The Continuing Crisis: Lessons from the American Response

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By James K. Galbraith

Thank you very much indeed. It's a great pleasure to be back in Athens.

I thought I would devote my remarks to two topics: the great crisis and the small one. The great crisis obviously has been underway for two years, although in some respects I think we may look back and say that it really is just beginning. We may say that the consequences of the crisis have not yet been felt; that we shall see them in the general decline in standards of living that will follow for a long time -- unless we somehow figure out how to deal with it.

The small crisis is a crisis among we who are economists, and it has been going on for much longer. It is obviously much less significant in and of itself, but it has proven in its own way to have the gravity and intractability of the great one.

In America the small crisis is rooted in what I call 'the grand illusion of the great moderation'. The 1980s which I remember very well as a young man with a policy position were a very turbulent decade. A decade of de-industrialization in parts of the country, the collapse really of the power of labor unions and of infrastructure investment, and in the larger world, the conditions of international debt crisis which ultimately contributed to the collapse of the Soviet Union and its neighbors, and to the opening of the world markets and natural resources -- the commodity markets -- and then finally the rise of China as a workshop for the world's supply of wage goods.

It was a decade, too, of a rising value for the dollar, and many countries subjected to financial instability came to use the dollar as a reserve. And for all of these reasons, at least as far as the United States is concerned, the decade saw the termination of inflation and the institution of a world monetary system of which the dollar held the central position.

In retrospect the economics profession reduced all of this to a tale of the credibility of central banking –

of the Federal Reserve -- and of fiscal responsibility, of probity, plus an element of accelerated technological change. Within that world, what they created was a mental vision of self-stabilizing markets guided inanimately by hands-off policy makers. These in turn were motivated by the greater good, but disciplined by the recognition of the limits of power; of the limits of intervention.

Thus there was a general acceptance, for example, of forecasts and concepts of the natural rate of of unemployment; recognition that pushing too hard to lower the unemployment rate would produce undesirable consequences in the form of accelerating inflation. If there was an argument within this widely-accepted narrative, it was between the purists, who believe that government need never intervene to support employment, and those who were a bit more, say, agitated in their attitudes, and who thought that temporary, targeted measures were sometimes useful, so long as they weren't too big and and didn't last too long.

There's a certain irony for me personally in this general view of the range of opinion in the economics profession. A great deal of the conceptual structure of that view rested on alleged improvements in the transparency and credibility of monetary policy. And part of that was attributed in the United States to the procedures that were instituted in the middle 1970s for regular oversight and discussion of the role and purposes of the Federal Reserve. I find that to be extraordinarily amusing, because one of the first things I did as a young member of the staff of the House Banking Committee in 1975-76 was to invent the process of monetary policy oversight. And I was in charge of those hearings at the staff level for six or seven years. I also drafted the statutory language that went the Federal Reserve Act of 1978 which made those hearings part of the regular U.S. code. So, if I thought they were in fact as important as the economics profession later would deem them to be, I suppose I could claim some credit for the institutional structure behind the Great Moderation.

In Europe -- and this is history obviously familiar to all of you -- the same ideas underlay the architecture of the European Union and the Eurozone. These relied very heavily on the theoretical stability of markets and on the capacity of a system to function when its governmental structure simply adheres broadly to prescriptions and rules. Seven years ago, I wrote about this, in an essay in *Le Monde Diplomatique*, of which I'll just read a few sentences, because to me they seem to summarize reasonably well the situation. I wrote, "in Europe, here we see rising a curious project of monetary union, free-trade and capital flow -- an economic superstate married to an entirely pre-Keynesian vision of its capacities and responsibilities. European countries are enjoined by the Stability and Growth Pact to limit their unified budget deficits almost at all costs and notably irrespective of the rates of unemployment. They and their private sector companies are enjoined to pay interest at whatever rate the central authority demands. There are no facilities for a lender of last resort to help them when in the end they cannot pay."

In America, the illusion of the Great Moderation justified an uncritical attitude toward the risk of financial instability. Yes, as the 1990s progressed, it was conceded there was a bit too much household debt, but on the other hand, home values were rising and balance sheets on the whole looked good, so the situation could not be that dangerous. And interest rates were low (it was said) partly because Alan Greenspan wanted them low -- particularly after 2000-2001 -- and partly because of the surplus of the Asian countries. Whatever problems might be rising in the shady fringes of housing finance could surely be contained.

Nothing could happen, surely, that the markets couldn't handle. So, for that matter, said Ben Bernanke, Chairman of the Federal Reserve, right up through July of 2007. And after that, by strong implication, what did happen was something *no one could have foreseen*. I've heard that phrase many times in the last several years.

What we now know of course was that it was perfectly well foreseeable. And indeed some very clever people did foresee it. And some of them made hundreds of millions of dollars by betting accurately and with great confidence on the collapse of the entire system.

Tha group however did not include any of the mainstream economists. Fortified in their faith, the American economists fundamentally missed the Achilles heel of their system. And that was something that lay in the half-hidden intersection of economics and law. The economists assumed that markets could fairly price any security; any bond. In this assumption, they overlooked the fact that fraudulent securities are intrinsically worthless. That fraud is something which is intrinsically concealed, because of this.

And they failed to notice that by the middle part of the 2000s an enormous share of the new mortgages issued in the United States were *per se* fraudulent. They failed to notice that there were people, including the Federal Bureau of Investigation, in Congressional testimony in mid-2004, who were saying so in public. For those who were close the industry this was not a secret. There was in fact an entire vocabulary, a language that described the conduct of business -- the business model -- in very explicit terms. The phrase Liars Loans. No-Doc Loans: loans issued to people who didn't provide documentation. NINJA loans: loans to people with no income no job or assets. Neutron loans: loans that were destined to explode destroying the people but leaving the buildings intact. Toxic waste: the worthless residue of collateralized debt obligations.

No one using those words could have been, in any serious way, in doubt about what was going on in this industry. What had happened was something that was, in important respects, encouraged to happen; encouraged to happen in very explicit ways. In the early part of the first term of the second Bush presidency, the director of the Office of Thrift Supervision, the principal regulatory office with responsibility for the quality of mortgage loans, came to a press conference, with colleagues of his from other regulatory agencies, holding a stack of the Code of Federal Regulations dealing with underwriting standards and a chainsaw. His colleagues who were more moderate brought pruning shears.

This was a message for the business press can which was not in a way subtle. It was not nuanced. It was just a clear signal that regulations which had previously been applied would no longer be enforced. Economists had by that time all the tools they needed to analyze the situation. They had seen it happen already in the crisis of the savings and loans in the 1980s and they had had it explained for them by George Akerlof and Paul Romer in an article entitled *Looting: The Economic Underworld of Bankruptcy for Profit* in 1993. But they chose overwhelmingly to look the other way. And it was not until 2007 that one ratings agency, Fitch, did a study of the incidence of fraud in a very small sample of highly-rated residence mortgage backed securities and found that, in the language of the report, that the results were 'startling'. There was "fraud, abuse, or missing documentation in virtually every file." That is to say: fraud was the rule. It was practically universal by the time the housing bubble reached its peak.

I think in fact it's fair to say that the conclusion of the investigations now going on, and ultimately of historians, will be that mortgage origination in America by the middle part of the last decade had become a criminal enterprise. The origination was an act of counterfeiting. Bad loans were passed off as good ones. These were loans that were made to borrowers who couldn't document their incomes, who didn't have credit histories, on houses that had been appraised by appraisers chosen for their willingness to inflate the appraisals. And there is no honest reason why a lender would knowingly accept an inflated appraisal on a house. Loans were set with two or three year teaser rates so that the borrowers would face, necessarily, doubling or tripling their payments at the end of 24-36 months and they would be forced to refinance in order to give the lenders, the originators, a chance to earn another fee. The originators did not care whether the loans defaulted because they were able to sell them within 30 or 60 or 90 days and therefore refinance themselves, with the risk passed on to the buyers.

The buyers were there because of the laundering operation. The laundering operation was managed by the ratings agencies which took piles of loans which were destined to have very high default rates, which should've been raided BBB- at best, and found a way to package them so as to justify an AAA rating. That's essentially the equivalent of money laundering.

And the investment banks and the others who passed these on to the investing public were playing the role of the fence. That is to say they took the fraudulent goods – the counterfeit mortgages -- and placed them on the open market; passing the bad paper to those who were naive enough to trust in the credibility of the ratings agency. As I say, the language of a criminal network is appropriate here because in effect that's precisely in technical terms what it was.

In Europe the intellectual failure was I think of a slightly different kind. It was a substitution of ideal types and model virtues for the study of historical cases and practical experience. In setting up the economic structure of the Union, Europeans appear to have asked what is good, rather than what works in practice. And they built constitutional structures that were essentially Confederate. We have experience in North America with this particular model; the model of confederation. We've had it twice. Once failed by 1792 and the second one in 1865. A confederacy essentially is a currency union, with local responsibility for taxation and social welfare and even for the financing of Defense. It is vulnerable to tax evasion, free-riding, and prone to unstable financial flows that reinforce the regional concentration of wealth. All of these features contributed to the military failure of the southern Confederacy in the American Civil War.

I'll return a bit later to the fact that this was not a matter of remote history. These failures were not in fact resolved in North America for *seven decades* following the end of the Civil War.

It's sufficient to say that the view the economists took of the structures of the European Unification were rooted in notions of what was proper and virtuous and not in an examination of historical precedents. So the great crisis came to America as a breakdown fundamentally in the rule of law. It came to Europe as the banking panic which followed. It was essentially a run on the banks and on other assets which seemed to be at risk. It was a flight to safety precipitated in the first instance by the knowledge that there had been these vast losses -- exact scope undisclosed -- on American debts. The capacity and willingness of the authorities to manage the resulting damage to the financial system was at best doubtful.

As in all such panics the weaker borrowers were the primary victims. Just as in 1997, in Asia, the Thai crisis spread to Indonesia and Korea, so in 2008 the mortgage crisis spread to Greece. You can trace the widening of the spread between Greek and German bonds basically to the month when the crisis exploded in the United States. And so while my host said in introducing me that Greece was at the center of the universe, I'm afraid not. I think the reality is that there is no crisis of Greece specifically. Greece is an instance of a much larger global financial crisis which originates in the first great crisis that I've just described as coming out of the misgovernment of finance in the United States.

Now, I'm not going to defend the structure of society here or conduct of the previous Greek government, but the notion that the crisis was caused in some sense by irresponsible public finance in any small country is, it seems to me, clearly a misapprehension. It's the nature of credit booms that investors seek every small increase in returns that they can find; that the weak borrowers look good and that poor countries run big deficits financed by capital inflow. It's the nature of credit slumps that the weakest borrowers are singled out for being wicked. The discovery of bureaucrats, budget deficits, and tax-evaders, in Athens was exactly as relevant this crisis as the 1997 discovery of crony capitalism in Bangkok. It overlooks the fact that all capitalism is crony capitalism. It's just that some cronies control the narrative more effectively than others and sometimes the narrative is deemed to be more relevant than it is at other times.

But the crisis struck and to this day the story continues. The IMF, the EU, the OECD, and many private commentators have maintained that Greece, not to mention Latvia, Portugal, Spain -- and now Hungary and even Britain -- must cut their public services savagely and raise taxes in order to regain the confidence of the bond markets. This presupposes that it is possible to regain the confidence of the bond markets. But it is not.

It seems to me the original construction of the European Union had an element of fantasy, that virtuous conduct would be rewarded by stable results and prosperity, and this is also a kind of Victorian fantasy. It's a fantasy of a darker kind, practically a domination fantasy, whose satisfactions deserve study from a psychoanalytic point of view. It doesn't bear any close relation to the actual economics or politics of the situation. As economics it overlooks that fact that real damage is done by the budget cuts and that that damage will be felt on the foundations of economic life -- possibilities for economic growth. In politics it overlooks the presence of the political players. Of the bailout game if you like.

Now, the International Monetary Fund knows about the economics. I was in Princeton a few weeks ago and I heard Paul Krugman give a talk on this issue. And he described the IMF plan for Greece. He presented a slide showing the projected cuts and tax increases totaling 11.2% of GDP in three years time. It was an interesting slide with a number of economic assumptions on it but I noticed there was one that was missing: The IMF had chosen not to put on that page its estimate of what would happen to Greek GDP. But it's obvious that if you cut 11 percentage points of GDP from total demand -- half of it from public spending and half of it from private spending -- you are going to get a terrific effect on GDP itself. It is not as though private banks or foreign investors will rush in to fill the gap. And not as though Greece can devalue its way out or impose capital controls as those with money flee the new taxes. So I raised this point with Paul, and he agreed, and he made a rather rueful remark, which I think was intended in part to apply to the technical staff at the IMF who were being tasked to produce these projections, but in part to all of us who discussed them with any degree of seriousness, that this kind of forecasting was making liars out of everybody.

On the political side, it's my belief that the government here has pretty well understood all along that, while cuts could not be avoided, their purpose was not to reopen a bond market that had already closed, but to play a role in a political drama whose objective was to satisfy the requirements of other governments in Europe. They were a blood price in other words for the voters of Angela Merkel. The only questions were how long would this game continue? Would the players bring it to an end before the disaster of an uncontrolled crisis took hold? And whether the end result would be something that would tolerable from the standpoint of the people of Greece.

I think that the answers are that the players chose to play this game right up to the last minute. That whether they manage to bring it to a successful and credible conclusion without it getting out of control is still unclear. And that the scale of the sacrifices being demanded are not in fact -- or should not be -- tolerable.

The question now is whether Europe will descend – as in fact Europe appears to be descending -- into a vicious circle; a black hole of competitive fiscal austerity in which there is no clear route back to economic growth and rising employment. With the result that one can see a progressive decline in employment possibilities; rising unemployment everywhere, and effectively the deterioration and collapse of welfare states that have been built up over half a century. Eventually there will be very substantial increases in immigration from the most damaged countries to those who are less damaged.

And the question is, if that's indeed the situation, what, if anything, can be done about it? I want to talk for a few minutes about the American response to the crisis. As a model, or perhaps a partial model; certainly an inadequate model for what is going on here and now. Our response in effect came in two ways. The first has been described, in a very good article by Rob Thompson and Tom Ferguson in the *International Journal of Political Economy*, as the Paulsen Put: a prolonged effort to conceal the effective insolvency of the financial system and followed, when things could no longer be concealed, by the massive bailouts at the end of 2008. This succeeded in keeping the major financial institutions alive, but at the cost of absorbing their losses and overlooking their misdeeds.

And the second wave of this response was a very powerful fiscal reaction. It was comprised first of all of automatic stabilizers; the decline of tax revenues and increase in public spending that follows when there is a sharp decline in production and rise in unemployment, the stimulus package in early 2009, and the inventory cycle. And this too succeeded, for a time, in creating the impression that an ordinary business cycle expansion would get underway. That impression has now lasted for about six months.

There were, in fact, several months earlier this year when we actually moved into the territory of positive job creation for the first time in about a year and a half. But the problem always was that inventory cycles come to an end. Stimulus packages run out. And the burden of financing a continued expansion comes to fall on the banking sector. That was true in the 1990s when the banking sector eventually took over and fueled the credit boom that went from 1994-2000 and it was true in in the middle part of the last decade where the housing bubble took over from the Iraq war to fuel an expansion that lasted until 2007.

But the banking sector is itself on life support as a result of the American response. It is sitting passively borrowing from the central bank at zero lending back to the treasury at 4% and facing a clientele, the American middle class, which is substantially insolvent -- because of a vast oversupply of houses, because of the inability to sell those houses, because of the resetting of the bad mortgages, and because of the presence of home equity loans, and the whole structure of finance leftover from before the crisis, which renders a very large share of the population upside down – they owe more on their houses than the houses are worth. It leaves an even greater share in an uncertain condition because they don't know what their houses are worth at all.

It seems extremely unlikely that this financial system is going to be in a position any time soon to take over the job of financing a continued economic expansion. And we may already be seeing the end of this phase as in the last unemployment reports it was revealed that only 22,000 private-sector jobs were created. All the rest -- almost 400,000 -- were simply temporary government jobs to take the Census.

The failure to resolve the American banks when the opportunity presented itself a year ago, and the failure to take meaningful action to restructure private debts, thus emerges as a game changer. And it seems to me that this situation is not dissimilar to one that will surface, by-the-by, in the condition of the the European banks. That Europe lacks any central fiscal authority simply makes matters that much more difficult. Conclusion, or inference: there does not appear to be, either here or on our side of the ocean, any powerful reason for optimism that these large economies that are central to the functioning of the world system will have strong recoveries for any near term.

So what's next? In his talk at Princeton, Paul Krugman spoke -- and you may already be aware of this, I don't know if it was reported in Greece -- of the possibility of an exit from the Eurozone. And he sketched a scenario of an exit that would follow a run on the banks; essentially a forced conversion of assets. I'm skeptical. I think most people here are highly skeptical. Because it would be something that would be extremely difficult to manage and to control; it's probably best if that possibility is left off the table for the time being.

The second possibility is to restructure debts inside the Euro area. Again, I have sort of personal experience with this. I was the author, at the age of 23, of the legislation that provided financial rescue for the city of New York; which at that time was the third largest government in the United States after the state of California and the Federal Government. And as the United States Congress in that bill insisted on a restructuring of the New York City's municipal bonds as part of a package in order to lighten the burden of cuts that would otherwise fall on public services and on the unions. The United States in fact has provisions -- Chapter 9 of its Bankruptcy Code applies to municipal governments -- and the point of those provisions is to permit an orderly restructuring of public debts while preserving the most essential parts of public services. And I know that Professor Raffer, Kunibert Raffer of the University of Vienna, has been writing about the desire for the application of those provisions to sovereign debt in Europe.

The difficulty of course is that such action would expose the losses in the banking system and, except to the extent that those losses have already been shouldered by an entity, the central bank, that would be willing to write them down. And it is not difficult -- it's not easy to manage losses on a massive in a highly leveraged banking system. I learned, at the peak of the U.S. crisis of 2008, that the Reagan administration in 1982 had a plan for the complete nationalization of the large New York banks and would have put that plan into effect had a single large Latin American country -- Brazil, Argentina, or Mexico -- declared a default on sovereign debts at that time.

So I've lain out three possibilities. One is the black-hole scenario of continued economic decline. The second is the chaos of monetary dissolution. And the third is the awkward, and also inadequate, process of debt renegotiation. Which may well be inevitable but, as you know because of the size of the primary deficit, is hardly a formula for economic growth and recovery. This would still imply very severe fiscal intervention.

I wanted to ask if there was a fourth possibility. Going out beyond the realm of what is probable or likely, is there something that could be done in an understanding of the extreme character of the situation? I mentioned before that the second U.S. confederacy failed in 1865 and that the economic failure continued for seven decades, 68 years actually, until Franklin Roosevelt took office in 1933. A failure that was interrupted only by the very short-term boom of the first World War and the speculative explosion in real estate and in the stock market in the mid-late 1920s. It was a failure that left the United States, over this entire period, a deeply divided nation with no unified national economy. Essentially, we were a currency union and a customs union with a large region, the South, which remained chronically depressed: backward, share-cropping, mired in poverty, malnutrition, illiteracy. Immigration for most people to the North, to the extent that it was possible at all, was the only way out.

Franklin Roosevelt was perhaps the first president of the post civil war period who understood just what the South was. And the New Deal, which many of us think of as the reaction to the Great Depression, was in fact far more than that. It was in some ways more fundamentally a project of structural transformation on a grand scale. It began with financial reform, with decisive action to remove the insolvent banks from the system, and move very quickly to agricultural adjustment, a process of setting prices and controlling production in agricultural, vast conservation programs which in the end planted over a billion trees, the Tennessee Valley Authority which industrialized that region of the deep South, the Rural Electrification Administration, employment programs, the Works Progress Administration, public works programs, the Public Works Administration, and continuing into the mid-1930s the establishment of the common Social Security system, the enactment of the minimum wage, and collective bargaining rights on the national level . In the course of all that the New Deal built a million kilometers of roads, a thousand airfields, it built 2500 hospitals and 45,000 schools and I just scratched the surface of an extraordinary list of accomplishments great and small. In the course of four years if you count and we must those people who were working for the New Deal as employed, unemployment in America fell from 25% in early 1933 to under 10% by 1936. Only then did the United States as it presently exists really emerge, and the New Deal, moreover set off a process extended by the Great Society in the 1960s which brought the South from its position of deep penury and backwardness right into the mainstream of American economic life. So that average incomes in the South are now roughly average with the rest of the country as a whole; it is neither poor nor rich by comparison with the rest.

Over seven decades, in other words, the failure of the seven decades following the civil war, was gradually, progressively, and successfully reversed. But it required the creation, in a very short period of time, and implementation of a whole set of institutions that could operate at the level of a continent.

If I had a cheap alternative to the present situation I would surely offer it. But I don't. Europe can of course choose a path that could lead to, let's say, seven decades of economic stagnation interrupted by a credit bubble somewhere once in a while. And I don't want to dramatize, but it does seem to me that is the course that Europe is presently on. Or the alternative is serious work, despite all the ideological difficulties, at the one thing which historical experience tells us might actually work. This is a very long-term project. I would not begin to suggest that there's anything short-term that can be done to completely fix the situation that one is in, but it does seem to me that perhaps there is a responsibility for economists to begin to articulate a path that could begin here and now. And it might be useful to have that begin with the people who have the most to lose otherwise: you my professional colleagues here in Greece.

Thanks very much.

(Transcript by Amy Masarwe)