

Comments by James K. Galbraith at a meeting of the Socialist International Commission on Financial Affairs, presided by Joseph Stiglitz and in the presence of Prime Minister George Papandreou. Poros, July 12, 2010.

Thank you, Prime Minister. I think, at the outset, you correctly pointed to the origins of the crisis; and Joe has expanded on that considerably. I would add one word and one framework of interpretation to that discussion of origins. And the word is fraud.

It's important to recognize that at the root of the financial crisis there was one of the greatest swindles of all economic history. The mortgages that were originated in the private sector in the United States which were then transformed into securities and sold through the financial markets around the world were in effect counterfeits. They were documents that looked like mortgages but were known by the people making them to be certain to fail. It was known that they would either have to be renegotiated or that they would default within a short period of time. They were made to borrowers who couldn't document their incomes, didn't have credit histories on the basis of homes that whose values were grossly inflated by corrupt appraisers.

These mortgages were laundered. Counterfeit documents were laundered -- in the technical sense of that term; money laundering -- by the ratings agencies. That is to say, they were transformed from the BBB- paper that they were, into AAA paper. And then they were fenced -- again, in the technical sense of that term -- by the investment banks and the commercial banks. That is to say, sold onto the legitimate market. Massively. Including massively to Europe. Which is to say, that the victims of this fraud include, to a very large extent, European investors, European pensioners, European funds, and European banks.

It's important to recognize that this fact links this crisis -- the financial crisis in the United States -- and the sovereign debt crisis in Europe. Because what happened, in effect, when the fraud was exposed -- which happened already in August of 2007 -- what happens with counterfeit documents is that they lose their value completely. No responsible investor will purchase them. As a result of that, the inter-bank lending markets collapsed; and after a period of policy maneuvers, that were intended to delay the inevitable, the financial markets themselves collapsed in September-October of 2008.

And there was, in the panic, a flight to safety. The flight to safety is the origin of the sovereign debt crisis. And it is not a question of certain states having taken on the liabilities -- here I would differ with Joe's interpretation -- the liabilities of the banking sector. It was an act of the world investment community attempting to get out of assets that they perceived to be relatively risky and into assets that they perceive to be relatively safe. The safest assets are the sovereign debts of the largest countries; especially the United States. And for that reason the yields on US Treasury bonds went down -- reached practically historical lows -- and the dollar has risen while the Euro has fallen; and spreads between the large Northern European countries and the smaller southern countries rose dramatically from that date forward.

This problem was complicated by the innovation in the financial markets of the Credit Default Swap; which is essentially a way to sell a bond that one does not own. That is to say, to short the bond market. This transformed the debt markets -- especially for smaller and less liquid markets of smaller nations -- into highly volatile and speculative behemoths which they had not been before. That is probably an irreversible event which needs to be taken into account in thinking about how to handle the crisis going forward. Because it is now possible, and it has now in fact happened, that groups of financial operators -- hedge funds and private equity funds and so forth -- can and have made decisions to mount raids on the debt of smaller European countries with the result that they drive down their prices and up their yields.

The role of the governments who are caught up in this crisis, and I would especially cite the government of Greece in this case as having reacted in an exemplary way, is to face these difficulties with discipline, as effectively as possible under the circumstances. And above all realistically. That is to say without illusions. Without pretending that things can be managed without pain and difficulty; but also without threats and without exaggeration. And without imposing cuts for theatrical purposes to impress a market that will not be impressed or to inflict pain for the purpose of inflicting pain -- something I think which is going on in the politics of the right-wing governments and other parts of Europe.

The policy that is required, and what we are seeing in your government, Prime Minister, is a strong effort to seek original ways to preserve and advance a social agenda. To protect and improve the economic performance and the public administration of the country in the face of objective difficulties and very, very strong external pressures. And this is I think a mark of a serious and realistic approach for which your government is being recognized.

What then is the responsibility of the larger community? It seems to me that the least that one can expect of the larger community in this circumstance is that it be equally realistic. That it approach this problem in a way which is pragmatic. That is consonant with the laws of economics -- and frankly with the laws of bookkeeping and national income accounting.

I'll just mention three broad areas where it seem to me that it is very important that this principle be respected. First is in Central Bank policy. The Federal Reserve Bank in the United States, from the start of the crisis, took the view accurately that it had to provide liquidity if no one else was going to do so. And it effectively, and very rapidly, nationalized the commercial paper market and stabilized the money market funds, and in other ways provided -- extensively became -- the dealer of last resort in a money market which is founded these days on the operations of dealers rather than the operation of

banks. That action greatly contributed to the stabilization of the United States and to the current rising position of the dollar.

In Europe, the Central Bank has been pragmatic in certain respects of its actions, but much more reluctant to recognize the necessity of those actions. And that has created a lot of uncertainty which has affected the price of the sovereign debt of the smaller European countries. It is difficult for central banks to change policy and to recognize that the doctrines on which they were founded were fallacious, but it is sometimes necessary for them to do so, and it should be part of our agenda to explain this. So if it is now necessary, and I believe that it is necessary, for the European Central Bank or some other agency such as a European debt agency to provide a market for the sovereign debt of members of the European community then so be it. That is now, it seems to me, a necessary feature of the scene given the fact that the bond markets were destabilized by the intervention of large and speculative actors and so we should recognize that this is now a permanent feature of the scene. A Rubicon has been crossed and cannot be crossed back in the other direction.

The second point concerns the targets for budget consolidation, for fiscal austerity. These targets, to the extent that they are necessary at all, should be set in a way which is realistically consistent with the resumption of economic growth and with progress toward higher levels of employment. They should not be set in a way which is locked-in by past practice or by a set of numbers written into a charter for reasons which are no longer relevant.

If you ask the senior economic staff of the International Monetary Fund -- and I have done this -- why there should be a target of 3% for budget deficits, and why there should be a target of 60% for the debt-to-GDP ratio, and why the targets should be implemented over a five-year horizon, they don't know. You ask them why it should not be 80% of GDP, or 100% of GDP, for the debt target, and why it should not be 2025 or 2050 rather than 2015 for the target date, they have no answer. Because there is

no answer from the standpoint of any economic theory. It is one set of arbitrary and capricious rules and of course it is a fact that the harsher the austerity program the more intrinsically unrealistic and incredible it is. The more intrinsically impossible it is to achieve the targets. This is something that the credit markets understand very well.

Again, the IMF's own studies show that half of the increase in budget deficits in the period since the crisis -- fully half -- has been due to the collapse of revenues. A very large further share is due to negative growth in relation to previously existing debt burdens. Less than 10%, in fact just 7.5% of the increase in public deficits in the advanced countries is due to discretionary fiscal stimulus, to Keynesian policies. Less than 10%. So this is not a crisis caused by -- or not a problem, not an issue -- caused by an increase in discretionary public spending. It is an issue that is essentially an artifact of collapsing revenues. And if policies are pursued in such a way that forecloses successful return to economic growth, revenues will collapse further and the deficits will not go away. And it is clear that, for example, that the leadership of the International Monetary Fund understands this full well. So one can ask in discussions on this policy for a degree of realism that has not been present before.

Joe mentioned the longer-run debt issue. And I want to just say a quick word about that. My view is that debt-to-GDP ratios will rise. They will rise as a result of the crisis, until the underlying cause of the crisis -- which is the dysfunction of the financial sector -- has been resolved. When a financial sector again exists which is capable of providing funds for business activity and for public investments, then the public debt-to-GDP ratio will fall. This is what happened in the United States after the Second World War, when the public debt-to-GDP ratio in 1946 peaked at 121% of GDP, and then it fell gradually to 33% of GDP by 1980. This was not because there was any great obsession with it, and certainly not because it was provoking any crisis; this was when the United States was the dominant force in the world economy. The public debt-to-GDP ratio made no difference to the way the strength of our economy was perceived, and it fell simply because we entered a very long period of largely

privately financed economic growth. And that will happen again and that will resolve the debt-to-GDP issue. Until it happens again, the debt-to-GDP issue will not be resolved.

The third point concerns the question of imbalances between countries. This is largely an issue of current accounts. As a point of elementary realism, it should be realized that a balanced trading area -- which the Eurozone is, the European Union largely is -- a Euro's worth of surplus in one country, is a Euro's worth of deficit in the other countries. This is a matter of bookkeeping. It is a matter of basic economic reality. It cannot be repealed by a call to higher levels of virtue. As long as the surpluses exist, the deficits have to exist somewhere else.

Injecting an element of morality into this discussion is distinctly unhelpful. There is no greater virtue in surpluses and no greater vice in deficits. The imbalances simply reflect the different economic positions of the constituent countries of an economic area. And what is required here is that the surplus countries recognize that a stable and harmonious economy requires that the surplus countries hold the debts of the debtor countries. End of story. It is easy to see that there is no crisis, although there is a certain amount of grumbling about it, but there is certainly no crisis in the trade relations between the United States and China. China is a surplus country but it holds the debts of the United States largely without complaining about it, and it does not try to tell the United States how to behave. In any case it would not succeed. I'm just suggesting that within a community like the European Union, the same rules should apply, and a reasonable and harmonious relationship similar to that of the U.S. and China ought to be the least that one should expect inside such an economic union.

What then are the ultimate goals of a functioning community that tries to base its principles on realistic recognition of the economic realities? Many years ago as a very young man I was on the team that drafted the basic law governing the goals and objectives of economic policy in the United States. This was ultimately enacted in 1978; the Humphrey-Hawkins Act, formally known as the Full Employment

and Balanced Growth Act. The goals and objectives set by statute for the United States, including for the Central Bank, were full employment, balanced growth, and reasonable price stability. Phrasing is important. That phrasing I submit is reasonable and sets objectives which are coherent, with the emphasis in the right places. To replace such a standard with an objective entirely focused on accounting numbers – on deficit numbers and debt numbers -- would be both unrealistic and highly counterproductive. So the broader objectives should be, as always, full employment, balanced growth, reasonable price stability. And these should be achieved, in our particular day in age, in the context of addressing real problems; not invented ones.

We have real problems. We have problems of energy and the environment. We have the problem of climate change, and Prime Minister, your government has made this into a very important priority. We have the priority of caring for an aging population. And the problem of caring for a younger population so it can continue to function effectively in a very demanding world. All of these require organization and resources and they require also institutions capable of carrying them out.

Historically, when countries have effectively tackled the need to construct and reconstruct themselves in a serious way they have done so by constructing appropriate institutions. The United States did this in the New Deal, first of all by taking Herbert Hoover's Reconstruction Finance Corporation and turning it into a large instrument of business finance, which replaced what was not happening in the private banking sector. The RFC also spun off institutions which created the modern American housing sector and much else besides. We created specialized public institutions like the Tennessee Valley Authority, Rural Electrification Administration, and many others that set themselves the task of rebuilding the country. In post-war France there were an entire host of specialized credit institutions. From the Caisse des Dépôts et Consignations, Crédit Industriel et Commercial, Crédit Agricole, Crédit Foncier; a whole series whose purpose was to provide specific help to sectors that were deemed strategic or useful in post-war development. And this succeeded in giving us the modern French state.

Similarly in Japan. Similarly in Korea. And I would suggest that if we confront the reality of disorganization and of institutional failure of the private financial sector, that we should be thinking seriously at the level of the continental entities that we now have of the appropriate credit institutions for taking up this task and carrying it forward.

And finally, there is a question of the relationship between entities between regions and countries in a larger community. Over time, if a larger community is going to succeed, it is necessary that the less wealthy regions come together with the wealthier ones. That there been convergence in levels of income and prosperity. Prosperity and competitiveness do not require that one come to surpass the other, but that the gaps gradually narrow. This too is something with which we have concrete historical experience in the United States. The New Deal, inaugurated in 1933, is often thought of as a response to the Great Depression. But it is in fact -- it was, in fact -- pretty much a response to the Civil War. To the failure of the second American Confederacy -- the confederacy of the southern states -- in 1865 and to the seven decades of economic failure in the south of the United States that followed.

That failure had left the southern United States immensely poor, backward, illiterate, malnourished, undeveloped. The New Deal provided the framework for the emergence of an American South which was fully integrated into a national economy that in fact did not exist before. And which could function as a successful part of that economy to the point that now, seven decades later, the American South is right at the average levels of the country as a whole.

This is something that has to be part of an agenda for construction of a successful community. It has been of course part of the European project all along, implemented in part by the structural funds, but not to the point of adequacy and in a way that is greatly threatened by the present crisis. Preserving and advancing this agenda seems to me to be a very, very crucial piece of the larger picture.



And I also would suggest that it's an unavoidable piece, because otherwise the problems of divergence simply get worse. The problems of divergence lead to migration. They lead to higher levels of conflict between the countries in the region and ultimately they lead to the unthinkable. Since the unthinkable is unthinkable I won't even mention it, but it seems to me that we can all see a successful way forward and an unsuccessful way forward, and the successful way forward has to be consistent with the basic democratic values. And with the basic values of human development, the basic values of economic development, the basic values of sustainability -- both of the larger environment and of the economic community of which one would like to be a part. Thank you very much.

(Transcript by Amy Masarwe.)