Clark University
The Economic Crisis and Obama's Response
Dr. James K. Galbraith
Sponsored by the International Study Stream

Mr. Dick Peet: Welcome to the talk. It's sponsored by the International Study Stream. My name is Dick Peet and I'm the Interim Director of the International Studies Stream, sponser of this talk with the Economics Club and the Geography Department and IDCE.

The speaker is James K. Galbraith who has his degrees from very prestigious places like Harvard and Yale. Then he worked for the Joint Economic Committee of the United States Congress. He is presently a professor at the University of Texas.

Now, James says some strange things. Just to give you a quick example, invited to someplace in Ohio to give a lecture on Milton Freedman he said, quote, "I come to bury Milton, not to praise him."

James, if you're going to say naughty things like that you've come to the right place.

[Laughter and Applause]

Mr. Peet: That's enough from me. James K. Galbraith, the Economic Crisis and Obama's Response; and questions afterwards.

Thank you.

[Applause]

Dr. James K .Galbraith: Thanks very much indeed. It's a great pleasure to be here.

I have a peculiar credential for discussing the present economic situation. That is that I have been, for much of my career, a kind of ambulance chaser of financial crises. It is not a job one chooses, but in my case it fell upon me.

I arrived at my first professional employment, on the staff of the Banking Committee of the House of Representatives, in 1975. One day the chairman of the committee, a Congressman from Milwaukee named Henry Reuss, stopped by my desk that was just outside his office. He said, "Come with me. We must go to a meeting." He took me through the tunnels of the House Office Buildings to a meeting room on the top floor of the Longworth Building where the entire New York City Congressional Delegation had assembled. They were deeply worried because the City had been told by its bankers that they would not renew four billion dollars of short-term debts that were coming due in the middle of 1976. The City was faced with bankruptcy with what they anticipated would be chaotic consequences for services and for the city workers. They were anxious to enlist the support of their colleague, the Chairman of the Banking Committee, because the Administration—the Ford Administration at that time—was unsympathetic.

Henry Reuss listened to the worried account of the situation for fifteen or twenty minutes. Then he said something which has been burned on my brain ever since. He said, "Don't worry about it. My staff will have a plan for you in the morning." I was twenty-three years old.

I later worked on the rescue, in 1979, of the Chrysler Corporation; in various subversive ways on the Third World debt crisis in the 1980s; and then after moving to academic life I spent a fair amount of effort on the Asian crisis in 1997, the Russian crisis in 1998, and the Information Technology boom and bust in the late 1990s and 2000. This was before becoming aware, in the middle of this decade, of the very large wave of speculative and unstable lending that we would come to know as the Housing Debacle and the financial crisis that broke in August of 2007.

It's an odd career track for an economist because it has essentially no intersection to speak of with the development over the same period of three decades within my professional field. That is to say, I found myself working in an area that had essentially no professional audience and very few professional colleagues.

It had been the fate of the tradition in which I was raised—the tradition of Keynesian economics of the 1960s and 1970s—to go down in discredit, in the mid to late 1970s, as a result of the sin of complacency: the sin of believing, as a professional group, that they had solved the major problems of the national and, indeed, of the world economy. This was just in time for those economies to be beset by a problem they had not thought of, namely stagflation, the combination of inflation and unemployment.

It's an irony of professional history that what rose when Keynesian economics declined was a school known as Neoclassical Economics that, if anything, became even more complacent over the following twenty-five or thirty years. It became, in effect, complacency squared.

The Neoclassical tradition grew out of a body of thought that we call General Equilibrium Theory of which the central idea is that the economy is a self-stabilizing system with the tendency to revert to a set of normal values, to a set of normal conditions over time. If unemployment exists and persists in that system it is likely due to a deliberate obstruction of the ordinary process of adjustment such as the insistence of trade unions and government on wage rates that are too high for employers to be offering the quantity of employment that they might otherwise like to offer.

Depressions in this vision of things are caused only by avoidable errors committed principally by central bankers. That was Milton Freedman's interpretation of the Great Depression. Cycles—to say movements up and down in economic activity over time—are thought to be based more or less strictly on waves of technological change. Therefore, they are not to be appropriate subjects for interventionist public policy.

In this way complacency is mixed with fatalism in a vision of the economic system that is not entirely self-consistent or coherent, but that gave us a reinforcing logic for policy—a common position shared by all of these diverse threads—which is that the government's role in the economy should be minimized. Indeed, that public power exists in opposition to the benevolent

force of the so-called free market; that the market is capable of doing everything that government does, only better; and that the appropriate role for government is essentially to get out of the way.

This was the vision of the economics profession until a year ago. It led to a set of scholarly preoccupations that left our profession completely unprepared for the economic developments of the last eighteen to twenty months.

Meanwhile under this penumbra of complacency and fatalism the practice of political conservatives holding public power changed.

I think it's fair to say that when conservatism experienced its first rise to power in the early 1980s under President Reagan it was animated, to a degree, by an economic philosophy that was held, seriously and in good faith, by at least part of that Administration. It was a philosophy that called for small government, certainly, but also for the consistent application of a stabilizing monetary policy, for free trade, for balance in the public budget, as well as for deregulation and privatization. It was in some ways a coherent vision with deep roots in the academy. However, it was one that as time went on was shown, in one dimension or another, to be completely impractical and completely unworkable as an actual philosophy of government; and conservatives learned from that experience.

By the time the second Bush Administration took power in 2000 I think it's fair to say that the principles of the Reagan period had been substantially forgotten and would remain ignored and neglected; and that, instead, conservatives in power in the past decade were largely interested in the exercise of state power, not its minimization, and its exercise substantially for the benefit of the particular clienteles, the particular circles of economic life who had sponsored those political forces in the first place. In other words, rather than having a coherent economic vision of any kind we fell under a government that was essentially a government of constituencies, a government of clienteles, what I've called the Predator State.

I give you this background, very briefly, both intellectual and political in order to lay a basis for discussing the origins of the crisis that we are presently experiencing because those origins are precisely in the exercise of state power in the service of particular constituencies and clienteles; and specifically in the active and deliberate de-supervision of the financial sector in the middle part of the past decade.

There is a kind of Gresham's Law of business practice. That is to say in an environment where underhanded sharp practices, speculative excess, and fraud for that matter are tolerated there is a tendency for those practices to become the dominant ones in the industry in which they are found and for the ordinary business practices that we tend to come to accept and to expect to be crowded out by the pressures of market competition. The market, in other words, becomes the vector or the enforcer of the worst practice of the most aggressive abuses because they are rewarded by a favorable bottom line and a high price in the stock market.

The result inevitably is a tendency toward instability, toward boom, followed by exposure, disillusion, bust, and ruin. This is essentially what happened in the financial sector.

There is a body of economic thought that deals with this. It can be linked to two major theorists, one of whom I think is at this stage just emerging.

The first is Hyman Minsky who argued very persuasively in the 1970s and 1980s that financial processes were inherently unstable; and that stability itself inspired confidence that led to excessive risk-taking that led to unsustainable positions and ultimately to financial position-taking that was destined to collapse.

The second is a criminologist by the name of William K. Black who has written about the concept of control fraud—namely fraud committed by those who are in control of large enterprises— as the most efficient way towards self-enrichment in an excessively permissive environment.

How did that environment take hold in the middle part of the past decade? The story is really very simple. It was a deliberate action of public policy.

The first Director of the Office of Thrift Supervision in the second Bush Administration, the first term of the second Bush Administration, came to a press conference on one occasion with a stack of copies of the Federal Register and a chainsaw. It was not a subtle thing. He was sending a very clear and unmistakable signal to the business press who were assembled there about the attitude that his agency, the Office of Thrift Supervision, would take toward underwriting standards in the mortgage business. The consequence was—and this just one example; there were many other things that they did including the return to positions of high authority in the regulatory structure of those exact regulators who had been proven the most incompetent and the most complacent in the savings and loan crisis fifteen, twenty years earlier—a rapid spread of the most aggressive, the most abusive, and the most unsustainable practices in the private mortgage industry.

Mortgages were passed out to people who could not document their incomes, whose credit histories were non-existent or bad, and on the basis of houses that were appraised by appraisers who would only get paid if they assigned a satisfactorily high value to the house so that the market for appraisals was systematically biased toward inflating home values. These mortgages were then structured in such a way that the payments would be barely affordable by the people who received the mortgages for the first two or three years, at which time the contract specified that rates would go up and, in many cases, there was also negative amortization so that the principal balance grew over time.

The lenders were very well aware, as the borrowers were not, that the mortgages would not be sustained past a very short period of time. The borrowers, if they expressed anxiety, were told that housing prices always went up and, therefore, they would be in a position to refinance those mortgages favorably two or three years down the road.

The whole exercise was replicated hundreds of thousands of times, millions of times. The resulting mortgages were packaged in bundles of ten thousand or so and sold in slices to the investment community with various devices that we needn't go into like over-collateralization, to

persuade the ratings agencies that they could be ranked as a triple A—that is to say as safe as government debt—and thereby acceptable to pension funds and other institutional investors.

The originators were committing fraud. The underwriters were committing fraud. And the ratings agencies, by representing that a quantitative risk-management model was as good as actual inspection of the documentation underlying the mortgage, were also committing fraud. They were doing so because they would not get paid for issuing a rating unless they issued favorable ratings: the originators would not come back to them for repeat business.

In all of these cases the market model incentivized the expansion and the metastasis of unsustainable finance in the housing sector.

That which cannot be sustained will not be sustained. Herb Stein, Richard Nixon's Chair of the Council of Economic Advisors, famously articulated the law that when a trend cannot continue it will stop. In August of 2007 the banks, apparently for the first time, examined their own portfolios and came to the conclusion that they were sitting on massive quantities of worthless assets. Thrown in to grave doubt about the state of their own balance sheet, indeed their own institutional survivability, they came to the sensible conclusion that everybody else in the industry was probably just as badly off as they were and they ceased being willing to lend to each other. That was the start of the crisis: the collapse of the inter-bank loan market around August of 2007.

That crisis percolated for a year or so until it became clear, in the fall of 2008, that there would be no easy out and panic set in leading to, in very rapid order, the collapse of the entire investment banking sector of the United States' financial economy and a situation in which there was incipient panic because it was not clear to the broad public that the deposits in ordinary banks were safe with the very low limit of a hundred thousand dollars for deposit insurance that existed until Congress stepped in, in late September, early October, and raised it to a quarter of a million.

At the same time the Federal Reserve effectively nationalized the commercial paper market taking an entire enormous source of liquidity out of the hands of the private sector altogether, an action without which the economy would have collapsed in the fourth quarter of last year and the first quarter of this year even more thoroughly and completely than it did.

The consequence, I would argue, of this corruption and destruction of the financial sector is something substantially more grave than the kind of recession or business cycle movement that we have become accustomed to periodically in the postwar period. It is a collapse in the fabric that underpins credit relations, a collapse therefore in asset valuations—particularly in housing, but also in corporate equities and just about everything else—and, therefore also, a collapse in lending and borrowing that rests both on the prospect for profitability and the existence of adequate collateral. It's a very profound event, something that is unseen certainly in this country in my professional life and in most of our biological lives, and something that has only one historical parallel in the last century and that is the Great Crash and subsequent events from 1929 into the early 1930s.

All of the postwar credit cycles were essentially driven by policy—that is to say by the action of the Federal Reserve raising interest rates—or by external shocks—such as the rise of oil prices in the mid-1970s—and not by a systemic collapse of the trustworthiness and creditworthiness of the financial system. But that is what we are experiencing now.

The reaction in the late part of last fall was one of panic and confusion overlaid by the existence of an essentially dysfunctional Treasury Department that was not competent to analyze or handle the crisis in an Administration that was rapidly going out of existence. It was the best, I think, that Congress could do at the time to pass an enormously inefficient relief bill that managed to stave off utter disaster from October until January, until the new Administration could take office.

I had some role, actually, in the congressional discussions that led to the passage of that bill. I think it was very interesting to see that, perhaps contrary to reputation, Congress played a constructive role in adjusting what the Bush Administration additionally asked for, taking a three-page bill and turning it into, ultimately, a four hundred and eighty page bill that was actually an improvement. It at least expressed certain principles for the protection of public interest and also took certain essential steps—like raising the ceiling on deposit insurance—without which panic at that moment would not have been quelled.

I want to turn now—and spend the last few minutes of these remarks—to talk about the approach to this crisis that has been taken by the new Administration.

It is certainly a relief to have a new Administration, to be at the start of a new government rather than at the end of one, and to have a President with both the talent and the public confidence that are enjoyed presently by President Barack Obama. I say that though I think there is a real question as to whether this opportunity will be used in a way that makes an effective course of action in the time during which the window of opportunity will be open.

There are serious questions about both the capability and the motives of the economic team that presently is in charge; but I want for the purposes of argument this afternoon it give them the benefit of the doubt, describe briefly what I believe to be their understanding of the situation, and then to offer my critique of it.

The formula, of course, has been a combination of early action to stimulate the economy—a stimulus package, the Recovery Act, the A double R A that was the first legislative achievement of the Administration—and a bank bailout, a bank rescue program whose stated objective is to get credit flowing again. In the Administration's view, or in the view of the economic team, these two measures are intended to work together to provide, on the one hand, some impetus toward activity, toward expansion to thwart and stall and slow the massive loss of jobs that the economy is experiencing and the consequences of that, and on the other to resurrect the banking system by cleansing its books of the so-called toxic assets on the theory that it is a kind of congestion or clogging of those books that is the principal reason why bank lending and borrowing have dried up as thoroughly as they have.

With these two steps the Administration envisages, and its economic forecasts reflect, an expectation of a fairly rapid return to normal where normal is defined as the conditions, let's say, of the middle 1990s or the middle 2000s; that is to say an economy operating at a fairly high level of employment and driven forward by an active financial sector, always in the leading position, extending credit and making possible profitable private enterprise.

If you assess the Stimulus Package as it was developed and enacted it seems to me that the most obvious features of the situation all lead toward the conclusion that it was smaller than it should have been and not as ambitious in time as it should have been. In the first place there were political constraints.

In spite of the fact that the administration came in with massive public support that support did not extend to the Congress, it did not extend to complete control of the Senate, and it did not extend to the so-called centrists in the Democratic Party, in both Houses, who remain deeply preoccupied with fiscal questions—that is to say with the size of deficits and public debt—and with a Congress for whom a trillion dollars is a very large number.

Secondly, there was a technical question, which is the context of economic forecasting within which the Stimulus Package was constructed. The economic forecasts, for example, of the Congressional Budget Office or the Office of Management and Budget are built around the presumption that the economy has certain normal values to which it will return in a reasonable period of time.

In the case of the CBO there is an expectation that an unemployment rate of 4.8 percent—the so-called natural rate—is the normal value and that the economy will get back there over a four- or five-year period even if nothing is done. That being so estimates of the effect of a stimulus package are in the context of a recovery that is expected to begin in the early part of next year whatever policy steps are taken.

That context, professional expectation, reduces the urgency associated with the Stimulus Package and makes it very hard to argue for a package that would have been dramatically larger than the one that was enacted even though the real situation leaves us no reason to believe that the underlying forecast is correct.

Secondly, there is in the expectation that the economy will recover a certain short-term-ism, a certain short-term view that caused the Administration to place an enormous emphasis on measures that could be put in place quickly that were so-called shovel-ready: that is to say projects that municipal and state governments were already planning to undertake and that they were holding up on simply for lack of funding. The result of that was, and is, that measures that would rebuild the economy over the long run did not get high priority in the design of the recovery package, the expectation being that after two years things could be wrapped up and we would be back to the previously policy-making paradigm. Again while that expectation is driven by these habits of thought in the forecasting community it is, strictly speaking, without foundation and there is no reason to think that it's correct.

Let me turn now to a brief assessment of the banking question. It took us a long time, of course, to get to the Geithner Plan, to the program advanced by the Treasury just a few days ago, for the banking sector. So we should ask what does it do? It is, obviously, a complicated structure involving the creation of public/private entities, partnerships, that would purchase the securities—based upon the toxic assets, the toxic mortgages—and remove them from the books of the banks at the purchase price thereby permitting the banks to report a capitalization based on net values. These purchases would be funded, very largely, eighty-five percent, by loans from the Federal Deposit Insurance Corporation—which is to say basically from the taxpayer—that would be non-recourse in nature, meaning that if the assets did turn out in the end to be non-paying, to go bad, the loans would default to the FDIC and the losses would be absorbed in the first instance by the bank fund and then, secondarily, by the taxpayer.

The presumption behind this program is, once again, that the world will return to normal and that as the economy recovers those bad mortgage assets will, in substantial measure, become good again and they will pay off over time; that they will retain and regain value; and that the investors will make money, including the Treasury which would have a seven and a half percent ownership equity share in the partnerships.

There are many people who think that is a reasonable proposition. I'm not one of them for the reason I've given you earlier.

The mortgages that underlie these assets, these securities are, in my view, intrinsically unmarketable. They represent a set of financial instruments that exist only because of the abandonment of state responsibility in the regulation of finance in the Bush Administration; they are intrinsically unsafe; and that came to market only because of the pervasive climate of openness and permissiveness with respect to financial fraud. It, therefore, seems to be very likely that no matter what happens to the economy—and I'm not optimistic—these mortgages will not recover value; that they are, in effect, permanently impaired; and that if there is a market for them in the first place it is very possibly a market that the banks will thoughtfully create for themselves by bidding up the price of these assets in order to get them off their books at a high price, recognizing that when reality sets in the loans will default and the assets will end up as a loss to the taxpayer. That seems to me to be the most likely scenario; and it's a scenario that could, if it plays out as I've described, work to save the major banking institutions. But there are two problems.

One problem is that there is absolutely no reason why we should have or will have, over the next several decades, a banking system that is as large in relation to the economy as we have had for the last couple of decades.

The banking system grew enormously after around 1994 in relation to the economy as a result of a couple o credit bubbles: information technology and housing. It will shrink. It has to shrink. There is no way, going forward, that we are going to have a bunking system that pays ten percent of all wages and earns thirty percent of all profits, which was the case just a few years ago.

The issue is which banks will shrink? Which will be squeezed out? Will it be the very large number of very small banks—that are largely community-oriented, that were largely

conservatively managed, and largely avoided involvement in sub prime securities and in toxic mortgage assets, generally speaking, and which are solvent today but deeply affected by rising insurance imposed by the FDIC to pay for the crisis—or will it be a handful of large banks—all the familiar names— that were at the root of this disaster? These large banking institutions are, themselves, very arguably in many cases, too large to be managed even by their own leadership let alone regulated by public authority simply because they are deeply complex international institutions designed to make money by tax and regulatory arbitrage—that is to say a very large part of their business is effectively legal tax evasion and regulatory avoidance—that has created a situation that if you are too big to regulate you are too big to manage.

The head of AIG—an insurance company admittedly, but a firm deeply at the heart of this crisis as the major issuer of credit default swaps—wrote in the *Washington Post* ten days ago or so that when he was installed last fall it became clear to him that the organization was too big to operate as a going concern. It seems to me if that's true of that insurance company it is probably true of certain other major financial institutions.

Therefore, it is, it seems to me, insane, to put it mildly, to design a financial policy that is intended to preserve those institutions as they presently are and thereby force the adjustment onto everybody else. That's point number one.

The second point is that the objective of the bailout plan is to restore the flow of credit. We have to ask ourselves is that likely to succeed? Is it possible that it will succeed? I think the answer to that is that the argument, indeed the whole metaphor that we hear time and again, is based on a misconception. If it, in fact, reflects the underlying thought processes of the policymakers it reveals that they do not understand very much about banking.

Credit is not a flow; it is not a liquid; and it is not something that goes from on high in the banking system down to the rest of us, the borrowers, at the rate governed by the amount of money that happens to be inside the banks. Banks are not money lenders. They do not need money in order to lend. Credit is not a flow. Credit is a contract. A contract is a bilateral relationship between a lender and a borrower based in the borrower's case upon the prospect of profitability—that is to say the underlying condition of the economy and the optimism felt in the population for the economic future—on the one hand and, on the other hand, on the value of collateral—that is to say the security you can put up against a loan. In this environment the prospects are exceedingly bleak and the collateral—namely the housing stock—has fallen so far in value that it will not support lending no matter what happens to the capitalization of the banks.

The result of that is, it seems to me, illusory to believe that the Treasury's bailout plan—even if it were designed appropriately to create an effective restructuring of the financial system, which it isn't; even if that were the case—would achieve the overlying economic purpose, which is to say the restoration of credit flows.

What should be done now? Well, the argument I've laid out for you, it seems to me, has two implications; and I'll take them in reverse order. First with respect to the banks.

It is, it seems to me, imperative to tackle that problem head on to recognize that the government has to be larger than the largest commercial bank. It has to be capable of dealing with whatever problems the banking system throws at it. If that problem is that banks need to be restructured, downsized, broken up, and sold, then that action should be taken as quickly as possible. The legal authority to do this largely exists and the practice of doing it is well-established.

In the savings and loan crisis under the late Reagan and first George H. W. Bush Administration scores of troubled or insolvent institutions were taken over by the Federal Deposit Insurance Corporation; their assets were evaluated in a penetrating and an independent way by new management that was not tied to the cover-ups and deceptions of the old management; and they were handed off to the Resolution Trust Corporation and sold at an appropriate value. The institutions themselves either closed or kept operating in insolvency until economic conditions improved and they could be refloated as viable, going concerns. This happened. It continued to happen, on a small scale including with banks as large as IndyMac in California, as recently as last year.

It's clear that taking over a very large institution is a different proposition in a technical sense, but it is not a different proposition in a legal sense and certainly not a different proposition from the standpoint of economic necessity.

The second point I would make is that with respect to fiscal policy, with respect to public spending, with respect to what the government does directly to support the economy it's essential at this point to recognize that we're in this for the long term. This problem is not going to be over with in two years. Therefore, we need to have a range of new institutions capable of dealing with our economic dilemmas and our problems for an extended period into the future.

We have obviously neglected public infrastructure in this country for two or three decades. It's in deeply decrepit condition. We need to finance that activity, the reconstruction of the country, on an ongoing basis very much as Franklin Roosevelt did in the New Deal: something that can engage the energies and activities of the whole country for a long period of time.

This is of particular importance as we confront the problems of energy security and climate change: energy security because if we do not engineer ourselves to have economic expansion without increasing the demand for imported oil we will become victims of new increases in the oil price almost as soon as the recovery gets off the ground and that will tend to forestall the realization of sustained growth over time; and climate change because if we do not rebuild the country in such a way to keep our total energy demands and greenhouse gas emissions down, put them on a sustainable basis, the country itself will not be habitable in finite time. Certainly over the course of the lives of our children and grandchildren we will begin to see major adverse changes and after that what will happen is practically anybody's guess.

On the bright side… Maybe there is no bright side. But I do think that it will become reasonably clear that the first round of the Obama New Deal was not sufficient and we will have another round of debate over what should be done. It's going to be a very dangerous period because every snake oil salesman in the country will be out claming that their own remedy was the right one in the first place; but we will at least have a chance to revisit these issues and, in

these two areas, it seems to me that these are the most important points to make and that with persistence there is at least some hope that eventually they might prevail.

Thanks very much.

[Applause]

Mr. Peet: We'll have a few questions. We have to move him to lunch and then he has to catch a plane. So, if you will, keep the question fairly brief. As you see, he speaks very concisely.

Dr. Galbraith: Sir?

Question: What do you think about the possibility of future declines in housing prices in general?

Dr. Galbraith: Well, nothing can stop the adjustment and the slump in housing prices. If I sell my house to you that's a private contract. It's whatever price you're willing to pay and whatever price I have to accept to move the thing.

My view is that what has to be done on the housing front is not to try to control the price, which can't be controlled, but to try to reduce the overhang of excess supply of housing stock on the market by trying to keep people in their houses, as much as possible, and to forestall the collapse of neighborhoods and the spread of blight and decay and homelessness, which is obviously in parts of the country becoming a very serious phenomenon.

There are two ways essentially to do that. One is to put a moratorium on foreclosures, then to turn the whole stinking mess over to a new version of the Homeowners' Loan Corporation of the 1930s that would then renegotiate the mortgages, deal with the servicers, and try to put those people who can be put on a sustainable basis on a sustainable basis.

The problem with that approach is moral hazard: you don't get help unless you're in trouble so you don't get help unless you stop making your payment. So people who are not in trouble will have an enormous incentive to get themselves in trouble; and people who don't get themselves in trouble will resent the help that's being given to people who are in trouble.

An alternative that I think has a lot of appeal is to let the foreclosure process go forward, and then have the government buy the house and rent it back to the original owner at a fair market rate, thereby keeping people in the house but they have to sacrifice their equity—if there is any, which in most cases there isn't—and give them an option to buy it back in three or four years if economic conditions improve. In that way you would have less institutional disruption and less moral hazard.

One way or another dealing with the housing problem in a much more aggressive fashion seems to me to be a very, very important part of what needs to be done.

Question: Hi. I was hoping you could put this in a geopolitical context. It seemed that when the crisis began people thought it would negatively affect the US disproportionately more than other economies. Recently Paul Krugman argued that Europe is actually in worse shape because of debt in Eastern Europe. Not that the crisis will end, but in the next few years how do you think it will affect geopolitics in general?

Dr. Galbraith: A lot of people felt that this crisis would mark the end of the dollar's position as the reserve asset in the world economy; and that turned out not to be the case. The basic reason is that for all of the fact that we are the country that originated the mortgage crisis we have a governmental structure, that was created in the New Deal, with a national government that can borrow and spend what it wants—on congressional decision we can launch a one trillion or, if you want it, a two trillion dollar recovery package—and a central bank that is essentially unlimited in its capacity to work with the financial system so that Ben Bernanke could take two trillion dollars of commercial paper onto the Fed's books without asking for any additional authority.

The major competing currency, the Euro, doesn't have that. It has neither a powerful central government nor a fully functioning central bank with lender-of-last-resort capacity. As a result the European system is intrinsically much more unstable. In addition to that the Europeans are afflicted by the problem of incomplete integration in that the European banks were able to extend themselves into Central and Eastern Europe making mortgages that were denominated in Swiss Franc or Euro or Sterling, or dollars for that matter, against incomes that were still being earned in forint or kuna or zloties. When those currencies started going down many of those mortgages started going bad with the result that Central and Eastern Europe is essentially a sub prime region. Even though without the same kind of massive fraud that characterized the American case it is simply a fact that it is intrinsically unsafe to make long-term loans that are denominated in currencies that are other than the ones in which incomes are being earned.

The result is the rest of the world is stuck with the dollar; and the dollar has been going up rather than down. That has actually aggravated our economic situation because the one thing that was going for us last year was the growth of exports. Of course, with an expensive dollar the export industries are in the tank along with everything else.

Sir?

Question: My question is in two parts. Was the improper regulation and improper incentive of the securities rating agencies the real linchpin of the crisis? Could it have been avoided had they had better regulation and the appropriate incentives? And what are the prospects for changing their incentives going forward?

Dr. Galbraith: It would have helped if the ratings agencies had done their jobs properly and if they had not had a market model that basically made their revenues contingent upon giving ratings.

However, I think the central responsibility is with the Office of Thrift Supervision, the Federal Reserve, and the other agencies that should have been on the ball with respect to what was happening in housing finance. They simply were not; they were deeply failed regulators.

It's not just that they failed, that they were incompetent. They were operating according to a working philosophy or working set of principles that actually encouraged this kind of financial innovation, celebrated it, and tolerated it. For that it's a question of a whole regulatory system that has, I think, been compromised in a deep way.

One way of describing this is I like to say that when the next Homer emerges to write the story he will say that the Russian mathematicians swept out of Muscovy and presented themselves before the gates of Wall Street bearing the gift of quantitative risk management models; and in twenty years they managed to infiltrate and destroy the whole thing. It was the biggest Trojan Horse operation since Troy itself.

Go ahead.

Question: Speaking up on the regulatory chain here, wouldn't some type of New Deal move—that I think you're advocating—essentially bring the government back into the economy. In particular, regulating the financial services industry wouldn't that actually raise the issue of once again nationalizing the Federal Reserve system and making its function, again, to be about balancing the economy rather than fighting inflation that acts in the interests of the wealthy in finance?

Dr. Galbraith: Two quick points. First of all, in 1976 I actually drafted the Federal Reserve portions of the Humphrey-Hawkins Full Employment and Balanced Growth Act. That language—which gives the Federal Reserve its dual mandate for full employment, balanced growth, and reasonable price stability—is something very near and dear to my heart. It is, in fact, their legal mandate.

The pretense that they are an inflation-fighting agency is just a conceit of economists with no standing in law.

The second point is on the question of the Federal Reserve as a public or private entity. It is clear that the Federal Reserve Board is a public institution. It is a creature of the Congress. It is not, in any sense, a private entity.

The residual privateness of the regional Federal Reserve banks is a constitutional problem. If we had another hour I could tell you about the lawsuit in the 1970s where we tried to deal with particularly the monetary policymaking authority of the regional banks; but we were not successful in getting standing in the courts to deal with it.

Yeah.

Question: Given that the market tends to encourage the most villainous practices—the ones that are not necessarily best for everyone else, but are best for private pockets—are we doomed for

another Great Depression in the next fifty, sixty, seventy years? Are we just treating superficial problems instead of treating the real problem?

Dr. Galbraith: If we're going to have a Great Depression we're going to have it now, not fifty, sixty years from now. If we're going to have a Great Depression we're in the opening phase of it right now.

We have an advantage over our predecessors in the 1930s, which is that we have that history, and we have certain institutions—Social Security, deposit insurance, Medicare—that are powerful automatic stabilizers that will tend to limit the depth of a slump. However, they do not, by themselves, make the economy prone to recovery. They don't make it resilient.

What gives you a Great Depression is a failure to recover from the slump that you have. That's what I worry about right now.

Are we doomed to it? It depends on how much of those lessons we've forgotten and how much of those institutions we've impaired in the last three or four decades. We have forgotten an enormous amount of it.

This is why I started with a discussion of the economics profession, and academic economics generally. We have a large intellectual community that has nothing to say about these issues, that has never studied them, and that reacts reflexively to this day in the belief that things will all get better by themselves in a relatively short period of time. So long as we remain substantially in the thrall of that belief, both in the way we react psychologically and in the way we do technical model-building and forecasting exercises, we are, I think, greatly impairing our chances of coming to grips realistically with what actually just happened to the financial system in the United States and the world.

Mr. Peet: Terrific, wasn't it? Absolutely fantastic. Precise, knowledgeable, fundamentally critical, and yet also amazingly realistic. Just an absolutely superb job.

Thank you for coming today.

Dr. Galbraith: Thank you.

[Applause]

[End of Recording]