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War and famine. Peace and milk. — **Somali proverb**

From Tunisia to Wall Street: The Globalization of Protest

Joseph E. Stiglitz

The protest movement that began in Tunisia in January, subsequently spreading to Egypt, and then to Spain, has now become global, with the protests engulfing Wall Street and cities across America. Globalization and modern technology now enables social movements to transcend borders as rapidly as ideas can. Social protest has found fertile ground everywhere: a sense that the "system" has failed, and the conviction that even in a democracy, the electoral process will not set things right — at least not without strong pressure from the street.

In May, I went to the site of the Tunisian protests; in July, I talked to Spain's indignados; from there, I went to meet the young Egyptian revolutionaries in Cairo's Tahrir Square; and, a few weeks ago, I talked with Occupy Wall Street protesters in New York. There is a common theme, expressed by the OWS movement in a simple phrase: "We are the 99 percent."

That slogan echoes the title of my article recently published in *Vanity Fair*, entitled *Of the 1 percent, for the 1 percent, and by the 1 percent*, describing the enormous increase in inequality in the United States: 1 percent of the population controls more than 40 percent of the wealth and receives more than 20 percent of the income. Those in this rarefied stratum often are rewarded so richly not because they have contributed more to society — bonuses and bailouts neatly gutted that justification for inequality — but because they are, to put it bluntly, successful (and sometimes corrupt) rent-seekers.

This is not to deny that some of the 1 percent have contributed a great deal. Indeed, the social benefits of many real innovations (as opposed to the novel financial "products" that ended up unleashing havoc on the world economy) typically far exceed what their innovators receive. Around the world, however, political influence and anti-competitive practices (often sustained through politics) have been central to the increase in economic inequality. And tax systems in which a billionaire like Warren Buffett pays less tax (as a percentage of his income) than his secretary, or in which speculators, who helped to bring down the global economy, are taxed at lower rates than those who work for their income, have reinforced the trend.

Research in recent years has shown how important and ingrained notions of fairness are. Spain's protesters, and those in other countries, are right to be indignant: here is a system in which the bankers got bailed out, while those whom they preyed upon have been left to fend for themselves. Worse, the bankers are now back at their desks, earning bonuses that amount to more than most workers hope to earn in a lifetime, while young people who studied hard and played by the rules see no prospects for fulfilling employment.

The rise in inequality is the product of a vicious spiral: the rich rent-seekers use their wealth to shape legislation in order to protect and increase their wealth — and their influence. The US Supreme Court, in its notorious Citizens United decision, has given corporations free rein to use their money to influence the direction of politics. While the wealthy can use their money to amplify

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Pressures on the Paradigm Issue

"When bankers seek out new clients, they're seeking out new ways to convince people that expected capital gains — that is, capital gains that have not yet occurred — can be converted into present income, and that present income can, in fact, be spent."

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From Tunisia to Wall Street: The Globalization of Protest (continued)

their views, police wouldn't allow me to address the OWS protesters through a megaphone back on the street.

The contrast between overregulated democracy and unregulated bankers did not go unnoticed, but the protesters are ingenious: they echoed what I said through the crowd, so that all could hear. And, to avoid interrupting the "dialogue" by clapping, they used forceful hand signals to express their agreement.

They are right that something is wrong about our "system." Around the world, we have underutilized resources : people who want to work, machines that lie idle, buildings that are empty — and huge unmet needs: fighting poverty, promoting development, and retrofitting the economy for global warming, to name just a few. In America, after more than 7 million home foreclosures in recent years, we have empty homes and homeless people.

The protesters have been criticized for not having an agenda. This misses the point of protest movements. They are an expression of frustration with the electoral process. They are an alarm.

The anti-globalization protests in Seattle in 1999, at what was supposed to be the inauguration of a new round of trade talks, called attention to the failures of globalization and the international institutions and agreements that govern it. When the press looked into the protesters' allegations, they found more than a grain of truth in them. The trade negotiations that followed were different — at least in principle; they were supposed to be a development round, to make up for some of the deficiencies that were highlighted by protesters — and the International Monetary Fund subsequently undertook significant reforms.

So, too, in the US, the civil rights protesters of the 1960s called attention to pervasive institutionalized racism in American society. That legacy has not yet been overcome, but the election of President Barack Obama shows how far those protests moved America.

On one level, today's protesters are asking for little: a chance to use their skills, the right to decent work at decent pay, a fairer economy and society. Their hope is evolutionary, not revolutionary. On another level, they are asking for a great deal: a democracy where people, not dollars, matter, and a market economy that delivers on what it is supposed to do.

The two are related: as we have seen, unfettered markets lead to economic and political crises. Markets work only when they operate within a framework of appropriate government regulations, and that framework can be erected only in a democracy that reflects the general interest — not the interests of the 1 percent. The best government that money can buy is no longer good enough.

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THE STORY OF BROKE

Why There's Still Plenty of Money to Build a Better Future

A new video from The Story of Stuff Project, released November 8, 2011

"The United States isn't broke; we're the richest country on the planet and a country in which the richest among us are doing exceptionally well. But the truth is, our economy is broken."

Watch the video at http://www.storyofstuff.org/movies-all/story-of-broke/.

From the Director

The Occupy Wall Street movement got me thinking. Was this just the lefty version of the Tea Party — an uninformed bunch of angry disenfranchised wackos?

Then I recalled EPS's extensive efforts since 2008 in addressing the economic crisis, its causes and effects. We have held symposia addressing many of the issues that the Occupiers are concerned with: jobs, housing, Social Security, and the banking and finance industry.

The Occupy protesters are coming from a place of emotion; they feel that the system is unfair. One of the contributions that EPS offers the activist community is to address with rigorous analysis and expertise the issues "everyone knows" to be true.

In January of this year, at the American Economics Association meetings in Denver, EPS held a session that gets to the heart of all of these issues. "Pressures on the Paradigm" addressed both the pressures that heterodox economists are bringing to bear on the dominant paradigm of orthodox economics, and the pressures from within that show that the system itself is not sustainable. Four of the foremost experts on problems and cracks in neo-classical economic theory comprised the panel.

In presentations summarized in this issue, the authors bring their expertise to bear on the central questions of the Occupy movement. Randy Wray says that, as mainstream economic theory does not allow for the possibility of crises, how could anyone possibly have predicted a crisis? Bill Black goes further, saying that devotees champion policies and laws that drive crises. Marshall Auerback predicts that as the austerity drive deepens, we will see further deterioration in the economy. Jan Kregel says we really should be looking at banks as viruses, and he is concerned about the infiltration of the financial system into the political process. The presenters brought clear evidence that supply-side economics does not produce full employment, income equality, or a stable economy.

A couple months into the Occupy Wall Street movement, I am starting to see articles that confer a good bit of legitimacy on the protesters. At ThinkProgress.org on October 31, Alex Seitz-Wald said, "If the 99% movement accomplishes nothing beyond fundamentally shifting the political discourse away from trumped up fears about the debt to real issues like inequality and jobs, then it has already succeeded."

On November 9, *Bloomberg Businessweek* ran "Occupy Protesters Inject Income Inequality into Political Debate." Occupy Wall Street has "started to change the debate in the country" and has "pried open some questions people hadn't been asking," said Nina Eliasoph, a sociologist at the University of Southern California in Los Angeles who studies grassroots political activism. "We've taken for granted that it's a natural fact that the rich keep getting richer," she added, and the fact that people are now starting to ask why is "a huge change in the political landscape."

The Occupy Wall Street encampment was forbidden from using electronic amplification for its speakers. They've met this challenge with the "People's Microphone:" the crowd loudly repeats to the rows behind them what the speaker has said. I have a fantasy of a rally where the protesters are chanting, à la Bill Black, "The system is criminogenic!"

Thea Harvey

Pressures on the Paradigm speakers, left to right: William Black, L. Randall Wray, Marshall Auerbach. Chair: James Galbraith. Not shown: Jan Kregel

William K. Black

Neo-classical economic theory, which dominates law and economics, is criminogenic; it assumes that control fraud cannot exist, while recommending legal policies that optimize an industry for control fraud, hyper-inflate financial bubbles, and produce recurrent, intensifying financial crises. Its hostility to regulation, endorsement of opaque assets that lack readily verifiable market values, and support for executive compensation that creates perverse incentives to engage in accounting control fraud have created a nearly perfect crime. The most extreme devotees do not simply fail to identify developing crises; they champion the policies, laws, and control frauds that drive crises, producing the widespread criminality that is in many ways precisely what the neoclassical paradigm is proudest of and gets wrong.

Executive compensation is supposed to be one of the great successes. There are tens of thousands of articles about how tying executive bonuses to short-term reported income has aligned the interests of the CEO with those of the shareholders. It typically does the opposite. It's overwhelmingly short-term, and since the crisis the percentage of executive compensation based on short-term reported gains has increased. In other words, in response to the crisis, they've made it worse.

I hear no serious discussion among economists regarding accounting, and to the extent they talk about it at all, it's to make it worse. Economists tend to be proponents of changing the accounting rules to cover up losses, which means that all of the bonuses that the banks are paying are based on fictional "record profits." Seventeen years ago, George Ackerlof and Paul Romer laid out the only extant model in economics that, I think, even comes close to explaining what we're seeing. Maybe one percent of modern articles cite Ackerlof and Romer. The title of the article should be remembered: *Looting: the Economic Underworld of Bankruptcy for Profit*. It said that because you use accounting, record profits are guaranteed. The article was written in 1993; which way has executive compensation gone?

When the person that controls a seemingly legitimate business or government agency uses it as a "weapon" to defraud, we categorize it as a "control fraud." Financial control fraud's weapon of choice is accounting. Accounting control fraud's exceptional "profits" render "private market discipline" perverse. It produces a Gresham's dynamic in which CFOs that optimize accounting profit maximize their CEOs' compensation, while honest CFOs report dramatically lower (but real) profits and their CEOs receive far less compensation. The accounting control fraud optimization strategy hyper-inflates and extends the life of financial bubbles, which causes extreme financial crises.

We have to take accounting very seriously; things have actually gotten worse since the crisis. We've covered it up, and done nothing about one of the primary drivers: loss reserves. Both GAAP and the International Accounting Standards mandate that we put aside more loss reserves. The fundamental disconnect with making capital requirements the pillar of banking regulation is that "capital," "net worth," and "equity" are accounting concepts. They have no meaning outside of accounting.

Worse, they are all residual accounting concepts. Accountants do not, and cannot, count a modern bank's "capital." They determine assets and subtract liabilities to determine capital. The implication of that is that the accuracy of reported "capital" depends on the accuracy of the valuation of every asset and liability. This means that capital is not only an accounting concept, but that it is the accounting concept most subject to error. For a large bank, there are literally tens of thousands of ways to use accounting to distort reported capital by enormous amounts.

All of this means that accurate accounting is essential for banking regulation premised on capital requirements to succeed. The Basel process relies primarily on capital regulation, but ignores the accounting games that allow banks to create their reported capital. Bank examination and supervision, globally, puts only minimal emphasis on accounting in the era leading up to the crisis.

There is no serious movement to change that. I don't think economists even know it exists as an issue. They talk about prompt corrective action, but prompt corrective action is inherently an accounting concept. We have, again, thousands of articles about how we should raise the capital standards; but they're meaningless without the accounting rules being fixed, and I see no movement there on the paradigm other than in the wrong direction in terms of the cover-up.

Another area that makes things highly criminagenic is professional compensation — not for executives and CEOs, but at a lower level. The bonus incentive structure creates a deliberate Gresham dynamic; when cheaters prosper, markets become perverse and they drive honesty out of the market. This creates appraisers who are willing to give inflated appraisals. How often were they able to get this? Essentially in every case, and to the tune of more than a million cases a year. How often were they able to get clean audit opinions for massively insolvent institutions? Virtually every time, at large places. How often were they able to get a triple-A rating for the top tranche of stuff that in my era was called toxic waste? Stuff that was D-minus at best was triple-A rated every single time! As long as the CEO gets to hire and to fire these people, and decide on the compensation, they can create this Gresham's dynamic time after time.

William K. Black

Vast amounts of income are absolutely guaranteed for the CEO. There are no serious efforts to get this into the economics canon. Well, there are some — mostly people who are here in this room. I know Romer and Ackerlof are quite supportive of our efforts, but not much is happening.

We still have the twin fictions: private market discipline and reputation. Private market discipline is a complete oxymoron when you deal with these kinds of institutions. If you report record earnings and you report next to no losses as a major corporation, it isn't hard to borrow money. You have to protect yourself against bankers trying to talk to you at every minute, to lend you money. They are throwing money at you, which is what creates the leverage, after all. That's why these places are so highly leveraged — because they are easily able to borrow vast amounts. Then there is what I call the "reputational trump." It's still in most of the literature; it doesn't matter if there are conflicts of interest, because no auditor would ever give a clean opinion to a fraudulent institution, because their reputation is so valuable.

Again, we've run real-world tests of these things. They've all been falsified repeatedly, but we see no major assault on this in economics, no major change. Without private market discipline, and without reputation as a trump, all the things underlying modern finance are gone. You don't have an efficient market; in fact, you have the market that is the opposite.

I'll leave you with this: we have produced negative Pareto optimality, and we did so to the tune of millions of transactions, where both principles were made worse off. The lender was made worse off, and the borrower was made worse off. The agents — oh, they made out like bandits.

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L. Randall Wray

I first want to address the question that Jamie raised as the title for this panel: the Pressures on the Paradigm, or discipline. I think the biggest pressure is coming from outside the discipline. The Queen of England asked, "How come none of you guys saw this coming?"

Why is it that economists were particularly clueless? Certainly none of the mainstream economists saw it coming, although many people outside the discipline did. I would argue that everyone on Wall Street saw it coming, planned for it, in fact wanted it; they got exactly the result they wanted.

I think the main reason economists didn't see it coming is because they don't understand money. They don't understand financial institutions, monetary policy, the relation of a sovereign's money (or state money) to fiscal policy. Not only did they not see the crisis coming; they cannot formulate any kind of policy that will get us out of this crisis. The whole deficit hysteria reflects a complete misunderstanding of the relation between fiscal policy and the sovereign currency.

There are five things missing from the mainstream macroeconomic approach to these areas:

1) Money is not a unit of account. By unit of account, I mean the mechanism by which debits and credits are measured; how do you keep score? Money is usually a commodity that we choose as the numeraire to measure all other commodities.

2) The sovereign nature of money doesn't exist in their theory. Money is intimately linked to the sovereign power. The mainstream story is like Robinson Crusoe and Friday using seashells, a commodity money that has no relation to the state.

3) Money is not interpreted as an IOU. It's something that exists as an asset, but it's nobody's liability. They don't have it as part of balance sheet operations. You've got to have at least two balance sheets, at least four entries, every time money is injected into the economy.

4) In their understanding, finance is not a scarce resource. We can have as much of it as we want. A lot of the "innovations" that Bill Black talked about are designed to increase the supply of finance as if it were a scarce commodity, but it's not. It's an IOU; we can have as much of it as we want. In fact, we have far too much finance.

5) There's no probability of default; it's ruled out by assumption in all rigorous macroeconomic models. The problem is that when you get too much of it, you start getting defaults.

What's the alternative? We begin with money as the object of production.

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L. Randall Wray (continued)

Money is not a commodity, however; it's an IOU. The purpose of production is not to accumulate a whole bunch of money, but to obtain credits on others, other people's IOUs. The problem is that you can get these claims without producing anything. That's what financialization is all about.

My solution is to reorient the financial system, to get finance to serve both a public and a private purpose, and to reduce the financialization of the economy. The specific orthodox macro theory that needs a stake driven through its heart (or a bullet through its zombie head, or whatever metaphor you want to use) is the new monetary consensus. It's just an updated new Keynesian version of monetarism, which completely misunderstands what money is and what monetary policy is all about. The idea is that inflation slows growth, so you have to diligently fight inflation. The Fed is going to keep inflation expectations low, which will keep inflation low, and that will keep growth robust.

There are three links in that statement, each of which is an illusion. The Fed supposedly manages expectations by convincing markets that it controls inflation, and so as long as it controls expectations, it controls inflation. But if it can't control expectations, it can't manage inflation, and all bets are off. That's the flimsy reed that they hang public policy on. We've pretty much abandoned fiscal policy, so all we have is monetary policy, and this is all it is. It's all based on controlling expectations that are supposed to control inflation, supposed to give us robust growth. It doesn't work in the real world.

First, why should low inflation generate robust growth? There's no theory behind this, and there's no empirical evidence. In fact, all the empirical evidence goes the other way. There is no negative impact on growth from inflation below 40 percent, according to orthodox empirical studies. So that link does not exist.

Second, out in the real world, expectations alone can't govern any economic phenomena. Inflation expectations will determine actual inflation only if those with ability to influence prices can act on those expectations. Let's take the current experience as an example. The Fed, through QE2, is buying $600 billion worth of government bonds. This is an application of the new monetary consensus. Ben Bernanke supposedly is injecting trillions of dollars into the economy to create expectations of inflation, and this is to counter the real world deflationary pressures. Creating expectations of inflation is working! We've got wing nuts running all over the country arguing we're going to get hyper-inflation. He has successfully created expectations of inflation, but labor and oligopolous monopolies with the power to set normal prices are unable to raise wages or prices in the current environment. Workers can't, because they're competing in a global economy with low wage pressure. Effective demand is so low that firms can't raise prices.

The purpose of production is not to accumulate a whole bunch of money, but to obtain credits on others, other people's IOUs. The problem is that you can get these claims without producing anything. That's what financialization is all about.

There's no way to act on those expectations, which means we can't get inflation, so "quantitative easing" is nothing but a slogan. It has no real world impact at all; all we're doing is reducing bank income. We're taking treasuries off their balance sheet, which admittedly they're paying very low; but we're replacing those with reserves that pay 25 basis points. How is that supposed to get us out of this crisis, and generate inflation? It won't. There is no operational mechanism that allows a bank to lend reserves, and having excess reserves does not encourage them to make loans. They already have one trillion dollars in excess reserves. They're not making loans; adding another $600 billion is not going to do it.

Finally, the last thing you could possibly hang your hopes on is that QE will lower long-term interest rates. With QE2, the Fed is only going to buy federal government debt. So the best-case scenario is they might lower the interest rate on long-term federal government debt by 18 basis points, and probably much less than that for private assets. Why on earth would that have any impact on the economy? There's no reason to believe that QE is going to have any positive impact.

I want to read my favorite quote from a Galbraith — not this one [James]. I think it nicely summarizes this orthodox view of the power of the central bank. "…Quiet measures enforced by the Fed are thought to be the best approved, best accepted, of economic actions. They're also manifestly ineffective. They do not accomplish what they're presumed to accomplish. Recession and unemployment or boom and inflation continue."

So here is our most cherished and, on examination, most evident form of fraud. The power — that orthodoxy, and policymakers, and unfortunately a lot of liberal and left-leaning economists, believe — that the Fed holds is a fraud. It doesn't have these powers. It doesn't have the kinds of effects that people want to impute to it.

In conclusion, even if the early postwar Keynesian economics had little to do with Keynes, at least it bore some relation to the real world. What passed for macro on the precipice of the economic collapse in 2007 had nothing whatsoever to do with reality. It's like asking flat-earthers to do the navigation for NASA. Would you expect them to be able to have the shuttle re-enter and land where you want it to land? Of course not, and there's no reason to believe that orthodox economists would ever foresee a crisis coming. Because of the five things that are left out of their approach, it's impossible for them to foresee a crisis.

L. Randall Wray

If we want theory that could foresee crises, it must bear some relation to reality. Of course, such theories do exist; it's just that they're outside the mainstream of the discipline.

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Marshall Auerbach

I need to say up front that I am a financial markets practitioner, but I'm not one of the people that created the toxic products that caused the problems in the first place. I actually still believe that finance is there to provide for productive uses in the economy — not for buying insurance on another person's home that you then burn down.

Real-world examples provide multiple illustrations that there are ample pressures on the paradigm. Just ask any person who lives in Ireland, Greece, Latvia, Estonia, and they would tell you that the way these things are written in textbooks doesn't really work.

Those pressures unfortunately do not extend to the policymaking elite. We had a brief period in the aftermath of the crisis where all of a sudden the primacy of fiscal policy was reaffirmed and fiscal policy was deployed very aggressively, and it helped to arrest the worst aspects of the crisis. Unfortunately, it wasn't deployed aggressively enough; those of us who are supporters of fiscal policy are in the invidious position of trying to argue a double negative. In essence, we're trying to say yes, it worked; but it could have worked so much more effectively. If not for the actions taken by various governments, we would have had substantially higher rates of unemployment. That's very hard to prove, of course, so our opponents — particularly those who are now leading the House of Representatives — say government spending was all a waste of money; we still have double-digit unemployment, so it was just a big waste of time.

Let me put my cards out on the table right away. As Bill Black says, a lot of this deficit cutting hysteria is dogma, nothing more. My own belief — not a popular notion within the financial markets, I can assure you — is that deficit cutting, whether now or in the future, is never a legitimate policy goal for a sovereign nation. Deficits are mostly endogenously determined by the performance of an economy. When an economy is doing well, tax revenues rise, the automatic stabilizer payments go down, deficits come down; it works like clockwork.

Some of our allies on the left believe we can still do stimulus now, as long as we plan to reduce it later on. It's something akin to Saint Augustine's "Oh Lord, make me chaste, but not yet." Of course, people on the Right hear this and say, "If deficit reduction in the long term is a good thing, why don't we start doing it right now? It seems to make a lot more sense." Well, we have real-world examples of the results when done too soon.

I like to use the UK as an example because, in contrast to many of the nations in the Eurozone, the institutional structures are very comparable to the US. A sovereign nation with full freedom of fiscal action doesn't want to deploy it, because the argument is it may end up being another Greece or Ireland. Of course this is nonsense, because Ireland and Greece are no longer issuers of their own currency; they surrendered that power when they entered the European Monetary Union. They are in effect more in the position of states, say like Colorado or California. They're users of currency with constraints that the UK government doesn't face.

Unfortunately, because the UK takes the view that they are likely to become more like Greece if they don't do something about their terrible budget deficit, they have actually started to act on that mistaken paradigm. Surprise, surprise: the economy, after doing reasonably well in the aftermath of the financial crisis, has started to slow down. One has to admit that Gordon Brown and Tony Blair surrendered too much to the forces of finance and, I think, made huge mistakes. However, one has to commend the approach taken by the government of Gordon Brown, in the aftermath of the crisis: they let the currency fall, and they ran a large budget deficit. Lo and behold: unemployment actually stabilized around 6.9 — 7 percent. Their economic performance in the aftermath of the crisis was, in reality, much more coherent and cogent than ours. They partially nationalized their banks, which now puts them in a position where they can restructure these banks, shrink

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Marshall Auerbach (continued)

them, and make them a far less destructive force in the economy. Whether they do that is another matter.

The indications regarding their conduct of fiscal policy now are not very encouraging. The June [2010] budget statement included significant cuts in fiscal expenditures. Now unemployment is up to 7.9 percent. Again, instead of the public sector providing employment leadership at a time when the private sector is not yet ready to expand jobs growth, the British government has been cutting jobs and forcing unemployment up. As the austerity drive deepens — including raising taxes and government cuts — I suspect that you'll see further deterioration in the economy.

We're seeing elements of this in the European Monetary Union as well. The solvency issues surrounding countries like Greece, Portugal, Ireland, etc. have been stabilized [as of January 2011] at a cost of huge fiscal transfers from the European Central Bank. That's the only reason why these countries have not actually become insolvent. The European Central Bank adamantly announced that it would not create new net financial assets by backstopping the Euro bonds, for fear that it would be inflationary, despite a 20 percent unemployment rate in Spain, 45 percent youth unemployment, and double-digit unemployment rates across the continent.

Kicking and screaming, the ECB has actually been put in that position, and managed to contain these solvency problems successfully. Of course, they've done so at a cost of constraining future aggregate demand; they have said, "Yeah, we'll backstop the bonds, but you have to stop spending money. Reduce your deficits." That applies to any bonds the Greeks have bought. The Irish taxpayer is taking a major hit for bailing out their banking system. Foreign creditors and the bondholders are not paying anything. It's an outrage. This is the same sort of situation we have in the US.

The only country that hasn't done this is Germany, which is doing extremely well. German exports are booming and if you look at their data, contrary to the lectures that they give to the rest of us about fiscal profligacy, they have not cut back on fiscal expenditure at all. In fact, despite the worst of the global financial meltdown, Berlin pumped tens of billions of Euros into the economy and spent hundreds of billions of Euros propping up German banks. Now the country is reaping the benefits. Germany is once again Europe's economic motor: partly because they haven't been cutting back their spending like the rest of us, and partly because all of the rest of us shameless profligates are actually using money to buy their exports. By accounting identity, running large current account surpluses allows them, in turn, to run smaller government deficits.

After three years of pent up non-consumption, [households] have begun to spend on essentials again, creating a short-term dynamic in favor of economic growth. It obviously can't continue.

Accounting is something that doesn't enter into the mindset of the economics profession. I look at balance sheets all the time. It's a basic accounting identity that the economy is divided into three major sectors: the domestic private sector, including households and businesses; the government sector; and the foreign sector. If households attempt to net save by spending less than they're earning, and businesses attempt to net save by reinvesting their retained earnings, the nominal incomes and real output are likely to fall in the absence of some counterbalancing action by the other entity on the balance sheet. Whenever people tell me that fiscal austerity or deficit cutting is an unalloyed good, I say, "Okay, fine: where are you going to offset the resulting losses in incomes and savings?" They seem to think that somehow, if we cut back government spending, we'll rekindle the animal spirits of the private sector. It doesn't work that way because you're destroying aggregate demand. The private sector takes its response from that, and they want to net save even more, setting off this great debt deflation cycle. That's what's happening in the UK, and what's likely in store for the US. We'll probably have the first taste of it when with this debate over extending the debt ceiling, one of the stupidest legal constraints imaginable. Many are now suggesting that the Republicans' House should increase the debt ceiling, in exchange for spending cuts.

The current situation is actually pretty reasonable largely because, thanks to the government budget deficit, households have been allowed to replenish their balance sheets and household savings to some extent. Now, however, they are suffering from what I call savings fatigue. After three years of pent up non-consumption, they have begun to spend on essentials again, creating a short-term dynamic in favor of economic growth. It obviously can't continue. Unless the private sector picks up the baton at some point, I think we will be inherently constrained by household debt levels.

The question for the future is, are we going to see pressures on the prevailing paradigm? Or is the GOP House, led by some of their so-called moderate Democratic allies, going to follow the trend that we're starting to see take hold in Europe and in parts of Asia as well? Or will we actually see another situation?

Marshall Auerback has 28 years of experience in the investment management business, currently serving as a global portfolio strategist for Madison Street Partners, LLC, a Denver-based hedge fund, and as corporate spokesman and director for Pinetree Capital, a Canadian-based investment, financial advisory and merchant banking firm focused on investing in early stage micro and small cap resource companies. He is also a fellow of Economists for Peace and Security.

Jan Kregel

I'd like to start out, in response to the challenge for the session, by noting that already — in the late 1950s — Hyman Minsky had pointed out that, as long as you had a theory in which there was no possibility of crisis, it was difficult to understand why crises would emerge.

Those of you who are as old as I am will remember a famous NBER conference where the potential end of the business cycle was discussed. Hy was especially incensed by this particular proposal. He argued that even if we did manage to stabilize the real system, the financial system would still be capable of producing business cycles; that even if we set up monetary and fiscal policy in a way that did manage to generate full employment, and did manage to generate stable growth over time, we would not rid ourselves of the problems of potential instability. We need an alternative theory in order to do that. Unfortunately, as long as the neoclassical synthesis Keynesians could argue that fine-tuning could keep the economy running, nobody was much interested in looking at the impact of the financial system, despite the fact that we continued to have many financial crises throughout this period.

Based on those early writings, Hy actually predicted the credit crunch of 1966, and subsequently we've had financial crises throughout the '70s, '80s, and 1990s. It's interesting that as early as the 1960s, Hy already predicted that one of the weak points in the system would in fact be in financing real estate. If you remember 1980, we did have a real estate crisis, and we've now had another one, which probably will not be the last, unless we manage to generate a whole lot more pressure.

What is the reason that this pressure doesn't seem to have much impact? Why do people fail to take this financial aspect seriously? Look at the way the financial system, or the banking system, enters into the traditional neoclassical synthesis' circular flow: we stick households over here, and we put firms over there, and we draw wages going one way, and we draw output and consumption going the other way, then we add in the government and its expenditures, and finally, we put the banking system here, to intermediate between savings and investment. Somehow or other, the financial system is the thing that takes those savings from being something that the households would like to have on a short-term basis and converts them into something that firms want to have on a long-term basis. In this process, we look at the banking system as a transmission mechanism, or something that exists in that circular flow.

We have really failed to understand how banks operate as commercial enterprises. If we look at the so-called traditional approach to banking, the old "originate and hold" idea was basically what we would call spread trading. Banks were trading on the spread between active and passive interest rates, and the profits financed productive activity. A banker in the old traditional approach maximized profits by keeping loan losses to a minimum. Loan losses were kept down to a minimum by doing very, very good credit assessment.

Unfortunately, the new "originate and distribute" banking system basically attempts to convert high-risk assets into low-risk assets — sort of the opposite of what a traditional bank did — and then tries to sell those low-risk assets to the general public. The way to maximize income here is by ramping up volume, so that the banker must sell as much as he possibly can; he has to go out and generate business. Instead of the old traditional banker sitting there waiting for somebody to come in and convince him that he should lend money, now the banker has to go out and find somebody to lend to.

Irving Fisher said that capital gains are not income, that they are fictitious and cannot be spent. Competition for customers in banking basically converts capital gains into income. When bankers seek out new clients, they're seeking out new ways to convince people that expected capital gains — that is, capital gains that have not yet occurred — can be converted into present income, and that present income can, in fact, be spent. This is more or less what happened in the sub-prime mortgage market. Borrowers were told that their house prices were going to increase by "x" percent per year, that they would have absolutely no problem meeting their mortgage payments, so that they could take the money from the bank and spend it.

Virtually every aspect of the recent financial crisis has been in some sense this sort of conversion of expected capital gains. Mergers and acquisitions are the act of buying a company that has some sort of potential for an increased capital gain, and converting that capital gain into current income. Now the banker simply has to convince somebody to put up money, he takes the fee and commission, and this becomes their increased earnings. If those expectations turn out to be false, well, the income has already been spent.

The problem is that you have created a position in which people can no longer meet those outstanding debt commitments, and Fisher turns out to be absolutely right. Those capital gains, which had been expected and converted into income, in fact did not exist. This brings us back to what Bill Black said: most accounting frauds end up creating some sort of fictitious change in asset prices, which is converted into income, which then goes down into the bottom line, and then manages to generate the profits that create the bonuses for the

Continued on page 10

Jan Kregel (continued)

guys who are setting up the accounting schemes.

Instead of looking at banks as financial intermediaries, we really should be looking at banks as viruses. Normally, viruses don't impose a threat on society. If it is really efficient, it ends up killing its host, so most viruses don't create international plagues. They don't create systemic problems. The difficulty is that before the 1999 Financial Services Modernization Act, we had a system in which viruses were constrained to a particular set of institutions — the FDIC. We could allow those institutions to die. But when we got rid of that system and allowed banks to go into what are basically bank holding companies, or to do certain types of banking activities, it meant that a virus that was created in the system now could be propagated. Inasmuch as people say that the risk of SARS is created by globalization and travel, I would say the Modernization Act has allowed banks to intermingle and viruses to spread very quickly.

If something is going to be done to change the system, it has to change the 1999 Act. Every piece of financial reform discussion that we have had so far leaves that Act more or less intact. Nobody is talking about repealing bank holding companies because they give the banks the opportunity to engage in this sort of competition. They give them the opportunity to use those gains to influence politicians, to prevent them from actually allowing the system to get to its weakest point. That, in turn, creates this possibility for the propagation of viruses or the kind of accounting fraud that Bill Black was talking about. The infiltration of the financial system into the political process, and the use of the financial gains that the financial system has produced by influencing that process — in making sure that there is no pressure on the paradigm, or the way that we look at the way the financial system — impacts the economic system.

Jan Kregel is a senior scholar with the Monetary Policy and Financial Structure program, and currently holds the position of Distinguished Visiting Research Professor at the Center for Full Employment and Price Stability, University of Missouri – Kansas City. He is rapporteur for The Commission of Experts of the President of the UN General Assembly on Reforms of the International Monetary and Financial System. He was chief of the Policy Analysis and Development Branch of the United Nations Financing for Development Office and deputy secretary of the UN Committee of Experts on International Cooperation in Tax Matters. Before joining the UN, Kregel was professor of economics at the Università degli Studi di Bologna, as well as professor of international economics at Johns Hopkins University's Paul Nitze School of Advanced International Studies.

James K. Galbraith, Panel Moderator — Closing remarks

I want first of all to say thanks to the panelists. It's clear that EPS has a very deep bench, because even with two substitutions on this panel we managed to come up with a very clear and coherent sequence of arguments that ran from accounting, to money, to deficits, to the structural instability of the financial sector, the structure of banking.

I will arrogate to myself as chairman the chance to make the first comment and ask the first question. As I listened to the arguments, I questioned whether there was anything truly important that's being left out of the analysis so far. I do have one thought along those lines.

Just to frame that thought, I think it's worth going back to remember that, at the period just before the peak of the financial crisis, there was something else quite important going on in the world economy: a major run-up in oil prices to $140 a barrel. A number of us met in Paris in June of 2008; at the time, the run-up in oil was at least as much on our minds as the impending apocalypse in the financial sector. Of course, by the time the crisis broke, the oil price had subsided, so all attention focused on the financial aspects of the crisis, and that has continued.

It does, however, raise a question whether the possibility of a strong recovery is impeded or perhaps even foreclosed by the exceptional potential for the elasticity of resource costs. This is an environment where resource costs are likely to go higher and higher — with effects running from the energy sector to other commodities, to food in the Third World, which is already proving to be a significant problem. The issue that I think has not been addressed, and probably should be addressed, is whether there is a systematic further relationship between the change in our geophysical environment and the potential for effective profitable recovery of the private sector.

I think if that is a reasonable argument, it indicates the need to consider the most effective way to mitigate that problem, if it in fact can be mitigated. What institutional changes are needed to make sure that a possibility for recovery is not choked off, time and again, by a speculative run-up of prices in the commodities sector?

James K. Galbraith teaches economics and a variety of other subjects at the LBJ School of Public Affairs. He holds degrees from Harvard (BA magna cum laude, 1974) and Yale (PhD in economics, 1981). He studied economics as a Marshall Scholar at King's College, Cambridge in 1974-1975, and then served in several positions on the staff of the US Congress, including Executive Director of the Joint Economic Committee. Dr. Galbraith serves as Chair of the Board of EPS.

The complete transcript of this session, with further comments from the panelists and questions from the audience, is available at www.epsusa.org/events/aea.htm.

Please see Dr. Galbraith's article on page 12.

The Myths of the Market

Paul Cantor

"Greed is good," said Gordon Gekko, played by Michael Douglas in his academy award-winning performance in the Oliver Stone movie *Wall Street*. "Greed clarifies, cuts through, and captures the essence of the evolutionary spirit."

"Not so!" say the hodgepodge of individuals occupying Wall Street. Indeed, if there is one single issue they agree upon, it is that greed is responsible for our current economic morass — and they are right. Greed led Wall Street traders to mislead their customers about the risk of the assets they sold them. That in turn led to the 2008 market crash and the worst economic crisis since the Great Depression.

Nevertheless, the view that greed is good continues to resonate with many because it is consistent with Adam Smith's observation in *The Wealth of Nations*: in a market economy, individuals are "led by an invisible hand" to promote the interests of society. The baker, for instance, doesn't bake bread to mitigate hunger. She bakes bread in order to exchange it for money she needs to purchase other goods, yet hunger is eliminated just the same.

But because their goal, like Smith's before them, is to make the case for fewer government regulations, Gordon Gekko and other miracles of the market mythmakers fail to point out that the invisible hand is also responsible for the kind of malfeasance that led to the Great Recession. To further their case, they have a mantra that includes, along with that of the invisible hand, the myth of consumer sovereignty. The mantra is that an individual's income is a measure of her contribution to society, that market economies breed democracy, and that markets — when left to themselves — lead, in the words of one economic textbook, to "the particular mix of goods and services most highly valued by society."

> **[T]hose who have the most dollars have the greatest say in determining what is produced, and the greatest ability to pay lobbyists and bankroll the campaigns of favored politicians.**

Consumer sovereignty is the idea that, in market economies, consumers determine what is produced. Hence, we should not blame the bankers and Wall Street traders for selling us a bill of goods and walking away with our money while we lost our homes and our savings went up in smoke. They were just giving us the loans and mortgage-backed securities we asked for. Of course that is not true, if they were lying about the risk embodied in the assets they were selling.

The myth that an individual's income is a measure of her contribution to society, furthermore, is belied by the fact that a world-class athlete like Serena Williams earns many millions while a world-class high school science teacher earns a tiny fraction of that amount. And the myth that markets breed democracies is belied by the fact that the highly unequal distribution of income (and wealth that results when markets are left alone to allocate resources) undermines democracy.

After all, the democratic ideal is one-person, one vote; but in the market it is one dollar, one vote. Hence, those who have the most dollars have the greatest say in determining what is produced, and the greatest ability to pay lobbyists and bankroll the campaigns of favored politicians.

Finally, what about the myth that markets lead to the production of those goods society values most? Ask yourself whether people would mind trading some of the automobiles we produce for better public transportation systems.

"These kids just don't understand how the world works," said the Wall Street Journal columnist Stephen Moore on Fox News, referring to the Occupy Wall Street protesters. In fact, the protesters understand the question Gekko was addressing when he made his "greed is good" speech better than Moore and others for whom the myths of the markets are gospel.

Economists call it the principal/agent problem. Think of our country as USA Inc. We are the owners or principals. Our elected representatives are our agents. We want to design an incentive-compatible set of rules to ensure our agents act in our interests, and not just the interests of a small group of Wall Street traders and wealthy benefactors who have made out like bandits while we have lost jobs and homes. That is the message, pure and simple, that the Occupy Wall Street protesters are sending the rest of the world.

Paul Cantor is a professor of economics, human rights activist, and EPS member who lives in Norwalk, Connecticut.

This article originally appeared October 13, 2011 on the CounterPunch.org website.

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Europe on the Brink

James K. Galbraith

Athens this October was a city on the edge, and not just because of the protests. Rather it was the empty storefronts, the addicts sprawled on the sidewalks, the beggars and the squeegee men that caught my eye. There was the polite conversation with working professionals about their 40% pay cuts, their escalating taxes, and moving their money out of the country while they could. The data show total output falling at a 5% annual rate, but specialists are sure the final figures will be worse. The business leaders I spoke with all said there is no hope at all.

Greece is a country with weak public institutions that are being destroyed. It is a country with fairly low wages that are being driven down. The government has accepted the terms imposed upon it, but the cuts and tax increases are never enough. The "troika" comes back time and again for new measures, such as breaking the national wage bargain or (as I heard) using up funds held in reserve to protect the banks. Looming in the background is a plan to place all of Greece's public assets under private management from abroad. Though floated by a consultant, this was described to me, by a high European official, as the "secret German plan."

It is obvious that nothing happening today in Greece will produce economic recovery or forestall default. On the contrary, even though the Greek government refuses to take the step of defaulting, it will be forced into that position whenever the Germans and French pull the plug on new loans, as they are plainly preparing to do. Meanwhile, they are punishing Greece and the Greeks — not for any specific crimes, but to make sure that when Greece is permitted to default and restructure, peripheral countries (especially Italy) will not be tempted down the same path. This is called "ring-fencing." It is also called the principle of collective guilt, destroying the livelihoods of 13 million people for political reasons.

> **It may be that Europe's leaders place their political survival in first place, the survival of the European project second, and the people of the periphery dead last.**

This is economic policy as moral abomination. It is not designed to succeed as economics, and it will fail as object lesson as well. What it may achieve is stringing out the destruction, as it proceeds eventually from Greece to Ireland and on to other countries, so that the effect of the popular rebellion now getting under way does not shake the foundations of the Eurozone. But then again, maybe it won't even do that.

There are technical solutions; these were discussed and debated at a workshop at the LBJ School on November 3 and 4, sponsored by the European Center of Excellence, with participation from faculty in the Government Department. These proposals involve European bonds, bank recapitalization and an investment program. The obstacles, however, are political, insofar as important constituencies in Germany and France oppose them. They are also financial, insofar as they would require recognition of losses to European banks that the banks would like to deny. The issue, therefore, is whether political leadership in Berlin and Paris is interested in technical solutions. It may be that Europe's leaders place their political survival in first place, the survival of the European project second, and the people of the periphery dead last.

That being so, it is only a matter of time before desperate populations erupt in revolt, forcing a change of course — or a crack-up.

James K. Galbraith holds the Lloyd M. Bentsen Jr. Chair in Government/ Business Relations at the LBJ School, and a professorship in the Department of Government. He recently returned from a lecture tour to Greece, Austria, Switzerland, France and Ireland.

This article was originally published in the November 2011 issue of Goodbye & Good Luck! *– a newsletter for the University of Texas at Austin Department of Government Alumni and Friends.*

From Project Syndicate's Unconventional Economic Wisdom Series: The Price of 9/11, by Joseph E. Stiglitz, September 1, 2011

"The September 11, 2001, terror attacks by Al Qaeda were meant to harm the United States, and they did, but in ways that Osama bin Laden probably never imagined. President George W. Bush's response to the attacks compromised America's basic principles, undermined its economy, and weakened its security.

"The attack on Afghanistan that followed the 9/11 attacks was understandable, but the subsequent invasion of Iraq was entirely unconnected to Al Qaeda — as much as Bush tried to establish a link. That war of choice quickly became very expensive — orders of magnitude beyond the $60 billion claimed at the beginning — as colossal incompetence met dishonest misrepresentation."

Read the full article at http://www.project-syndicate.org/commentary/stiglitz142/English.

An Evening with Alan Blinder


On November 16, EPS friends and members gathered at the home of Kathleen Stephansen to hear Alan Blinder speak on the economic situation in Europe and its possible ramifications for the US. Unfortunately, Dr. Blinder was unable to present a very optimistic picture, predicting that the solution which would work best is not politically feasible. A very interesting discussion ensued debating the possibility of “bailouts” by the European Union, and/or the European Central Bank buying sovereign debt.

Alan S. Blinder has been on the Princeton faculty since 1971, taking time off from January 1993 through January 1996 for service in the US government — first as a member of President Clinton’s original Council of Economic Advisers, and then as Vice Chairman of the Board of Governors of the Federal Reserve System. In addition to his academic writings (books, academic articles) and his best-selling introductory textbook, he has written many newspaper and magazine columns and op-eds and, in recent years, has been a regular columnist for The Wall Street Journal*. He also appears frequently on television on PBS, CNBC, CNN, Bloomberg, and others. Dr. Blinder is a Distinguished Fellow and past vice president of the American Economic Association, a past president of the Eastern Economic Association, and a member of the American Academy of Arts and Sciences, the American Philosophical Society, and the American Academy of Political and Social Science. Dr. Blinder is a Fellow of Economists for Peace and Security, and was chair of the host committee for the EPS dinner in honor of William Baumol at the AEA meetings in January of 2007.*


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Please make every gift count this holiday season. You can find coupons for more than 1,600 top stores (including Amazon, Macy's, J. Crew, Toys "Я" Us, Best Buy, Gap and more). A percentage of virtually every sale will be donated to EPS. Just go to GoodShop.com, designate EPS as the cause you support, then click over to your favorite store and shop away! Or, add the toolbar to your browser at http://www.goodsearch.com/toolbar — and your purchases will earn a donation for EPS even if you forget to go to the GoodShop site first!

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INTERNATIONAL NETWORK FOR ECONOMICS AND CONFLICT

The International Network on Economics and Conflict (INEC) is a comprehensive one-stop web tool for practitioners of economic development working in fragile states. The website offers information on the latest research and policy in the field. It was designed and developed after research and consultation concluded that there was a gap in resources for development practitioners working in fragile states, which presents a different set of challenges and concerns than traditional economic development.

Features:

- Resource Library: Provides links to hundreds of papers, reports and case studies and dozens of relevant videos, including interviews with development practitioners returned from work in conflict-affected regions
- Blog: Allows users to read blogs written by regional and area experts and interact by requesting general blog topics or asking specific questions of our expert bloggers
- Online Events: Hosts interactive online events which enable site visitors to engage expert panelists and contribute to discussions on timely topics related to economics and conflict
- Wiki: Includes a list of outside websites with useful information to INEC users, a glossary of terms relevant to development practitioners in fragile states and a reading guide for those interested in business and peace
- Events: Lists events, mostly in the Washington DC area, that might be of interest to users

Join EPS in partnering with INEC — be part of the solution with the INEC community.

If you are interested in connecting with INEC, please email your contact information to site moderator Michelle Swearingen at mswearingen@usip.org.

For further information on the INEC, please contact Raymond Gilpin by e-mail at rgilpin@usip.org, by phone at (202) 429-4724, or visit http://inec.usip.org/.

UPCOMING EVENTS

• **January 5 – 8, 2012** Annual meetings of the Allied Social Sciences Association and American Economics Association in Chicago, Illinois. EPS will present two panel discussion sessions on Friday, January 6.
The EPS Dinner in honor of Robert J. Gordon will be held Saturday, January 7.
Details can be found on the back page of this issue, or at the EPS website's events page: http://epsusa.org/events/events.htm.

• **January 13–14, 2012** Eurasian Peace Science Conference at Koç University in Istanbul, Turkey. The Conference's goals are to broaden cooperation among Eurasian and Middle Eastern peace science scholars, encourage interaction with the worldwide peace science community, and bring together research on conflict and peace-related topics from throughout the world.
To find out more, visit http://conflictstudiescenter.ku.edu.tr/call.html.

• **March 9–11, 2012** Eastern Economic Association 38th Annual Conference will be held at the Boston Park Plaza Hotel, Boston, MA. The Eastern Economic Association is a not-for-profit corporation whose object is to promote educational and scholarly exchange on economic affairs. Towards that end, the Association encourages the freedom of research and discussion.
Further information about the conference is available at http://www.ramapo.edu/eea/.

• **June 21 – 22, 2012** The sixteenth International Conference on Economics and Security will be held in Cairo, Egypt, hosted by Economists for Peace and Security (Egypt), and the American University in Cairo.
Contact Hamid E. Ali: hali@aucegypt.edu for more information.

• **June 25 – 27, 2012** The 12th Jan Tinbergen European Peace Science Conference, and annual meeting of the Network of European Peace Scientists, will be held at the DIW Berlin, Department of Development and Security, Mohrenstr. 58, 10117 Berlin, Germany.
To find out more, go to http://www.europeanpeacescientists.org/jan.html.

CALL FOR PAPERS

The 12th Jan Tinbergen European Peace Science Conference, annual meeting of the NEPS, has announced a call for papers. All abstracts (150—250 words) with tentative title submitted before February 18, 2012 will be considered for the conference.
Proposals received after that date will only be considered if any presentation slots are still available.

For more details about this call for papers, visit
http://www.europeanpeacescientists.org/jantinbergen_call.pdf.

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Annual meetings of the

Allied Social Sciences Association and American Economics Association

January 5–8, 2012 in Chicago, Illinois

EPS will host two sessions:

The Economics of Regime Change

Friday, January 6, 10:15am, Swissotel, Vevey 2

Panel Moderator:
Richard Kaufman (Bethesda Research Group)
- **Roger Myerson (University of Chicago)**
- **Linda Bilmes (Harvard University)**
- **Hamid Ali (American University in Cairo)**
- **Jennifer Olmsted (Drew University)**
- **Mark Weisbrot (Center for Economic and Policy Research)**

Sustainability

Friday, January 6, 12:00–2:30pm, Swissotel
Grand Ballroom Salons I & II

Panel Moderator:
Michael Intriligator (University of California, Los Angeles)
- **Robert J. Gordon (Northwest University)**
- **Teresa Ghilarducci (New School)**
- **J. Barkley Rosser (James Madison University)**
- **Allen Sinai (Decision Economics)**
- **Richard Parker (Harvard University)**

EPS dinner in honor of Robert J. Gordon

Saturday, January 7, 6:30–10pm, Swissotel, St. Gallen 2 & 3
Allen Sinai and Richard Parker, host committee co-chairs

Please register by emailing Thea Harvey at theaharvey@epsusa.org

A complete program of the conference is online at http://www.aeaweb.org/aea/2012conference/program/preliminary.php