Remarks by James K. Galbraith at the Economists for Peace and Security Bernard Schwartz Symposium on Jobs, Investment and Energy. Delivered March 13, 2010, Ronald Reagan International Trade Center, Washington DC. Transcript by Amy Masarwe.

To the extent that we are not in the second great depression, we owe that fact primarily to the budget deficit. We owe it first and foremost to the automatic stabilizers that are built in to the institutions of the Federal Government: to the fact that as output and employment went down, spending went up on unemployment insurance and disability and other forms of relief and that tax revenues fell very sharply, providing a cushion to private incomes. Very important help came at the start of last year with the enactment of the American Recovery and Reinvestment Act: the stimulus package which, as Linda just said, made an especially important contribution to stabilizing the crashing budgets of states and localities.

I would argue that there were further important effects from the extension in late 2008 of deposit insurance and from the steps that the government took to back up the commercial paper market; these tended to quell a panic that might otherwise have overcome the financial system. In contrast, in my view, very little was gained by the actions that were taken with respect to the largest banks. That is to say, flooding the biggest banks with zero cost funds had very little effect apart from the wealth of effect that results from the stabilizing of prices in asset markets. And the reason to believe that lies in the simple fact that although the federal budget deficit went up, and incomes were stabilized, bank lending went down very sharply and has not recovered at present. Therefore, one might say that spending out of current income has somewhat normalized, but spending from new credit has not. And the question going forward is, how long will that situation continue?

There are two ways to get an answer. One is to look at the collapse of home values and the perhaps at the continued troubled condition of the major banks. These factors say we can expect to be in this situation for a long time.

The other way to is to look at averages from recent history -- an approach which lends confidence to an optimistic view. Indeed, this approach that has the curious property that the steeper the slump the more rapid you expect the rebound to be. The point I want to make today is that we live in a world where professional forecasters, and in particular the official entities, the Congressional Budget Office and the Office of Management and Budget on which our policy rely, have all basically wedded to the second approach.

They may prove right or wrong. I tend to doubt that they will be right. I'm a skeptic for the reason just given; I lean to the view that we are in for a very long problem on the financial side. But that's not what we're attempting to resolve here. The point I want to make, or the question I would like to ask, is this: given a very large uncertainty about whether the standard model is correct, about whether we are in a normal or an abnormal crisis, what's the prudent and sensible course of action? In other words: how should we best take account of the risks associated with the outlook in our situation?

My argument has been and remains that the risks are asymmetric. Doing too little means you go through a very long period of high unemployment. That you do not replace the jobs that have been lost. That you do not provide employment for new workers coming on to the labor market. That they spend many years of their young careers looking for work and not able to find it. That you have a vast amount of lost output and foregone opportunities. That you do not meet to the requirement for investment and reconstruction. That you do not get the head start on the environmental issues on which we need to be working.

Doing too much, on the contrary, means that you have to slow the work at some point. That you have to pull back. That you have to make an adjustment. That you maybe have to curtail a few projects once you've got them under way because you discover you don't have the capacity to do everything you are trying to do.

In comparison to the risks of doing too little, the risk of doing too much is very minor. It is hardly anything more than an annoyance. This is clearly a moment when the bias in our actions should be on the side of action. Should be on the side of endeavor. Should be on the side of taking the steps that we feel we need to take to deal with our real problems.

And the question I would have -- the question I would like to spend the rest of my time addressing, is this: Do we face an insuperable financial obstacle to doing that? My answer of course would be no.

The Congressional Budget Office, just to take one example, already projects unemployment to decline to what one could describe as a natural rate; 4.8%, in their analysis, over 4 or 5 years. There is no basis for that forecast. It is an assumption. It is simply based on the patterns of recent history. They also forecast interest rates, the short-term interest rate on federal debt, rising, also coincidentally, to 4.8% and that too is an assumption based on past normality. There is no reason to regard either forecast as representing the likely path of recovery of the economy from present conditions, or as a likely outcome, if we do not act substantially to move the policy forward. Unemployment could stay higher and interest rates can stay lower for quite a long time.

Looking out further there is a problem in the way the official forecasts are made. The long-term projections commit two very serious errors in consistency. The first is to assume, and here the culprit is health care costs, that health care cost costs can rise faster than average costs indefinitely. That is to say, that they can grow more rapidly than the average for a very, very long period of time. As a matter of logic this simply isn't possible. As health care costs rise more rapidly than the growth of the economy, the health care share expands and eventually the two numbers are going to converge. That is to say, that either the health care costs will cease rising so rapidly, or the rest of the inflation rate in the economy will rise. Straight-lining such a projection produces an economic absurdity and it follows from that that one of the major issues that we're constantly hammered with which is the crisis of -- prospective crisis -- of Medicare major entitlements is also an exceptionally unlikely outcome in the real world.

Secondly, and perhaps equally serious, if you look at the long-term Congressional Budget Office projections, they show rapidly rising interest payments on the federal debt. Payments that are projected to rise to something like 20 percent of total output in something like 30 or 40 years from now. It's something which is extremely strange because interest payments are a form of federal spending. And it would be extremely unlikely, in fact economically impossible, for them to the rise to 20 percent of total GDP without also affecting the rate of growth for the GDP itself. But the CBO models show no such relationship.

Again, this is plain evidence that we are working under a budget forecasting framework which is logically inconsistent and, which, in fact, nobody would defend if they were offered by a private party. They are accepted because they remain substantially unexamined and because they come from a high authority which is deeply embedded in the bureaucratic processes of budget formation and economic forecasting.

There is a third serious flaw in the methods that we use as a matter of official discourse in these areas at the present time. Marshall has already discussed this so I won't spend a great deal of time on it. It is the failure to reconcile the condition of the public sector to the condition of the private sector with which it is in effect inexorably linked. Every economist knows that the public budget deficit must equal the private surplus, which is to say, the excess of savings over investment and the foreign balance. If the private sector is not lending, if investment is collapsed and private saving exceeds investment, then the public deficit must and will reflect this fact.

There is nothing that can be done about that by cutting spending or raising taxes. What the official procedures implicitly assume is that the private sector will just return to normal post-war patterns. That in fact this crisis has not made the structural change in the behavior of the private financial sector, that it appears to have, to everybody who has observed it and written about it in the past two years, let alone everybody whose house is now worth less than the debt they owe on it. I would argue that's an assumption for which there is no actual economic foundation. And if it did happen if by some miracle, if we were to move into another business cycle of expansion that resembled those of the late 1990s or even the middle 2000s, that is to say credit-fueled based on a boom in some private-sector activity that was financed by the private financial sector, then you would see the same result on the public budget deficit that we saw in those two periods. That is to say the budget deficit would shrink and the forecast we now have of the long-term fiscal problems that are described by the conventional view would melt away; as they did in the 1990s.

It's worth asking what the markets think. And it's quite clear that those who are the position of supplying funds to the Federal

Government do not in fact believe any of the dire predictions that are a constant feature of the policy discourse. For that matter they don't believe the leading figures from Wall Street itself who are at the source of those predictions.

How do we know this? We can know this by looking at the long-term interest rate that the Federal Treasury presently pays. If it wishes to borrow for 10 years or longer that's around 3%; 20 years, that's a little over 4%, the last time I looked.

If there were a risk of default or a significantly perceived risk of inflation, those rates would have to be substantially higher than they are. The usual response when had you raise this point to an advocate of the contractionary deficit-hawk position is to dismiss the markets as irrational. A very curious response for an orthodox economist. But, if it were so, then it would clearly make no sense to tailor policy to the supposed demands of the capital markets. The rational response in the face of an irrational market would be to take advantage of the irrationality and to borrow as much as possible and get as much done before the markets woke up.

The deficit hawks -- I've heard them described as the deficit hysterics -- have built a powerful case against Social Security and Medicare; and by extension against open-ended fiscal assistance to states and localities. And against the long-term investment programs to rebuild the country and solve our environmental and energy problems on the strength of forecasting models that are built into the budget process.

My conclusion for you today is that those models are fundamentally flawed, internally inconsistent, and incoherent as economics. They owe their high standing to their bureaucratic function; to the fact that they comfortingly reinforce predisposition and belief. The world in fact does not place those obstacles in the way of a program of action.

The United States has, in the past, in times when it was nationally necessary to do so, and could in the future, undertake a bold program of public and private investment. A promotion of new services making use of all of our man power and talent and directing it to the problems we actually face. The ones that we know about. The ones that we cannot deny. The decline and decay of our infrastructure. The need to rebuild the country. The need to deal with the energy problems; with climate change; with the greenhouse gas problem. And, above all, the need to provide employment. Useful productive employment to the American citizenry.

The country will not go bankrupt. On the contrary, it would get rebuilt. Its people would make a living and by looking past the false problems; looking past the artificial obstacles; looking past the political arguments that are really embedded in a set of procedures that are only 30 years old and really should now be reformed or dispensed with, we can perhaps, I think, begin to deal with the actual issues that are going to effect us for the generation to come. Thank you.