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ECONOMIC CRISIS FAR FROM OVER, PARIS GROUP WARNS

New Policy Brief from Levy Institute Senior Scholar James K. Galbraith Argues for Sustained Public Initiatives and Significant Regulation of Financial System

ANNANDALE-ON-HUDSON, N.Y.—Federal Reserve Chairman Ben Bernanke recently said the recession is “likely over,” and leaders in Europe, having declared the crisis substantially resolved, are urging a shift toward “exit strategies” aimed at deficit reduction. However, a group of economic experts associated with Economists for Peace and Security (EPS) and the Initiative for Rethinking the Economy (IRE) who met recently in Paris to discuss the ongoing crisis and resulting reform proposals took a very different view. According to James K Galbraith, a senior scholar at The Levy Economics Institute and chairman of the board of EPS, the economists and other experts who met in Paris warned that the crisis is not over, the policies that have been set in motion are not sufficient, and the goals set forth by the authorities to this point, which amount to a restoration of previous conditions, are neither desirable nor possible.

In a new public policy brief from the Levy Institute, *Financial and Monetary Issues as the Crisis Unfolds*, Galbraith reports that—while the Paris group recognized that emergency action and automatic stabilization had worked to avert a catastrophic collapse of liquidity in the world system, and to place a floor under the decline of output in the more advanced countries—the EPS and IRE experts warned that those efforts and current reform proposals would fall short of creating conditions for sustained economic recovery and a return to high employment. The Paris group, Galbraith says, strongly argued for fundamental reform and regulation of the international financial system, and for major and sustained fiscal support. Specifically, the group favored bottom-up strategies based on social support and public investment, such as expanded Social Security and unemployment programs as well as public job initiatives.

Perhaps most importantly, the group contended that the global financial system cannot and should not be put back the way it was before the crash, and that effective regulation needs to be established and enforced. “Banks are public-private partnerships, funded partly at public

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risk (via deposit insurance and implicit guarantees). They cannot logically operate independently of the power that guarantees their funding, and the attempt to allow them to do so is intrinsically destabilizing,” Galbraith writes, stressing the need to minimize financial behaviors that are likely to bring down the system. “The plain lesson of history is that this can only be achieved by national (or transnational) regulation of institutional behavior. Therefore, the task of governments going forward is not to find exit strategies that permit a return to the status quo ante. It is to establish and enforce effective rules for institutions operating on national territory and for citizens dealing with such institutions.” Enforcement, says Galbraith, “is essential. The crisis originated in one of the great financial frauds of history, the issuance and securitization of subprime and Alt-A mortgages that were designed to generate fee income on origination, leaving the originators with no incentive to monitor loan quality. Fraud and misrepresentation were not merely epidemic, not merely rampant: they were pervasive. The failure of market-based solutions to the toxic asset problem can be traced to this fact; independent investors realize this, and therefore know that these assets are permanently impaired. So long as the financial system is not thoroughly purged of those responsible for financial crimes—through investigation and prosecution before the law—the system itself will not regain credibility, nor the trust of domestic or international clients.”

Galbraith reports that the group favors a major strengthening of independent audit and enforcement capabilities, which, when applied to the redesign of financial systems, would largely reconcentrate financial activity in banks (shrinking the shadow banking system) and align the reach of particular banks with the regulatory frontiers applicable to that bank. “These steps would permit examination regimes to inspect the full range of a bank’s activities, reducing the scale of unregulated speculations and making it easier to detect and prosecute fraud. Together, they would begin to change the culture of the financial sector, promoting a more conservative, less predatory, and less reckless approach to financial services.” A further advantage of this approach is that “it would tend to shrink the largest and most transnational banking institutions relative to smaller, national and regional banks. . . . The object of a structured downsizing should be to achieve a structure that is aligned to public purpose: a universe of stable, numerous, competitive institutions that can be regulated effectively and that are individually not too big to fail.” In conclusion, Galbraith writes, “It is time to take account of the irreversible characteristics of recent events, to chart a course of new construction instead of reconstruction, and to build the domestic and financial monetary institutions and safeguards necessary to make it possible to pursue that course.

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Public Policy Brief No. 103: *Financial and Monetary Issues as the Crisis Unfolds*

(9.18.09)