TRANSCRIPT

Comments on the Financial Crisis
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[Begin]

Dr. Galbraith: It's a great pleasure for me to be here for the first time at the University of Chicago – home over the years, if you will forgive me for saying so and I know some of you will not, of so much inspired nonsense, now exposed.

Obviously things are changing even here. As I came in this morning I heard Mark Mizruchi talking about countervailing power (without actually naming it), and then I heard Duncan Foley talking actually about price control. And of course on both of those counts I felt right at home.

My analysis differs a bit in tone and emphasis from the framework of a crisis of global neo-liberalism, which Professor Foley presented this morning. Because in my view that term, global neo-liberalism, is an imprecise description of the governing order. The United States was never neo-liberal. The defining institutions of our society were and remain those that were created in the New Deal and the Great Society. Ronald Reagan did not succeed in abolishing those institutions, and George W. Bush didn't try.

The initiation of neo-liberalism, via floating exchange rates on the global stage, was no accident but the choice of a path of least resistance which achieved overseas, after 1973, something that could never have been done here in this country. Further and in consequence, the crisis is not a crisis of free markets. You cannot have a crisis of something that does not exist. It is rather a crisis of the subversion of the system of regulation. And its central feature is therefore not instability as such, but depredation and fraud.

Fraud came up a number of times earlier today and the response of the audience was a nervous giggle on most occasions. But I think it's worth reviewing what we're talking about in the financial sector. We're talking about mortgages that were issued to borrowers who in many cases could not or would not document their incomes; whose credit histories were non-existent or bad; on the basis of evaluation of houses by appraisers who were compensated for their willingness

to overstate the value of those homes. The payments were set in such a way as to be affordable for the first couple of years with a trigger that would drive them up thereafter if interest rate rose. And it was well known to the lenders, but not to the borrowers, that the climate of low interest rates would be temporary.

All this was abetted by the regulatory authorities, the leadership of which on one occasion – specifically the director of the Office of Thrift Supervision -- came to a press conference with a stack of copies of the Federal Register and a chainsaw, sending a message that was far from subtle about the approach that would be taken to underwriting standards.

We've heard here that nobody saw a problem. Quite the contrary, in 2004 the FBI saw the problem very clearly and warned of "an epidemic of mortgage fraud." No action was taken. The Justice Department and the FBI were not given the resources that would have been required to set up the strike forces that could have dealt with this problem as it emerged.

The fact that we are only now engaging the question of what caused the crisis in a serious way is a very bad sign. It is a sign of what I am not the first to call the systemic failure of the economics profession. We have a profession that in its large majority sees nothing but general equilibrium and technological waves, occasionally disrupted by sticky wages and bad policy mistakes—the latter somehow never spotted in advance.

At Milton Friedman's ninetieth birthday party, in 2002, Ben Bernanke confessed to Milton that he agreed that the Federal Reserve was responsible for the great depression, but promised that thanks to Milton and to Anna Schwartz it would not happen again. I realize that Ben has been busy in recent weeks. But I hope that in a quiet moment he reflects on the dilemma that he now faces. He can either accept responsibility for the crisis or repudiate Milton Friedman. He has no alternative.

Economics has been in an intellectual world where the ideal is a perpetual motion machine—a physical and biological impossibility. As Keynes said, and it's a pleasure here to quote Keynes in Chicago, "The classical economists are like Euclidean geometers in a non-Euclidean world, who on observing that lines apparently parallel sometimes meet have no recourse but to rebuke the lines for the unfortunate collisions that are occurring." We are in a world where those of us in the room who come with something other than that perspective, had to be recruited from the periphery, the far periphery of the economics profession. We

represent viewpoints which have for decades been actively repressed. And yet these are in many ways the only relevant views.

The major contribution at the present time of the mainstream economics -- and I have been getting into this in recent weeks, oddly enough, to lend respectability to the discussion -- is a debate over whether the New Deal in fact did anything good. Or whether it was perhaps responsible for prolonging the Great Depression. This is a debate with on one side those who think that the New Deal primarily raised wages and therefore *created* unemployment that would not have otherwise occurred. This viewpoint somehow overlooks the reality that unemployment was already twenty-five percent in March of 1933. And on the other side, there is a viewpoint holding that the major effect of the New Deal was to reverse the tight Hoover monetary policy -- in other words to do what Milton Friedman said, in retrospect, should have been done.

There is in this debate no place for what was once the conventional position, that the New Deal created a lot of jobs, did a lot of investment—rebuilt the country. Actually if you count those who worked for the New Deal as employed which they certainly were at least they thought they were -- they got up in the morning and went to work and got paid for it -- then unemployment was driven down from twenty-five percent in 1933 to below ten percent by 1936. But in the debate that has been gotten up within mainstream economics, this very basic fact-- that unemployment was reduced by direct public action -- has been forgotten.

There is problem of candor, honesty, and open-mindedness in economics. And until we deal with this problem in academic and professional life, I think the foundation for an effective way forward cannot be laid. What we will see instead is a perpetual re-justification of the existing order of things, a process which is plainly already underway.

The first step forward, let me suggest, is to disabuse ourselves of what the greatest Chicago economist, Thorstein Veblen called "the meta-physics of normality and controlling principles," and recognize that whatever you thought was normal isn't coming back. It is not merely, to take the premise of this session that we are not recovering yet. (The senior advisers who spoke of seeing shoots of green were perhaps thinking of their speaking fees.) It's that we are not going to recover in the normal sense. We are not going to return to the *status quo ante.* The long term trend has no probative value and provides no basis for prediction from where we are, going forward.

What do I mean specifically? I mean, that the Congressional Budget Office has a model which posits a 4.80 percent unemployment rate – precisely -- to which the economy automatically reverts after about five years even if nothing is done. This was their baseline model as of January before the Obama administration took office and presented its plans. Where did they get this? Well it's obvious they got it from Milton Friedman in 1968. It is nothing but the natural rate of unemployment.

But one thing I think I learned from the debates between Mandelbrot and Fama is that asset price changes are self-similar in different time scales. This means that major disasters happen, and that the long term trend is changed, when they do. And I would suggest that all the signs, to the extent that we can recognize the existing current phenomena, is that we're in such a major disaster right now.

I do believe, and again in contrary to the equilibrium view, in human and social agency. And so the future will be what we make of it and the question before us is, with what tools?

We are going to have to restructure the financial sector. And the financial sector will shrink going forward. This is not a question of what we want—this is a question of what is going to happen. Therefore, the issue is not whether we should make it happen but how we should approach it. The issue here is not merely toxic assets but in fact toxic institutions. When the next Homer emerges to write the history of this period, he may say that the mathematicians swept out of Moscovy in 1991, and presented themselves before the gates of Wall Street bearing the gift of quantitative risk assessment models. And they were welcomed in with open arms by the tenants of those skyscrapers, and it only took them twenty years to irredeemably ruin the place. It was in some ways the greatest Trojan Horse operation since Troy.

Mr. Edward Liddy, the man installed by Henry Paulson to run AIG, wrote just a few weeks ago that when he got there the first thing he realized is that he was in a firm that was unmanageable as a going concern. And in which the actions of the four hundred or so people, the financial products division, who were the bearers of this particular gift, simply could not have been and were not controllable by senior management. I suggest that what is not manageable also cannot be regulated, because regulation and management are essentially similar activities. And an institution that cannot be managed and cannot be regulated is intrinsically a dangerous institution. It is something that poses intrinsically a public policy problem.

We do have a way of dealing with this. It is not to bail them out and it's not actually the bankruptcy law, from which banks are exempt. It's called Conservatorship or a Pass-Thru Receivership. This is a New Deal institution to which banks signed on when deposit insurance came in. And for all that has been said so far today about the politicization and inefficiency of government, the reality is that as institutions go this one has served us fairly well (as have other New Deal institutions) over the years. Scores of savings and loans were put through Pass-Thru Receiverships and resolved -- either returned to solvency or closed down, or sold -- and it worked out. And so far as I know there was no accusation in that process of political influence. Quite the contrary, moving things into the hands of the professional regulators actually got away from political influence, which in the matter of Charles Keating of Lincoln Savings and Loan and many others, had been obstructing the resolution of the problem up to that point.

A second tool which was heavily employed in the New Deal and now worth remembering is social insurance. The New Deal, after all, was pre-Keynesian; it was not an exercise in fiscal policy from the beginning. Roosevelt came in, in March of 1933. Keynes had not published at that point although his views were increasingly well known. The core foundational institutions were deposit insurance, Social Security, the National Labor Relations Act, the minimum wage, the Agricultural Adjustment Act and even the National Industrial Recovery Act. All of these and others had the feature that they were designed to allow social institutions to develop where people could help themselves, and where basic minimums would be preserved and basic standards would be imposed and maintained.

I think that this is something well worth remembering, because these institutions succeeded by and large. The NIRA was of course ruled unconstitutional, but social security, deposit insurance and the others succeeded on their own terms even if one does not measure those terms by the growth of GDP. And it's especially important to recognize the extraordinary value that we have now, of having the social security system that was created for us at that time. Particularly at a moment when all of the bases of private wealth for the elderly and the near elderly, a lot of people in this room including me, have been deeply eroded if not collapsed by the collapse of asset values in housing and stocks, and by the collapse of interest rates on cash holdings. Social Security is the one thing that hasn't collapsed. And it exists as a very efficient institution for keeping that part of the population out of poverty going forward.

The third thing that we have and that we should use is a mechanism of standards and prices. The classical liberal view, the Epstein view if I may be so bold, is to take technology as fixed, to let the customer judge quality and let the prices adjust to clear the market. It seems to me that's essentially the Chicago view, but in the modern world, what we actually do -- what we should do and what experience tells us works -- is actually to regulate at least certain key prices (such as oil and interest rates) and wages, and quality -- and to let technology adjust. In other words, we use the system of regulation to keep the food chain safe and the planes in the air, and also to keep the financial system from blowing up. It was precisely the failure to recognize that that is the function of regulation -- that regulation is not a system which pits government as an adversary to private markets, but rather the enabling condition for the functioning of private markets, and for people's willingness to place trust in complicated systems -- that is, if anything is, a single fundamental cause of the crisis that we're in.

Finally, going forward there is the question of how the government should mobilize resources. Of how the government should spend money. I have to say that I am not, and have never been much of a fan of the concept of stimulus. The reason is precisely that the idea of stimulus subordinates the Keynesian tool to the objective of a return to normal. That wasn't what Roosevelt and the New Deal was about. And it shouldn't be what we are about now. Roosevelt set out to reconstruct the country and he did. And we need to think about how sensibly to plan to reconstruct a country which has fallen badly into disrepair, and is not nearly as functional as it needs to be from a standpoint of its position both in the world economy and the world's ecology.

We have before us as a fact, I would argue, the collapse of the private financialized economy. We have not yet realized that it is illusory to try to repair that collapse and re-launch the system on its previous foundations, so we must decide what comes next. And, it seems to me self-evident that very high in the priority should be to meet our energy security problems, our climate challenge, and ultimately to try and rebuild a stabile and prosperous lifestyle for the country on a sustainable basis. Only ultimately as this goes forward over time, will we or should we be re-capitalizing the household sector, and creating the conditions under which private finance can be restored in the very long run to a leading role. In the 1930s it took eighteen years, from 1933 to roughly 1951. And it took the Second World War, with its massive infusion of incomes into the household sector, incomes that were saved through victory bonds, made possible and palatable by price control, before this was actually achieved.

So we should not expect it to be achieved now, certainly not in the time frame of a single electoral cycle or a single administration.

Thank you very much.

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