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Inequality-Led Financial Instability

A Minskian Structural Analysis of the Subprime Crisis

Abstract: The paper uses Minsky’s Financial Instability Hypothesis as an analytical framework for understanding the subprime mortgage crisis and for introducing adequate reforms to restore economic stability. We argue that the subprime financial turmoil has deeper structural origins that go beyond the housing market and financial markets. We argue that inequality has been the *real* structural cause of today’s financial markets meltdown. What we observe today is only the manifestation of the ingenuity of the market in taking advantage of money-making opportunities at any cost, regardless of macroeconomic and social consequences. The so-called “democratization of homeownership” suddenly turned into record-high delinquencies and foreclosures. The sudden turn in market expectations led investors and banks to reevaluate their portfolios, which brought about a credit crunch and widespread economic instability. The Federal Reserve Bank’s intervention came too late and failed to usher adequate regulation. All attempts to stabilize financial markets will be temporary fixes if the structural inequality problem is not adequately addressed. Finally, the

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paper argues that a true democratization of home-ownership is only possible through job creation and income generation programs, rather than through exotic mortgage schemes.

Keywords: financial instability, full employment, inequality, Minsky, real estate, subprime mortgages, Wall Street.

On June 17, 2002, President George W. Bush declared that “there is a home ownership gap in America. The difference between Anglo American and African American and Hispanic home ownership is too big. And we’ve got to focus the attention on this nation to address this” (White House 2002). The goal was to increase minority homeowners by at least 5.5 million by 2010. In August 2004, the White House produced a document surveying President Bush’s achievements. The document stated that “the US *homeownership rate reached a record 69.2 percent* in the second quarter of 2004. The number of homeowners in the United States reached 73.4 million, the most ever. And for the first time, the majority of minority Americans own their own homes” (White House 2004: 44, emphasis in original). Unfortunately, the short-lived increase in homeownership was followed by a record high foreclosure avalanche that has pushed the U.S. economy into one of its worst financial crises since the Great Depression. Billions of dollars in asset write downs, rising unemployment, sluggish economic growth, and record high oil and food prices all add up to the end of what has been termed “the democratization of homeownership.” This fictitious “democratization” was made possible only by a combination of factors: three decades of financial deregulation, a very low interest rate policy by the Fed, an aggressive lending strategy by mortgage companies and banks seeking fees and commissions, and a set of financial innovations allowing mortgage loan issuers to unload their loan burden onto Wall Street to be securitized and marketed without any serious supervision or regulation. All these factors, in combination with increasing household economic vulnerability, have resulted from a chain of what seem to be disastrous policy choices that have undermined income security and overall stability. As James Galbraith (1998) points out, from 1945 to 1970 economic growth was paralleled by state expansion of protection for vulnerable workers, followed by its withdrawal as a result of private interests and laissez-faire ideals entering public policy making on a global scale.

Expanding on the work of Hyman Minsky, we argue that structural inequality breeds financial instability. The stagnation of real wage in-

come for the economically disadvantaged households (typically non-homeowners) combined with ever increasing real estate prices meant that those households would never be able to achieve homeownership. Such households would only be able to buy homes under one of the following scenarios: (1) real income rise, (2) real estate prices decline, or (3) government subsidies (down payment assistance and low-fixed interest rates). Unfortunately, the rise in homeownership achieved in 2004 and 2005 was not due to any of the above scenarios. The “democratization” of homeownership was nothing but a fictitious increase in the demand for homes fueled by innovative financing schemes that misled residential real estate developers into increasing the supply of new homes and setting up the industry for one of its worst declines in decades. We argue that this fictitious democratization of homeownership has turned into a *real* democratization of financial turmoil that has spread beyond subprime borrowers and the herds of lenders who serviced them.

Mainstream Versus Minskian Explanations of the Subprime Crisis

The “Bubble and Exuberance” Explanations

In general, irrational exuberance, mania, or bubbles are the usual mainstream explanations for financial instability. These are expressions of failure of the agents in the system to behave rationally. Financial instability is presented as unusual to the market system, where individuals act rationally. In the present financial crisis, which started as a subprime crisis, these are offered as explanations too: exuberance on the part of the homeowners who knew they could not afford the mortgages they undertook and bubbles resulting from overpricing real estate property. Following this logic, the advice is to allow financial markets to learn the hard way by letting agents go bankrupt. The assumption is that most of the time there is natural stability in the system and that financial instability is a quite exceptional event in a capitalist economy.

Just the opposite is suggested by J.M. Keynes’s analysis of expectations about investment returns under uncertainty, the so-called animal spirits are a major element of the capitalist system. Expenditures on current investment represent an exchange of money today for money tomorrow under specific expectations about returns in the future. Under conditions of uncertainty, it is only natural that these expectations will

be disappointed (alternatively we would have rational expectations). In the context of the present financial crisis, Jan Kregel (2008b, 2008c), following Keynes, emphasizes the natural instability of financial markets. Similarly, L.R. Wray (2007) points out the importance of going beyond the bubble and exuberance explanations of financial instability and looking at the systematic conditions embedded in financial markets, including the role of economic policy, in validating behavior that enhances financial fragility. Says Wray,

Blaming the “bubble” for the current crisis is rather like blaming the car for an accident—when we ought to take a good long look at the driver and at the bartender who kept the whiskey flowing all evening before helping the drunk to his car after last call. . . . Unfortunately, those in charge of the financial system have long encouraged a blurring of the functions, mixing drinking and driving while arguing that the invisible hand of self-interest can keep the car on course. The current wreck is a predictable result. (2007: 5)

This predictability refers to the socially created conditions in financial markets and does not imply that we could do away with financial fragility but merely react through policy and regulation so that the economy does not slip into debt deflation of a depression magnitude.

A Minskian Explanation

Hyman Minsky’s (1919–1996) financial instability hypothesis is a theory of the impact of debt on investment and presents a model of a capitalist economy that does not rely on exogenous shocks to generate business cycles. The structure of a capitalist economy becomes more fragile over a period of prosperity, and an endogenous process leads to financial and, consequently, economic instability (Minsky 1992a). Minsky became somewhat visible even in the popular media, specifically in a *Wall Street Journal* article by Justin Lahart (2007). A number of post-Keynesians and institutionalists have pointed out the relevance of the financial instability hypothesis to the current situation (Whalen 2007; Wray 2007). Others have emphasized some differences between the present situation and Minsky’s financial instability hypothesis (Davidson 2008; Kregel 2008b, 2008c). Kregel notes the deterioration of the banker-borrower relation and the absence of the lender’s ability to evaluate risk. Furthermore, whereas Minsky was focusing on business enterprises’ investment, the current crisis is entrenched in household debt due to the larger ability to

securitize household liabilities. Minsky himself recognized the potential destabilizing effects of securitization as early as 1986–87 in a previously unpublished note that was recently released by the Levy Economics Institute (Minsky 2008).¹ The institutional evolutions in the U.S. financial markets and the expansion of securitization have been identified as systemic structural reasons for the present financial instability (Kregel 2008a–c; Minsky 2008; Wray 2007). Central is the 1999 Bank Reform Act, which allows banks to engage in a wider range of financial activities (blurring the distinction between commercial and investment banking) with a larger degree of deregulation (Kregel 2008a–c). Under these conditions banks offer and promote increasingly bolder financial innovations.

With the evolution in the banker-borrower relation, repayment of loans is no longer the major concern for banks, because interest payments are displaced by fees as a source of profits. The ability of banks to earn fees and commissions for loan origination, while at the same time escape the risk of default by selling the loan through securitization, is a major element of the current problem, as banks were not concerned with repayment of the loans but rather with the expansion of their markets and generating more fee revenues by originating new loans. In addition, the acceptance of credit rating agencies (which represent a conflict of interest) as a viable valuation mechanism for risk is a policy validation within the increasingly fragile financial system (Kregel 2008a).

The expansion of lenders' markets to increasingly less creditworthy borrowers began with "financial innovations" such as "interest-only" mortgages and "option adjustable rate" mortgages with low payments at the outset but skyrocketing monthly payments later. Real estate appeared to be a good investment, and relatively safe too, especially when compared with the dot-com investments. Unregulated mortgage brokers did not hold the loans and, thus, did not have a long-term relationship with the borrowers, so they were not concerned with their creditworthiness, because they worked for commissions. Because adjustable rate mortgages (ARMs) are highly profitable for banks, brokers received high commissions to generate those loans.

The desire of the banking industry to expand markets (or to "democratize" credit) and the incentives to push ARMs, coupled with the tendency to overvalue real estate on behalf of commission-driven home appraisers, provided the foundations of financial instability. This was particularly true in the face of increasing default risk from subprime lending and unmet expectations regarding the valuation of real estate assets.

Fragility is added to the system by banks that bundle mortgages into mortgage-backed securities (MBS) and sell them as a package to investment funds that used these MBS bundles as collateral for highly leveraged loans. The mortgages are bundled in a variety of risk classes so that buyers could choose some option of perceived risk to return ratio. Furthermore, these loans were increasingly used to buy more mortgage bundles. As a guide to the likelihood of default, the credit rating agencies rate the debt packages for the banks that sell them. However, the rating agencies get paid by the issuers of the securities, not by the investors, so there is pressure to give better ratings or else they face the danger of losing business to other rating agencies. Investors' motivations in purchasing such securitized assets were driven by optimistic expectations under conditions of expansion, as described by Minsky (1986a, 1986b, 1992b).

With increased incidents in homeowners' default Minsky's "debt-deflation" follows. Homes are not being sold, developers are slashing prices to reduce their inventory, brokers are going out of business, appraisers are negatively affected, investment banks are holding mortgages they cannot sell, investors are trying to sell out positions (assets are devalued), rating agencies are downgrading securities, and the insurers are facing tremendous losses.

Economic policies that validate practices that actually contribute to financial fragility have also been identified as a structural problem (Wray 2007). Thus, the so-called affordability loans (the ARMs) that were part of the expansion of banks' market and strategy to obtain ever expanding fee revenue from loan originations was validated by the Fed. Furthermore, legislative changes allowed the rise in subprime mortgage lending, namely the Depository Institutions Deregulation and Monetary Control Act of 1980; the Alternative Mortgage Transaction Parity Act of 1982; and the 1986 Tax Reform Act. The volume of subprime loans increased from \$20 billion in 1993 to \$625 billion by 2005 (Gramlich 2007). Furthermore, some studies have pointed to the racial aspects of the rise of subprime lending (Goldstein and Urevick-Ackelsberg 2008) and have argued that redlining related to lending discrimination has evolved into a "reversed redlining" where impoverished inner cities communities were targeted by subprime lenders (Martin and Watt 2008: 3).

Globalization has also stimulated the practice of securitization, as the latter creates and distributes financial paper across national borders. Indeed, the value of securitized mortgages exceeds the value of national debt held by foreign investors (Minsky 2008; Wray 2007: 7). Ironically, securitiza-

tion has been offered as a financial innovation, which at the macrolevel is supposed to enhance risk management in the global economy (Bernanke 2004; Chancellor 2007). It was thought that MBS securitization into further collateralized debt obligations (CDOs and CDO²) would be a good risk-sharing mechanism that would spread the risk too thin and would allow investors to choose investments based on their taste for risk. The result, however, was that all investors ended up having the same risk exposure, hence spreading financial instability across the economy. The transformation of the financial structure produced rising insecurity for households, as well as growing inequality (Minsky and Whalen 1996).

Inequality Breeds Instability

In the *General Theory* (1936), Keynes identified economic inequality as one of the major destabilizing features of the capitalist system. In the 1960s, Minsky poured a considerable amount of ink working on the so-called War on Poverty. He was convinced that job creation for people with any level of qualification was the only true way to fight poverty and inequality. In this section we argue that the ongoing subprime crisis may appear to be the result of recent financial innovations gone wild, but a major contributing factor to the conditions leading to aggressive subprime lending behavior is the buildup and persistence of economic inequality that has intensified since 1980 in the United States.

Between 1980 and 2004, the real average hourly wage (in 2004 dollars) has hardly changed from its 1980 level of \$15.68/hour (\$15.67/hour in 2004). However, worker productivity has increased by 68 percent over the same period (United for a Fair Economy 2006: 12). Even the federal minimum wage law has failed to lift poor working families to the federal poverty line. In 2007, the federal minimum wage level was 57 percent of the “living wage” (the wage that puts a family of four on the federal poverty line), down from 81 percent in 1979 and 94 percent in 1964. The Gini coefficient has been steadily on the rise in the United States since the beginning of the neoliberal era of the 1980s (Figure 1). Real average family income has barely changed for the poorest 20 percent of the population between 1979 and 2006, whereas the richest 20 percent saw their income rise by 56.77 percent and the richest 5 percent enjoyed an 87.47 percent increase (Figure 2). And to make things worse for middle- and low-income groups, U.S. tax policy took a regressive turn, shifting the burden heavily onto those groups (Figure 3). According

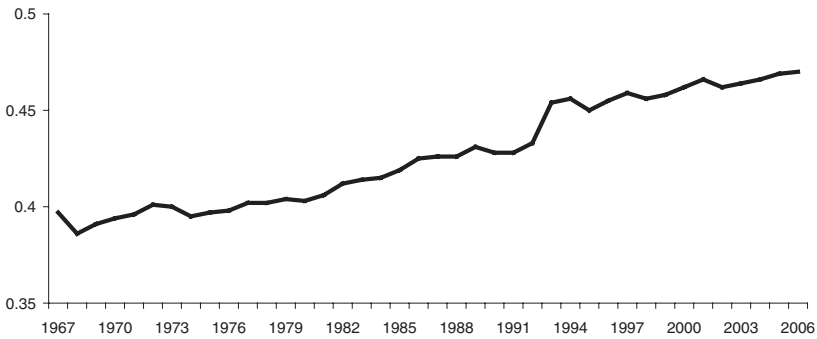


Figure 1. **Gini Ratio for U.S. Households (1967–2006)**

Source: U.S. Census Bureau, Historical Income Tables, Households, table H-4.

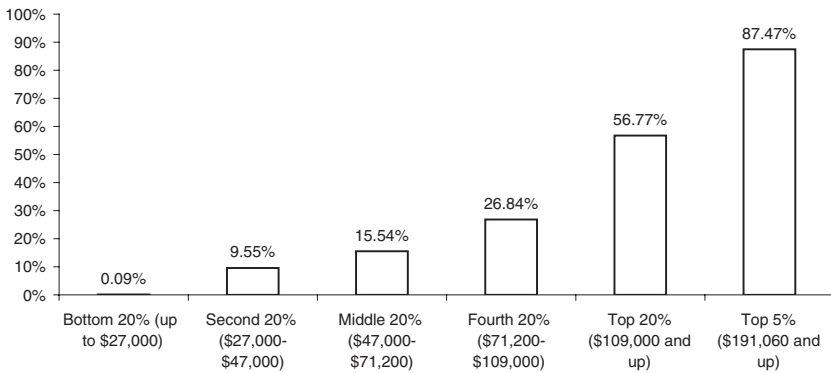


Figure 2. **Real Mean Family Income Growth by Quintile and for Top 5% (1979–2006)**

Source: U.S. Census Bureau and authors' calculations (2006 dollars).

to United for a Fair Economy, since 1980 the top federal tax rates on capital gains has declined by 31 percent and the estate tax dropped by 46 percent, whereas payroll tax has increased by 25 percent (United for a Fair Economy 2006: 23).

By failing to recognize the destabilizing effect of economic inequality, policy makers at the highest level in the Federal Reserve Bank welcomed the situation as a great way to keep workers in check and prevent inflationary pressures. Testifying before the Senate Banking Committee in January 1997, Alan Greenspan explained that the gap between pro-

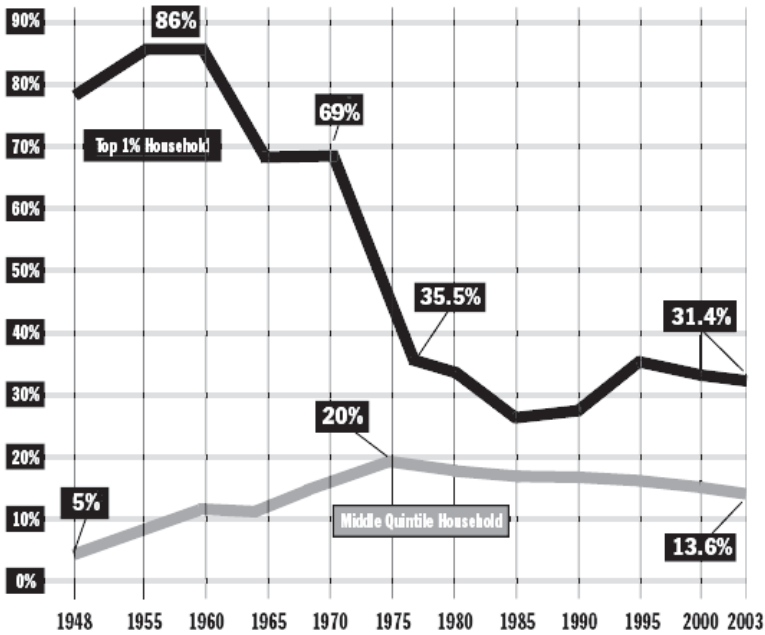


Figure 3. **Effective Federal Tax Rates (income tax + payroll tax) for the top 1% and the middle quintile of households (1948–2003)**

Source: United for a Fair Economy, 2006.

ductivity gains and wage growth has been a blessing in disguise for the U.S. economy. In other words, “employment insecurity” keeps inflation down. In Greenspan’s words,

As I see it, heightened job insecurity explains a significant part of the restraint on compensation and the consequent muted price inflation. Surveys of workers have highlighted this extraordinary state of affairs. In 1991, at the bottom of the recession, a survey of workers at large firms indicated that 25 percent feared being laid off. In 1996, despite the sharply lower unemployment rate and the demonstrably tighter labor market . . . 46 percent were fearful of a job layoff. (1997: 5)

Thus, Greenspan’s assessment of the cause of the “extraordinary” and “exceptional” U.S. economic performance in the 1990s was “a heightened sense of job insecurity” that has subdued wage gains for workers. These “traumatized workers” are even more compliant when they have a home mortgage to pay every month and cannot risk losing their home by striking or being laid off. With Greenspan’s blessings, workers experienced a

real wage freeze, whereas the Fed was busy fueling the biggest housing bubble in U.S. history.

The other side of the equation affecting homeownership is the rise in cost of living, but more importantly, the cost of buying a home. Real median home prices fluctuated roughly between \$120,000 and \$140,000 (in 2008 dollars) from the mid-1970s to the mid-1990s. However, a sharp increase began to take place in 1996, reaching a peak in 2006 at nearly \$248,000 (Figures 4 and 5). In short, working families have seen an increase in payroll taxes and more prohibitive home prices yet no increase in income. The picture is bleak, but thanks to expansive financial deregulation and innovation, working families can still aspire to homeownership through a plethora of home mortgage schemes, including subprime loans. The macroeconomic financial sustainability of the subprime scheme depended on the sustainability of the housing bubble, namely rising home values and low interest rates, both of which disappeared in 2006. Initially, the vast majority of foreclosed homeowners did not lose their jobs; they just could not keep up with the higher monthly mortgage payments once interest rates reset at the end of the teaser period. But for some communities with declining manufacturing, the subprime crisis adds on to the (often racially structured) concentrated poverty plus long-term job losses (Cohen 2008).

Over the past decade, the artificial improvement in homeownership has been sustained by an extreme reliance on consumer debt, given that disposable income was being squeezed by stagnant wages and higher taxes. Consumer debt to income ratio went from 65 percent in 1980 to nearly 80 percent in the mid-1990s, and by 2007 had shot up to over 125 percent (Figure 6). Furthermore, consumer debt service burden went from 10.5 percent in 1995 to a record 14 percent in 2006 (Figure 7).

When all the pieces of the puzzle are put together, it becomes evident that the rise and intensification of economic hardship on working families was not relieved by tax breaks or higher incomes, but rather was further compounded by easy access to consumer debt in the form of mortgage debt, home equity lines of credit, home equity loans, and credit card debt. However, consumer debt can only grow so much because it must be paid down sooner or later, and its continuous growth can negatively affect household spending capacity. Without a program in place that could boost spending and set a floor for household incomes, the destabilizing effects of inequality have led to financial innovation and

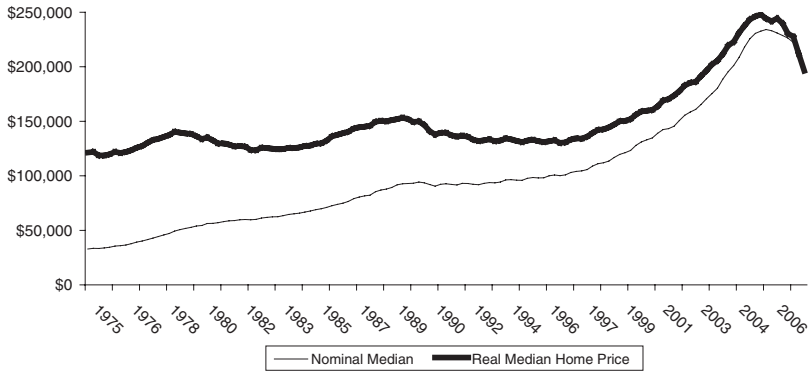


Figure 4. **Median U.S. House Prices (1975–2008)**

Source: U.S. Census Bureau.

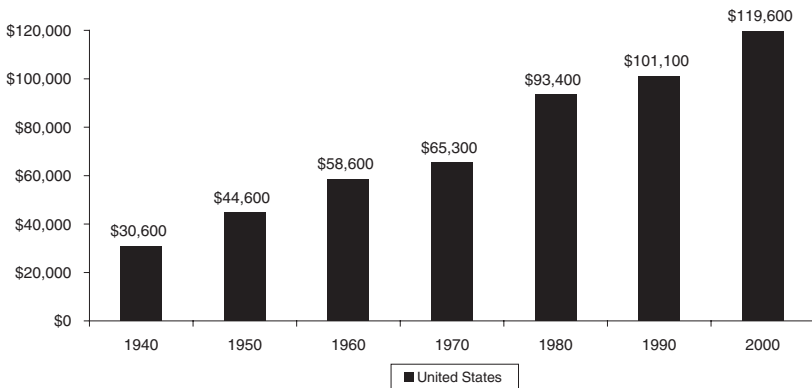


Figure 5. **Median U.S. Home Values (adjusted to 2000 dollars)**

Source: U.S. Census Bureau.

predatory lending that have caused financial turmoil and, consequently, the current recession.

From “Homeownership” to Delinquency and Foreclosure

National delinquency and foreclosure rates have increased significantly since 2006 as more American homeowners find it difficult to pay their mortgage obligations. The proliferation of “exotic” subprime mortgage products,

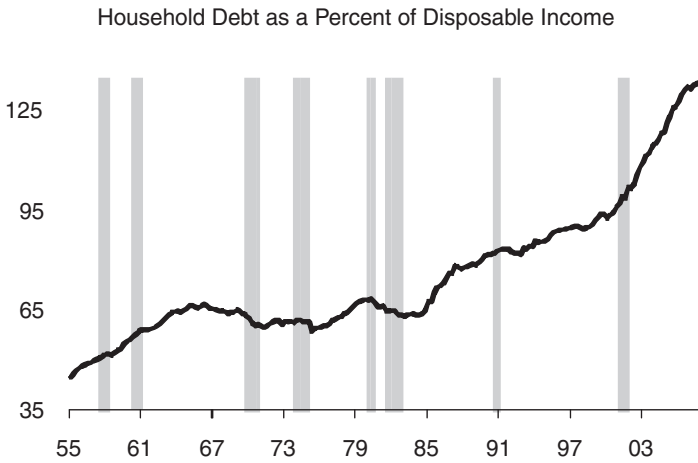


Figure 6. **Household Debt as a Percent of Disposable Income**

Source: U.S. Federal Reserve.

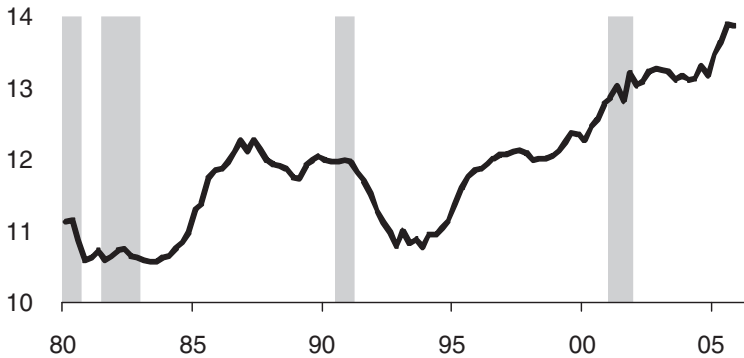


Figure 7. **Debt Service Payment as a Percentage of Disposable Personal Income**

Source: U.S. Federal Reserve.

specifically ARMs, during the housing boom of the past six years has been the key contributor to the rise in delinquencies and foreclosures.

Subprime loans are typically made to borrowers who are deficient on either a strong credit history or capacity to repay their loans. The slowdown in home sales and rising mortgage rates continue to drive

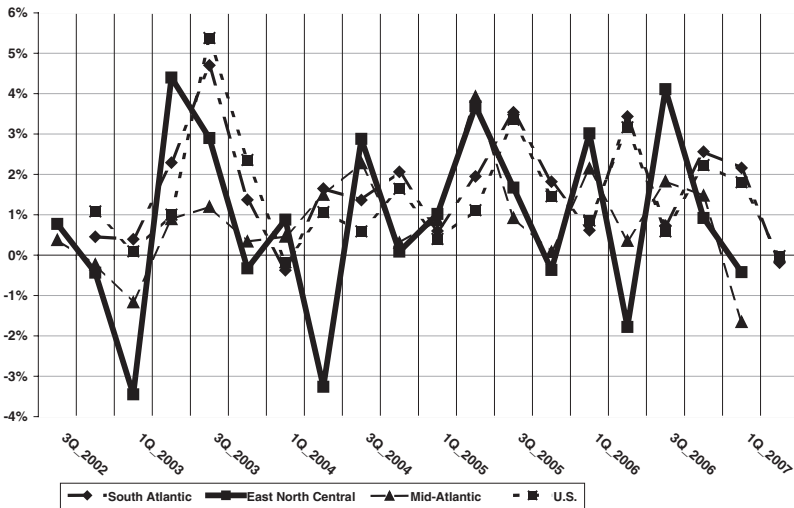


Figure 8. Growth Change in Prime Loans Serviced by Region (3Q2002 to 2Q2007)

Source: Mortgage Bankers Association (2007).

foreclosures at substantially higher numbers than they did a year ago. Further complicating this issue is the fact that approximately two thirds of the subprime mortgage debt issued between 2002 and 2004 was due to reset in 2007. Data compiled from the Mortgage Bankers Association corresponding to the third quarter of 2002 to the second quarter of 2007 for the U.S. South Atlantic, east north central, and middle Atlantic regions show that the number of subprime loans serviced had increased considerably. The persistent rise of seriously delinquent and foreclosure rates across the United States and these regions reflect this surge of subprime loans.

From the third quarter of 2002 to the second quarter of 2007, the growth change in the number of prime loans serviced fluctuated from the five year low to high (Figure 8). Nationwide, the number of prime loans serviced reached a high of 5.4 percent in the third quarter of 2003, but this trend changed to slight decreases and modest increases until it remained unchanged by the end of the second quarter of 2007. The south Atlantic region² mirrored the national trend. The mid-Atlantic region³ experienced modest lows and highs during those five years. The mid-Atlantic region’s number of prime loans serviced fell by 1.2 percent in

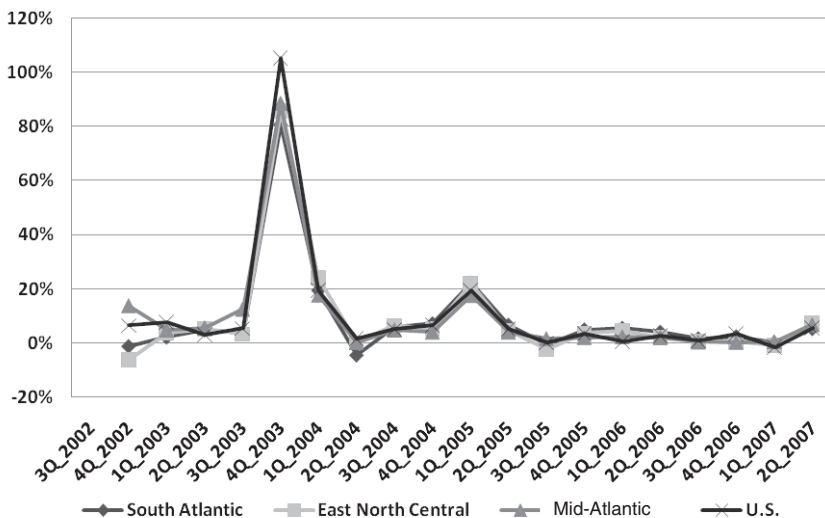


Figure 9. Growth Change in Subprime Loans Serviced by Region (3Q2002 to 2Q2007)

Source: Mortgage Bankers Association (2007).

the first quarter of 2003 but rose by 3.9 percent in the second quarter of 2005. The number of prime loans serviced in the mid-Atlantic region dropped by 1.7 percent by the end of the second quarter of 2007. The east north central region⁴ has been shown to be more volatile than the other regions. Since the third quarter of 2003, the east north central region has experienced three major declines and five major peaks.

The growth change in the number of subprime loans serviced from the third quarter of 2002 to the second quarter of 2007 illustrates a more persistent upward trend nationwide and across regions (Figure 9). All regions had a surge in the number of subprime loans serviced in the fourth quarter of 2003. The number of loans serviced nationwide rose by 105.4 percent in the fourth quarter of 2003. Similarly, the south Atlantic, mid-Atlantic, and east north central regions' number of subprime loans serviced climbed by 80.8 percent, 88.6 percent, and 85.7, respectively.

Figure 10 illustrates the percentage of prime and subprime loans that are past due. Loans considered in this category are between thirty days and ninety days past due. The bottom part of the figure shows the trend in prime loans, and the upper part refers to subprime loans. Across the regions, the percentage of prime loans past due oscillated from 2.0 per-

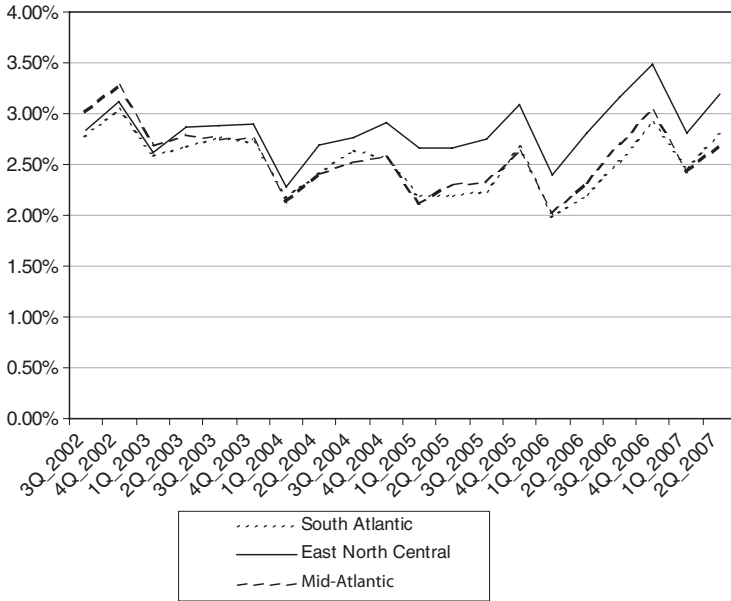


Figure 10. Total Past Due Prime and Subprime Loans (2Q2002 to 2Q2007)

Source: Mortgage Bankers Association (2007).

cent to 3.4 percent. On the other hand, the percentage of subprime loans past due was much higher across the south Atlantic, mid-Atlantic, and east north central regions. The percentage of subprime loans past due fluctuated between a low of 9.0 percent to a high of 17.18 percent. The east north central region had by far the highest percentage of subprime past due loans in comparison with the other two regions.

Table 1 shows the seriously delinquent and foreclosure rates for prime loans ranking among every state in the United States, as well the national rates. In addition, it indicates the growth rate of the seriously delinquent and foreclosure rates from the first quarter of 2007 to the second quarter of 2007. Seriously delinquent prime loans are those that are ninety days or more delinquent or in the process of foreclosure. Seriously delinquency rate is defined as the ratio of all seriously delinquent prime loans to all mortgage prime loans serviced. The same definitions apply to subprime loans. The seriously delinquent rate for the nation was 0.98 percent, and the foreclosure rate was 0.59 percent. In the south Atlantic region, West Virginia had the highest delinquency rate (1.24 percent), ranking

Table 1

Seriously Delinquent, Foreclosure Rates, Ranking and Growth Rates on Prime Loans, 2Q2007

State	Seriously delinquent			Foreclosure rates		
	Rate	Ranking	% Change previous quarter	Rate	Ranking	% Change previous quarter
South Atlantic						
Delaware	1.01	19	0.30	0.71	11	0.27
District of Columbia	0.53	43	0.06	0.27	45	0.04
Florida	0.99	21	0.23	0.59	24	0.15
Georgia	1.16	10	0.03	0.67	15	0.02
Maryland	0.54	42	0.13	0.29	44	0.09
North Carolina	0.85	29	-0.05	0.49	29	-0.03
South Carolina	1.14	12	-0.08	0.72	9	-0.07
Virginia	0.46	47	0.07	0.21	48	0.03
West Virginia	1.24	7	0.13	0.69	13	0.07
East North Central						
Illinois	1.06	14	0.03	0.72	10	0.01
Indiana	1.91	2	-0.05	1.38	2	-0.02
Michigan	1.86	3	0.23	1.17	3	0.18
Ohio	2.17	1	-0.02	1.57	1	-0.01
Wisconsin	1.02	18	0.05	0.70	12	0.02
Mid-Atlantic						
New Jersey	0.83	30	0.04	0.52	26	0.02
New York	0.79	32	-0.02	0.49	30	-0.01
Pennsylvania	1.15	11	-0.05	0.69	14	-0.05
Nationwide						
United States	0.98	n/a	0.09	0.59	n/a	0.05

Source: Mortgage Bankers Association (2007).

the state seventh in the nation while South Carolina had the highest foreclosure rate (0.72 percent) among its counterparts, ranking the state ninth in the United States. In the east north central region, Ohio had the highest seriously delinquent and foreclosure rate in the nation, with 2.17

percent and 1.57 percent, respectively. Pennsylvania, in the mid-Atlantic region, reported a serious delinquency rate of 1.15 percent, ranking the state eleventh nationwide. Pennsylvania's foreclosure rate was also the highest among the regions with 0.69 percent, ranking the state twelfth in the United States.

Table 2 shows the seriously delinquent and foreclosure rates for subprime loans ranking among every state in the United States and the growth rate from the first quarter of 2007 to the second quarter of 2007. In the second quarter of 2007, the seriously delinquent rate for the nation was 0.98 percent, whereas the foreclosure rate was 0.59 percent. In the south Atlantic region, Georgia had the highest delinquency rate (10.11 percent), ranking the state fourteenth in the nation while South Carolina had the highest foreclosure rate (5.96 percent) among its counterparts, ranking the state fourteenth in the United States. In the east north central region, Ohio once again topped the charts with the highest delinquency and foreclosure rates nationwide: 16.53 percent and 11.85, respectively. In the mid-Atlantic region, Pennsylvania had the highest delinquency rate in the region with 9.74 percent, ranking the state sixteenth nationwide. New Jersey's foreclosure rate was the highest in the region with 5.61 percent, ranking the state twentieth in the United States.

Wray and Pigeon (2000) illustrate the persistence of unemployment for a significant portion of the population during the Clinton era expansion. The Clinton boom was a classic demand-led expansion fueled by consumer spending and increasing consumer debt. The culmination of the cycle was brought to a halt with the dot-com bust and a subsequent reduction in consumer spending. The hardcore unemployed and the economically disadvantaged were simply unable to benefit from the Clinton era expansion. The 2000 recession made it difficult for the real estate market to continue its expansion and growth. Thankfully for the real estate market, the Fed aggressively slashed its Fed funds rate target from 6.5 percent in May 2000 to 1.0 percent in June 2003, a then all-time historical low, and kept it at that rate until June 2004. This four-year period of incredibly low interest rates allowed middle- and high-income consumers to refinance their homes and to pay off some of the debt accumulated in the 1990s. This was bad news for banks and real estate firms because creditworthy customers of middle and upper income were no longer flooding the market for homes. The next best thing were the subprime borrowers, those who have bad credit, then those who have no credit, then those who have no jobs, no income, and no assets. The

Table 2

Seriously Delinquent, Foreclosure Rates, Ranking & Growth Rates on Subprime Loans, 2Q2007

State	Seriously delinquent			Foreclosure rates		
	Rate	Ranking	% Change previous quarter	Rate	Ranking	% Change previous quarter
South Atlantic						
Delaware	7.35	37	0.49	4.45	31	0.26
District of Columbia	6.83	39	1.08	3.27	41	0.58
Florida	8.48	27	2.19	5.29	22	1.54
Georgia	10.11	14	0.44	5.19	24	-0.03
Maryland	6.10	40	0.99	2.73	46	0.38
North Carolina	7.62	36	0.02	3.81	35	-0.31
South Carolina	9.94	15	0.31	5.96	14	-0.11
Virginia	5.84	41	1.06	2.76	45	0.40
West Virginia	8.79	24	-0.76	3.39	39	-0.76
East North Central						
Illinois	11.24	12	1.20	7.42	9	0.63
Indiana	13.84	3	0.24	9.40	3	-0.17
Michigan	16.22	2	0.39	10.09	2	-0.17
Ohio	16.53	1	0.57	11.85	1	0.13
Wisconsin	11.47	9	0.67	7.85	7	0.11
Middle Atlantic						
New Jersey	8.94	20	1.26	5.61	17	0.71
New York	8.57	26	1.07	5.56	19	0.69
Pennsylvania	9.74	16	-0.11	5.37	20	-0.35
Nationwide						
United States	9.27	n/a	0.94	5.52	n/a	0.42

Source: Mortgage Bankers Association (2007).

lending criteria were consistently relaxed to issue the maximum amount of loans (and earn fees and commissions) that would be shipped off to Wall Street financial engineers for MBS and CDO packaging.

This “boom” in homeownership and demand for homes helped

jumpstart the residential real estate market, and the economy was set for another expansion. But as the economy began a modest recovery, the Fed immediately sought to bring the Fed funds rate back to higher levels, so it began raising rates continuously starting in June 2004, to reach 5.25 percent by June 2006. The subprime time bomb remained unnoticed thanks to the 2–28 and 3–27 mortgage schemes in which borrowers would pay a very low rate for two or three years but then would rest at rates as high as 12 percent, thus leading to almost certain default and foreclosure. By the end of 2006, delinquencies on adjustable subprime loans began to rise, and by July 2007, the damage reached major financial institutions in the United States, Germany, France, the United Kingdom, and Switzerland. It seems that the Fed was still not fully aware of the extent of the crisis and kept its target rate unchanged at 5.25 percent until September 18, 2007, by which time the financial crisis had fully developed.

Ironically, the most disadvantaged group of the population had been used to prevent a prolonged recession in 2001 by introducing the “democratization of homeownership.” At the same time, the financial schemes used to promote growth sowed the seeds for the subprime financial meltdown. What was presented as a strategy for “democratizing homeownership” was in fact the recipe for democratizing financial turmoil—the taste of which, at least initially, was most bitter among the most disadvantaged groups.

Homeowners’ financial woes continued. The American Bankers Association reported that in the first quarter of 2008, late payments on U.S. home equity lines of credit soared to a twenty-one-year high as a result of the subprime crisis. Home equity lines of credit delinquencies (more than thirty days past due) rose to 1.1 percent from 0.96 percent the prior quarter. This was the highest delinquency rate since the American Bankers Association began collecting the data in 1987. The subprime crisis escalated into a general financial crisis, prompting government bailouts, and despite the rising U.S. exports in the first quarter of 2008, which kept GDP growth positive, the official unemployment rate jumped to a five-year high at 6.1 percent in August 2008, reaching 10.2 in October 2009. Higher unemployment is going to be the main catalyst for further deepening recession and growing inequality. In the next section, we outline a policy proposal to deal with these problems by providing a boost to aggregate spending in times of restricted private sector investment, by guaranteeing a floor for the household sector: a sufficiently high, but stable wage income.

Employment-Led Remedy to Inequality and Financial Instability

Despite the popularity of Minsky's work on the financial instability hypothesis, most of his work has been on issues of employment and job creation policies to fight poverty (Minsky 1965a, 1965b). He advocated policies that would reduce economic insecurity while enhancing strong unions, family-friendly benefits, expanded child allowances, universal provision of adequate health care and education, higher and more effective minimum wages, and a full employment guarantee program. Minsky saw these as especially important in times of structural change in the financial system. In that respect he proposed institutional constraints on, and regulation of, money managers and a network of small, local community development banks (Papadimitriou and Wray 1999).

Our policy proposal here is nothing but an updated version of Minsky's employer of last resort (ELR) program, which we suggest as the basis for a *real* democratization of homeownership. Under conditions of real income stagnation combined with a tendency for real estate prices to rise, there can be no market-based solution for boosting homeownership. An ELR government program can guarantee a real employment opportunity for all at a socially established living wage (Forstater and Wray 2004; Minsky 1986a, 1986b; Mosler 1997–98; Wray 1998).

Minsky's philosophy about job creation is one in which the government would "take workers as they are" and provide "on-the-job training" when required. Minsky's aim was to have the government establish a decentralized job creation system whereby it would create an infinitely elastic demand for labor. The government would hire anyone who is ready, willing, and able to work. Jobs would be selected by local community groups and nonprofit organizations based on the social benefits to the community. The implementation and management of ELR projects would be locally based, whereas funding would be provided by the federal government. ELR projects would be selected to match the skills of the local unemployment pool and would not compete with projects already undertaken by the private sector (or the traditional government sector). ELR would stabilize economic activity at full employment, so when the private sector slows down, the ELR administration would hire more ELR workers, and as the private sector recovers, it can hire ELR workers away from the government at a premium above the ELR wage. The government, therefore, creates a buffer stock of employed (rather than unemployed)

labor to stabilize wages and inflation, while at the same time providing a living wage floor for household income, which decreases inequality as well as increases opportunity for upward mobility for those at the bottom of the income scale. Furthermore, having stable employment and rising income is the only secure mechanism to ensure a consistent rise in homeownership, in contrast to exotic financial innovations, which were possible not only because of deregulation and technological computation ability but also because a large portion of the population did not have any other chance at homeownership but subprime borrowing. An opportunity for a steady living wage income creates the ability to generate household savings, as well as a floor to income, which can prevent, or at least reduce, foreclosures in case of growing unemployment in the private sector and their deflationary pressures on the economy.

Most critics of the ELR program claim that the cost of the program would be prohibitive and that it would lead to massive budget deficits and rising national debt. Several reliable estimates, however, have shown that the cost of implementing ELR in the United States is around 1 percent of the gross domestic product (Fullwiler 2007; Gordon 1997; Majewski 2004; Majewski and Nell 2000). The establishment of an ELR program would also produce substantial cost savings, as it would make several government assistance programs redundant. The cost of implementing ELR is by far lower than the trillions of dollars that have been spent on government bailouts of Wall Street firms. Furthermore, ELR introduces a sense of security and confidence, so it stabilizes expectations. When employment is guaranteed, consumers and businesses can engage in long-term planning based on stable aggregate demand. Moreover, job guarantee ensures that homeowners can qualify for affordable loans and that they do not miss any mortgage payments, which in turn ensures the stability of the MBS market. ELR does not eliminate inequality altogether, but it puts a floor to income and aggregate demand levels. For this purpose, it is important that the floor wage is set at a living wage, including an adequate benefit package (Kaboub 2007a, 2007b).

The establishment of ELR would also require a substantial coordination of fiscal and monetary policies between the Federal Reserve and the Treasury to ensure the establishment of full employment and price stability simultaneously. The financing of the program would be done in the same way as any other government program. Government spending injects reserves into the economy, then taxes or bond sales would withdraw excess reserves from the system, thus preventing inflationary pressures

and keeping overnight interest rates at the desired policy target. There can be no financing constraint on the monopoly issuer of the currency. A financially sovereign government has the ability to finance any economic activity it wishes to undertake, because it can issue debt denominated in the sovereign's own currency and collect taxes in that same currency. According to the basic principles of functional finance, the ELR program would add to the annual deficit and the national debt, but those levels are just accounting indications of the private sector's desire to net save and do not represent any financial burden on the government. It is the *function* of the deficit and the national debt that matters, not their levels. The desired *function* here is to address the root cause of the financial crisis (i.e., income inequality) through a job guarantee program. Without an ELR program, all other attempts at improving homeownership will remain ineffective and superficial and therefore temporary at best. The massive government bailout of Wall Street firms, though necessary, is yet another temporary patch to the system and does not deal with the root cause of the problem.

Conclusion

The paper presented a critique of the ill-conceived policies of increasing homeownership in the United States. We explained the subprime crisis with Minsky's financial instability hypothesis. The system according to Minsky is inherently unstable. Financial crises are not the result of irrational exuberance but, rather, deep structural flaws that are inherent to capitalist systems. We identified that inequality has been the main structural cause of the subprime crisis. When aggregate demand began to fall in the late 1990s as overindebted consumers began to slow their borrowing, the real estate lending frenzy went after subprime borrowers with exotic lending schemes to put a temporary patch on inequality, claiming the "democratization of homeownership." The scheme spread to Wall Street through securitization. The highly complicated structured investment vehicles had consequently become too illiquid and almost impossible to value and had turned into "toxic assets" on the balance sheets of all major financial institutions.

Fixing the financial crisis through bailouts of any sort would at best restore temporary financial stability, but it does not address the root cause of the problem. We propose attacking the problem at its roots through a job guarantee program that ensures that homeowners have access to a decent employment opportunity with a living wage and benefits. This

would help homeowners keep their homes and provide stability to real estate values, thus indirectly stabilizing the MBS market and financial markets in general. The data illustrate the extent to which inequality over the past four decades has built up an economic iceberg with stagnant income, rising cost of living and home prices, and little or no real assistance for low-income homebuyers. The subprime lending schemes with cheap money financing came as a fictitious and temporary remedy for low-income groups seeking homeownership. The mirage disappeared as interest rates rose, cheap financing disappeared, and home values plummeted. The end result was a “democratization of financial turmoil” rather than “democratization of homeownership.”

Government bailout only sets the system up for another financial crisis down the road if it is not supplemented, not only with new regulation but also with a comprehensive plan to build racial and ethnic equality. A larger role for public sector investment is necessary to restore income growth and debt relief for middle- and low-income groups. The most efficient and productive way to do this is through a job guarantee program à la Minsky, which will achieve full employment, price stability, and financial stability while reducing poverty and increasing actual homeownership.

Notes

1. Minsky warned that the securitization frenzy must be countered with strict regulations because “all that was required for the originators to earn their stipend was skill avoiding obvious fraud in structuring the package” (Minsky 1992b: 22–23).

2. U.S. Census Bureau defines the South Atlantic region as Delaware, District of Columbia, Florida, Georgia, Maryland, North Carolina, South Carolina, Virginia, and West Virginia.

3. U.S. Census Bureau defines the mid-Atlantic region as New Jersey, New York, and Pennsylvania.

4. U.S. Census Bureau defines the east north central region as Indiana, Illinois, Michigan, Ohio, and Wisconsin.

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