bubble when others did not. The story is quite simple: Dean plotted price/rental ratios, and when these departed sharply from trend he assumed they would return. What went up, had to come down.

The question before us is: does the same analytical principle apply to the slump? Will what went down, come back up? Does the fact that there was No New Paradigm imply that there must also be No New Depression?

Early in this crisis I attacked the baseline forecasting models of the Congressional Budget Office, which asserted that the economy would revert to a natural rate of unemployment – arbitrarily set at 4.80 percent -- in about five years, even if no action were taken. This assertion provided a rationale for a smaller, shorter expansion package than we might otherwise have demanded. The rationale was purely mystical, and it was unfounded in the strict sense.

Today, though, we have heard (from the bank economists) a Keynesian case for an imminent turnaround and relatively rapid expansion – the Obamaboom, as Warren Mosler has named it. The case has four major elements:

– The fact that recessions are self-limiting through the inventory cycle. In the slump, production always falls much more than consumption, so that inventories are liquidated, and as this process is completed, production must be restarted. To this, we can add the fact that sharply falling commodity prices have helped restore real purchasing power.

– The fact that services are more stable than either manufacturing or agriculture and that they are a much larger part of the total economy than they were eight decades back.

– Even more important, the fact that rock-stable government is much larger, in proportion to the economy, than in 1929. To this we can add that falling income taxes and rising unemployment insurance provide massively for automatic stabilization as unemployment rises. It's ugly but it works.

– Finally, the fact that the fiscal expansion package (including the recent increase in social security benefits) is the largest on the post-war record, and also the longest-lasting, with expenditures expected to surge for two years rather than the norm of one.

That is the optimistic Keynesian case. It's noteworthy that it is a *Keynesian* case. It bears no

resemblance to the easy automaticity of market equilibrium. Nor does it rely on the magical powers of money creation. And these are good things. At least our discourse has stabilized around a sensible and realistic, which is to say Keynes-Minsky, analytical framework. As such, plainly this case has a good deal of practical force.

At the same time, in an equally Keynes-Minsky spirit, one can offer three caveats or reservations, which may affect how events play out.

The first caveat concerns the debt position of the household sector. The Levy Institute Strategic Analyses see no alternative to a continuing paydown of household debts, on average and in relation to income – until such time as more "normal" levels are restored.[1] Then there are the effects of the flight to liquidity and the collapse of home equity and therefore of debt collateral. And (to some, though I do not share this view) there is a question whether the banks would be willing to lend, even if willing borrowers with good credit and sound collateral were to present themselves.

The more aggressively households insist on holding cash and reducing debts, the more their collateral has collapsed and the more frightened are the banks, then the larger the fiscal stimulus has to be in order to stabilize, let alone reverse, the course of total demand and production. Some fear that politicians will not allow the budget deficit to go high enough. It was a reasonable fear *ex ante*, though for the moment it seems that truly gigantic deficits are evoking no adverse reaction. Perhaps the political world has resigned itself to deficits as large as the economic system can produce – and if so, we are saved.

A second caveat concerns the marginal propensity to import in the upturn, particularly if a large part of the domestic capital stock (especially in the automotive sector) is wiped out by bankruptcy or otherwise in the slump. Twenty years ago in a book called *Balancing Acts* and an article entitled, "North-South Trade and the Destabilization of the North" I described a process of "trade-distorting business cycles," in which differential rates of capital destruction ensure that each successive upturn has a larger import component than the one before. The result is an unbalanced and largely jobless recovery, at least until capital spending in the technology sectors takes over, far down the road.

The third caveat concerns shoes that may yet drop, in domestic finance (commercial mortgages, credit card debt, insurance companies, credit default swaps) or in overseas. The world break-down of the 1930s occurred, in part, because of the system's failure to coordinate a settlement of German reparations. Germany owed Britain and France, who owed America, which had lent to Germany, and no one was willing to be the first to sacrifice their link in the chain. Something similar is going on today, in the breakdown of the carry trade from the US to Western Europe to Central Europe, and while the situation is surely manageable in principle no one can be certain that it will be managed in practice.

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1 Exactly what constitutes a normal level for the household debt-income ratio is, however, not clear. And there is a question whether the levels may not be reduced, much more rapidly and effectively than through repayment, simply by mass defaults. Mortgages are, after all, non-recourse loans in most of the country.

These reservations are serious. But they are also imponderable. They rest on intangibles of psychology and of disasters that have not quite yet happened. When you stand them against the mechanical processes of the Keynesian optimists, they lack the same statistical foundation. It reasonable, at least for purposes of argument, to grant that the optimists' position is plausible. So let us ask a conditional question. *If* a recovery starts later this year, what will it be like?

It seems to me that there are four essential points to make about the expansion to come.

– It will surely be very slow to restore employment. At present writing jobs are being lost at the rate of over 600,000 per month. To reverse this in six months would require a swing to job creation of the same amount, or a net swing of 1.2 million jobs a month for half a year. This is not going to happen – not even close. Among many reasons, homebuilding is likely to be depressed for a long time, while elsewhere production gains will be backed by productivity increases. As a result, we can expect the human wreckage of this slump to persist and to deepen as the period of unemployment lengthens. Without direct employment measures, many of the people most hurt will not again find decent jobs.

– As a result of the administration's determination to save the big banks, we will emerge from this slump with an unreformed financial sector in the hands of the same people who produced the disaster in the first place. While some bad assets will recover value, many will not, and losses will either go unrecognized or they will be transferred, via the public-private partnerships, first off the balance sheets of the banks and then to the taxpayer, when the mortgages default, via the non-recourse feature of the FDIC's loans. We could assess the likelihood of this happening, if we chose, by the simple step of auditing the loan tapes underlying a fair sample of sub-prime securities, to determine the prevalence of missing documentation, misrepresentation and *prima facie* fraud. Such a study would constitute minimum due diligence and that fact that one is not underway is a very bad sign.

– In the expansion the early easy buck, especially for speculators, may well be in commodities, especially oil. A rapid increase in imported energy costs would reverse the effective stimulus now being given by low oil prices. It will also generate CPI inflation, perhaps inducing the Federal Reserve to slam on the brakes. There is little reason to hope that the recovery will be allowed to march us all the way back to full employment unless we overcome our vulnerability to volatile oil prices, and nothing in the plans so far suggests we have faced up to that elementary necessity.

– A turnaround could bring the deficit hawks back out of the woodwork, arguing vociferously that "now is the time" for tax increases and entitlement cuts. Should they prevail, the process could be thrown into reverse, in a recapitulation of Roosevelt's balance-the-budget recession of 1937-38.

The British used to call this scenario "stop-and-go." A future of short and incomplete expansions may be the most likely case, with no prospect for a return to full employment. For the working population of the country, this is no recovery at all. And it will be made all the worse rising financial markets and premature declarations of victory, the gloating of the bailed-out.

The next question is, is this the best we can do?

Let me close by laying out four steps that would help to avert this future, and help to assure a long and relatively stable expansion, leading ultimately back to high employment.

– Treasury should change its bank plan, recognize that too-big-to-fail is also too-big-to-regulate, and too-big-to-regulate is also too-big-to-manage. A financial institution that cannot be controlled by its own top leadership is an intrinsically dangerous thing. Since the financial sector must and will shrink in any event in the post-crisis economy, the strategic choice facing policy is how to do it. That choice is between preserving vast rogue companies whose major functions are tax and regulatory arbitrage, or allowing the smaller banks that have largely played by the rules to grow into the legitimate market niches the big players may vacate. Apart from the vast political power of the big banks, this is not a difficult choice.

– The unmet human disaster of this slump remains urgent, and the way to meet it is to strengthen, not weaken, the social safety net. Given the triple hit to the elderly as a group – in home values, stock values and interest on cash holdings – Social Security benefits should be increased, not cut. Medicare eligibility should be reduced to age 55 as an emergency measure. The payroll tax should be placed on holiday, and measures to mitigate foreclosures or otherwise keep people in their homes taken urgently. Fiscal assistance to states and localities should be made open-ended, putting an end to job cuts in those vital public sectors, indeed permitting them to grow and add employment.

– For the long term, we should build institutions now, including a National Infrastructure Fund and a cabinet Department for Energy and Climate, capable of planning and funding the reconstruction of the country. The point of this is to build expectations for a sustained expansion and also to give it a direction, charting the course that private investments will follow when they eventually return.

– Finally, we should recognize that we are fortunate in this country to have the governing institutions established for us in the New Deal and Great Society, including a central bank with unlimited lending powers, a national government that can borrow and spend at will, and the global reserve currency. These institutions have -- despite flaws and mistakes -- served us well. But we should recognize that the rest of the world is not so favored. In particular, Europe lacks the mechanisms and the inclination to take action as we can, and all the pathologies of structural adjustment that we avoid here are routinely imposed everywhere else.

It is therefore quite possible that the rest of the world will not cooperate in economic recovery even if one gets started here. It is possible that credit, debt and exchange-rate crises still to come will overwhelm the capacity of the global system to cope. We should be prepared, if we can, to deal with that risk.