

Comments by James K. Galbraith at a Symposium of the Global Progressive Forum, Res Publica and the Parliamentary European Socialists, Lisbon, July 9, 2010.

Thank you very much indeed and it's a pleasure to be here. I want to thank the Global Progressive Forum and Res Publica for organizing this meeting. And I want also to pay a word of tribute to remarkable leadership of Poul Rasmussen over many years of the Parliamentary European Socialists. A leadership of true conceptual originality and I think great historical importance. As an American, it's a particular privilege for me to have a role in these discussions, and I also need to say that as a Texan, I would like to thank those who arranged the climate in this room for making me feel at home.

A crisis is necessarily and properly a time for reflection; introspection. Why are *we* in trouble? What did *we* do wrong? How can *we* improve? I think the conduct of the socialist governments affected by the crisis here in Greece, also in Spain, has been realistic and disciplined. It's been free of false populism, bluster, or threats; conscious of the need for internal reforms; on the lookout for feasible measures that might mitigate the damage; seriously attentive to the crushing external pressures; and alert to the complex politics behind those pressures.

Austerity and adjustment are inevitable in crisis. But there are better and worse ways to proceed. And one hallmark of the Socialist approach must be to avoid inflicting gratuitous harm on weak victims. This is something that we have actually seen, and are seeing, in the ostentatious austerity programs of some right-wing governments. Austerity for its own sake. Austerity as an excuse for mounting an attack on longstanding targets in the welfare state. Austerity to show off how tough you are. Austerity to show how much pain you can inflict. There is a difference and it's an important difference and it's a difference that shows up at the level of national politics.

Having said that, let's also recognize that this is a global and a systematic crisis. It is not a Portuguese, Irish, Greek, or Spanish crisis. And when you think about that unflattering acronym -- PIGS -- you have to ask yourself, who invented it? Where did it come from? My understanding was that it came from an analyst at Goldman Sachs. If so, one is entitled to doubt that was entirely accidental. And I suggest that perhaps it might be useful going forward to change the referent of that acronym to its true meaning: Principal Instigator Goldman Sachs. The same flaws that are now singled out for criticism, in those countries I just mentioned, were not very long ago excused, overlooked, and readily financed in the upswing of the credit expansion. What changed was not the condition of the debtors, but the credit conditions in the larger world economy.

When did they change? They changed because in September of 2007 already it came to be recognized that the global financial system had been subjected to a vast swindle. A swindle originating in the American mortgage markets. Millions of mortgages: sub-prime mortgages; so-called Alt-A mortgages; mortgages known as "liar's loans"; as NINJA loans, because their recipients had no income, no job or assets; as neutron loans because they were destined to explode destroying the people but leaving the buildings intact.

These mortgages were, in effect, counterfeits. They were destined, when issued, to default if they could not be refinanced in two or three years. The lenders -- the originators -- knew this very well. They were putting people into homes who they knew could not document their incomes, whose credit histories were bad, and they were giving loans on homes which had been appraised at multiples of the actual market values of the house. This is intrinsically a dishonest practice. There is no reason why a mortgage lender would ever accept an inflated appraisal on a house unless it is simply a matter of selling a loan for an inflated fee.

Those counterfeits were then laundered in an exact equivalent of money laundering operations. They were transformed from dirty to clean, from BBB- to AAA, by the actions of the ratings agencies. The rating agencies were doing this because that was a very large share -- as much as 80% -- of their business. And their willingness to give an AAA rating to a BBB asset determined their market share and their profitability. Ratings agencies were once quite good at evaluating commercial credit -- say, the capacity of a corporation to service its bonds. But we are now talking about mortgages -- bundles of payments from millions of people -- and the ratings agencies never looked at the underlying documentation because they did not want to know about the actual quality of the borrowers. So they were complicit essentially in a laundering scheme.

The third stage in the network was a fencing operation -- the passing of these laundered counterfeits on to the legitimate market. The fence -- the entity that sold the counterfeit goods -- was the investment banks and the commercial banks. The ultimate buyers -- the marks -- were in many cases Europeans. They were pension funds and banks and others who had come to place a trust in the reliability of that AAA rating.

So we have all the elements here of a criminal enterprise; and I use that word in the technical sense. Not for rhetorical effect but because it was exactly as I am describing. People were swindled. Defrauded of vast sums. And that is something that demands a judicial response; not merely a regulatory response. Although regulation and good supervision are extremely important going forward, it is also necessary to clean up the practices of the institutions and to clean out the people who were responsible for those practices. This is normal practice. We did it 20 years ago with the savings and loan crisis. And one thousand insiders from that industry went to federal prison in that case in the United States. So I'm not speaking of something which is unprecedented. I'm speaking of something which is legal practice normally but which needs to get underway for this crisis to be finally resolved.

One of the things I think would be extremely useful, for those who articulate a Socialist and Social Democratic response, as they speak to the American authorities -- or for that matter to the investigating and judicial authorities in their own countries -- is that they insist on the priority of effective investigations and, as appropriate, indictments and prosecutions in these matters. It will be an important force in making this step, the recovery from the financial crisis, happen.

I have also to say that so far there is only one country which is setting the pace, which is acting as the model for the pursuit of the fraudulent element in the financial crisis, and that country is Iceland.

Iceland did, in fact, send Interpol to Luxembourg to pick up four senior officers of one of the major failed banks. It did put one senior officer of another failed bank, now in London, under indictment. It has frozen the assets of another in pursuit of a major case in the New York courts for yet another. So this is something which can be done, which is being done, and which needs to be done much more comprehensively and on a much larger scale.

The crisis began in the United States but it spread to Europe and to southern Europe. Why was that? Clearly, there was a global flight to safety; to the security of the United States treasury bill and to the bonds of Germany and France. But why was it away from the bonds of the small and southern European countries and not small northern -- or for that matter the large -- European countries? Why were these particular bonds suddenly deemed unsafe? I think the answer to that needs to be sought on three levels: One relates to the performance of the capital markets; the second to the economic provisions to the European Charter; and thirdly to the Constitutional structure of the European Union itself.

As far as the character of public debt markets are concerned, it seems to me worth pointing out that the innovation of credit default swaps -- which are effectively a way of selling bonds without actually owning them -- fundamentally changes the character of sovereign debt markets, and in a way which

probably cannot be reversed. That is to say, it is very hard for me to imagine a world in which the situation that existed, let's say, ten years ago -- which small countries could effectively sell revenue bonds on capital markets in a predictable and safe way -- will return. It is now possible to sell those bonds massively in very sudden ways in order to manipulate their price and take advantage of the resulting volatility. And that is a world which we have entered and from which we probably will not exit.

This suggests that we really do need to think how (and Poul Rasmussen spoke about this earlier) to create mechanisms which are larger than the markets, more stable than the markets, and that effectively replace the markets as the funding mechanism for capital expenditure in smaller countries.

The relevant economic provisions of the European Charter are two. First of all, there are the arbitrary, capricious, and in any event outdated and yet still, in many people's minds, sacrosanct objectives of a 3% of GDP deficit and a 60% debt-to-GDP ratio. Whatever the original purpose of those goals -- and they did serve a purpose at the time of the movement to unify European currencies -- they are clearly inappropriate to a global financial crisis. Everyone who is technically involved in these questions knows this. If you ask -- and I have done so -- if you ask the senior economic staff of the International Monetary Fund, why not 80% of GDP? Why not 100% of GDP as your goal? And why not 2025 or 2050 as your date for reaching that goal rather than 2015? They have no answer to that question. They have no answer to that question. There is no answer to that question. These are simply, as I said before, arbitrary and capricious standards which have somehow become stuck in law and in people's minds, and which are now highly destructive in their effect on the social structure of Europe.

The second relevant treaty provision concerns the role of the central bank; which is very different from that in the United States. The Federal Reserve is statutorily charged with furnishing an elastic currency; it's a term of the U.S. law. The European Central Bank was formally focused on price and

monetary stability and denied the role of lender of last resort. This is now already effectively a dead letter. Even the ECB has come to recognize this – grudgingly but nevertheless - to recognize as necessary the reality that it must become the buyer of last resort for sovereign debt. And it is buying sovereign debt. It is doing so as we speak. It has been doing so for some days. And I think that is the reason why the crisis in recent days has eased. Why Spain, for example, was able to issue sovereign debt a few days ago. And why the Euro has stopped its precipitous decline in relation to the dollar. So this is a good sign. It is good to be realistic about this and to point out to the central bank when it is taking a step in the direction of an appropriate degree of flexibility -- and away from dogmatism -- in its response to the crisis.

If I may be permitted an historical reference, this is not the first time that Europe committed itself, by treaty, to unrealistic economic goals imposed for political reasons. The previous major instance was at Versailles in 1919. With the difference being that, at that time the conditions were being imposed on Germany, whereas now they are being imposed by Germany. But that's a minor distinction; that's not the important point. They were totally unrealistic then and they are totally unrealistic now. And then, as now, as Keynes wrote in 1920, the inevitable necessity is for a revision of the treaty.

The constitutional issue raises a set of even more profound considerations. And here again I will simply make a few references to, what seem to me to be, the appropriate historical parallel.

Europe is a confederation. It is basically a customs union combined with a currency union. It has a great many other regulatory structures, but from an economic standpoint those are the essential features.

We have experience with that. We've had two confederacies in North America. We got rid of the first one when we adopted our Constitution in 1789. The second one failed in 1865. An important point about that second American confederacy is that the economic consequences of that failure, which were

a backward, impoverished, undeveloped South -- a very large part of the country -- those consequences went on for a very long time. They went on effectively almost 70 years. And the situation did not begin to be resolved until Franklin Roosevelt and the New Deal in the 1933.

We tend to think of the New Deal as a response to the financial crisis and the Great Crash and the Great Depression of 1930-33. But it was in fact far more than that. A better way of thinking is to say that the financial crisis of 1929 was the last gasp of an effort to create prosperity in the United States on the basis purely of private finance. The New Deal was transformational.

That transformation began in the American South with the Agricultural Adjustment Administration, the Tennessee Valley Authority, the Rural Electrification Administration, and ultimately the Social Security system which created a national or a continental basis for stabilizing the incomes of the old. This was the first effort remotely adequate to the task. And only when it was undertaken, on a scale never before seen, did the United States begin to forge a fully national economy capable of resolving mass unemployment, which was 25% in 1933, and of containing the pressures for mass migration, which was occurring and continued to occur through this period.

This coincided with the innovation of Keynesian economics and the large-scale application of expansionary fiscal policies on the continental scale as the general means to resolve what was both a structural and a financial crisis. And that fact also is not accidental. So it seems to me worth recognizing that ultimately this too should be on the agenda for Progressive and Socialist forces, as we think realistically about what will be required to resolve the present situation.

To summarize, within the limited means available to governments in Europe, the Socialist program is, and in my view it should continue to be, one of reform, innovation and imagination. It should be one of protection of the vulnerable and an honest search for the best ways to advance. But at the same time,

there are larger issues -- jobs growth, care for the elderly, climate change -- which will not be resolved at the national level and probably cannot be resolved without confronting the larger economic legal and constitutional issues that face Europe as a single integrated economic region.

Those problems do exist and sooner or later they will need to be dealt with effectively. Thank you very much.

(Transcript by Amy Masarwe)