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# THE GREAT CRISIS AND THE AMERICAN RESPONSE

JAMES K. GALBRAITH

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## Preface

In this new brief, Senior Scholar James K. Galbraith addresses the nature of the financial crisis in the United States, and, in particular, its relationship to the role played over the last generation by the economics profession.

The global abatement of the inflationary climate of the past three decades, combined with continuing financial instability (e.g., the Asian and Russian crises of the late 1990s), helped to promote the worldwide holding of U.S. dollar reserves as a cushion against financial instability outside the United States, with the result that, for the United States itself, this was a period of remarkable price stability and reasonably stable economic expansion.

For the most part, the economics profession viewed these events as a story of central bank credibility, fiscal probity, and accelerating technological change coupled with changing demands on the labor market, creating a mental model of self-stabilizing free markets and hands-off policy makers motivated by doing the right thing—what Galbraith calls "the grand illusion of the Great Moderation." A dissenting line of criticism focused on the stagnation of real wages, the growth of deficits in trade and the current account, and the search for new markets, with its associated costs. This view implied that a crisis would occur, as the situation was intrinsically unstable, but that it would result from a rejection of U.S. financial hegemony and a crash of the dollar, with the euro and the European Union (EU) the ostensible beneficiaries.

A third line of argument went beyond these two broadly opposing and symmetric views, a line articulated by two figures with substantially different perspectives on the Keynesian tradition: Wynne Godley and Hyman P. Minsky. Galbraith discusses the approaches of these Levy distinguished scholars, including Godley's correlation of government surpluses and private debt accumulation and Minsky's financial stability hypothesis, as well as their influence on the responses of the larger economic community.

Galbraith himself argues the fundamental illusion of viewing the U.S. economy through the free-market prism of deregulation, privatization, and a benevolent government operating mainly through monetary stabilization. The real sources of American economic power, he says, lie with those who manage and control the public-private sectors—especially the public institutions in those sectors—and who often have a political agenda in hand. Galbraith calls this the predator state: a state that is not intent upon restructuring the rules in any idealistic way but upon using the existing institutions as a device for political patronage on a grand scale. And it is closely aligned with deregulation.

In the last decade, as clear signals were sent that previous laws, regulations, and supervisory standards would be relaxed, the financial industry was overrun by the most aggressive practitioners of the art of originating and distributing mortgages *that were plainly fraudulent*. The rewards of involvement were extraordinary, to the point that 40 percent of reported profits in the United States were earned in the banking sector by enterprises that paid out about half of their gross revenues in compensation.

The game came to an end, of course, in September 2008, with the failure of Lehman Brothers. The Troubled Asset Relief Program effectively quelled a panic, but at the price of forestalling restructuring and reform that would get at the root of the financial crisis. And even though we have managed to sidestep a second Great Depression, that success is marked by extreme limitations: by a decimated housing sector and a reeling middle class; by the functional dismantling of the major institutions of the American welfare state; and by a loss of trust in the financial sector that cannot be regained until those responsible for the mortgage fraud are identified and prosecuted, in full.

And there is the issue of Europe. The events in Europe are customarily treated as a Greek crisis, but this is a profoundly misleading narrative, and it misses the essential part of the story. In September–October 2008, as the U.S. financial crisis was peaking, the spreads on Greek government bonds began to diverge from those on German government bonds, and they have been diverging ever since. Clearly, this is related not to Greek profligacy but to the crisis in the United States and a generalized flight to safety.

Still to be resolved is the political game between the bond markets and the EU and European Central Bank over whether the latter entities will relieve the large financial institutions of their losses. In Galbraith's view, the only way this game *can* be resolved is with the capitulation of the authorities and the Europeanization of Mediterranean debts. This leaves Europe with a situation very similar to what we have in the United States, in which the banks have been effectively rescued but the economies have not, and the price is paid by relentless rounds of fiscal austerity—with the possibility that the economies on both continents may be unable to move back to a pattern of constructive growth.

As always, I welcome your comments.

Dimitri B. Papadimitriou, *President*
June 2010

*This brief is adapted from an address to the German Association for American Studies, Humboldt University, Berlin; May 27, 2010.*

I want to address the nature of the financial crisis in the United States, and, in particular, its relationship to the role played over the last generation by the economics profession. The first theme of my remarks I've given a little subtitle to, "The Grand Illusion of the Great Moderation"—a characterization of the last three decades in economic life that gained a great deal of prominence, partly because it was championed over the years by Ben Bernanke, the now-incumbent chairman of the Board of Governors of the Federal Reserve System.

The late 1970s and early 1980s were an extraordinarily turbulent time. They were a time of sharply declining competitiveness in manufacturing and trade union power, followed later in the 1980s by the collapse of the Soviet Union and associated governments, the opening of world commodity markets to a very significant degree, and the rise of labor-intensive goods produced in China and their penetration in world markets. Consequently, there was a global subsidence of the inflation that had built up in the late 1960s, throughout the 1970s, and into the early 1980s. At the same time, continuing financial instability, including the crises in Asia in 1997 and in Russia in 1998, helped to promote the worldwide holding of U.S. dollar reserves as a cushion against financial instability outside the United States—with the result that, for the United States itself, this was a period of remarkable price stability and reasonably stable economic expansion.

The economics profession did not give these events the cosmopolitan interpretation that I just have. Rather, it reduced them to a story of the credibility of the central banks (specifically, the Federal Reserve), of probity and responsibility on the part of the fiscal authorities, of accelerating technological change coupled with the changing demands on the labor market—all of which were, if you like, characterizations of causal relationships that very well could have happened in any closed economy. Thus, the economists created a mental model of self-stabilizing free markets and hands-off policy makers motivated to do the right thing, full of good intentions and primarily dedicated to maintaining an overarching climate of price level stability so as to permit the forces of the free market to reach their maximum efficiency.

Arguments between economists largely resolved into a debate between the purists, who held that essentially no government intervention in the economy was required; and those who professed a slightly more pragmatic bent, and who argued that, from time to time, it might also be useful to have a stabilizing contribution from the fiscal authorities to offset external shocks and other forces that might, from time to time, cause a disturbance in labor markets. This view came to be a very widely held one in the economics profession right up into 2008, when the American Economic Association was sponsoring sessions with such broad and confident titles as "How Did the World Come to a Consensus on Monetary Policy?"

I find a little irony in this, because one of the ostensible great contributors to the climate of the Great Moderation was the change in Federal Reserve reporting procedures instituted in the mid-1970s under what came to be known as the Humphrey-Hawkins process, whereby the chairman of the Board of Governors reports every six months to both houses of Congress as to the goals and objectives of the Federal Reserve. The irony for me is that I happen to have been the young staff member on the banking committee of the House of Representatives who drafted the statutory language that went into the Humphrey-Hawkins Act, requiring that testimony. And for seven or eight years I was the staff person who actually organized the hearings, who wrote the questions and otherwise tried to antagonize the Federal Reserve to the extent that I could. Certainly, as a young man in his middle twenties, I did not think that I was contributing in any serious way to a revolutionary development in the stabilization of the global economy. But there were economists 30 years later who, if they could have known of my role, would have been obliged to give me some credit for it.

This is not to say that everybody in advance of the crisis accepted this worldview. There was a line of criticism that for the purposes of this brief I will call the Marx-Lenin-Luxemburg critique. This is a view that pointed to the dark side of the Great Moderation, a view that focused on the alleged—and indeed, reported—stagnation of the real wage in the United States, particularly in relationship to productivity growth, and the implied deterioration of the distribution of income, of wages in favor of profits. It emphasized the highly measured and much remarked-upon increase in economic inequality. It also drew attention to the consequences of the deindustrialization of the 1980s, in particular the large and ever growing deficit in trade and the current account, and, ultimately, to what Rosa Luxemburg would have described as a "crisis in realization," otherwise known as the problem of imperial overstretch, of the search for markets and the cost of that search, vividly brought to the world's attention in 2003 at the time of the American invasion of Iraq.

This story formed the basis of a leftist critique in and outside of the United States. It implied that there would be a crisis, as the situation was intrinsically unstable, but that the crisis would come first and foremost from a rejection of U.S. financial hegemony as a whole, and of the instruments of that hegemony; namely, the assets denominated in dollars held around the world. It would come, in other words, from a crash of the dollar; ostensibly, the beneficiaries of that crisis would be the euro and the European Union. Europe, in this view, was considered a contrasting sociopolitical entity with largely solid social democratic virtues, a relatively low military burden—in fact, a turning away from militarism—and a relatively balanced set of international accounts. So I think we did see a number of scholars who had misgivings about—or indeed, a radical dissent from—the narrative of the Great Moderation.

But both of these views, the GM view and the MLL (or Marx-Lenin-Luxemburg) view, showcase what is essentially a real-economy analysis. It is an analysis rooted in deep phenomena—in a flexible labor market, for example, which could either be celebrated for its ability to deliver employment or castigated for its inability to sustain real wages; in an efficient capital market, which could be celebrated for bringing world production to its highest achievable level or castigated for its effects on American labor—and a process of class struggle and the search for the realization of surplus (in the MLL view). Neither the GM nor the MLL perspective focused intently on the financial sector, on the monetary aspects of the production process or the relationship of credit to output. Nor did either focus on the relationship between the public and private sectors in the United States. Neither, therefore, came very close to developing a truly useful and relevant analysis of what actually occurred.

A third line of argument went beyond these two broadly opposing and symmetric views, a line I see as descending from the ideas of John Maynard Keynes but in modern times largely articulated by two figures with substantially different perspectives on the Keynesian tradition. One of these was Wynne Godley, a former senior adviser to the treasury in the UK, a professor of applied economics at the University of Cambridge, and a great gentleman who just recently passed away, in May. The other was Hyman Minsky, a maverick financial economist to whom I shall return momentarily. Godley articulated his approach in a series of papers published by the Levy Institute beginning in the mid-1990s. He argued above all that it was essential to develop a macroeconomics in which the accounting relationships were consistently articulated, so that their implications could not be ignored and the consequences of things happening in any one part of the economy would be fully taken into account in the analysis. One of the things that Godley's analysis pointed to, very effectively, over this period was the unsustainability of surpluses in the government's budget. It is odd now to reflect on that, but in the late 1990s the U.S. government budget went into a very substantial surplus, and at the end of that decade Larry Summers, then secretary of the treasury, happily made the projection, at a meeting I attended and on other occasions, that if things continued, the United States' public debt would be totally eliminated in the space of 13 years or so.

The essence of the Godley analysis was that it was pointless to make such projections, as things could *not* continue: the law once articulated by Herbert Stein, chair of the Council of Economic Advisors under Richard Nixon, would apply. Stein's Law famously states that when a trend cannot continue, it will stop. Why so? Because the accounting obverse of a surplus in the public sector is a deficit in the private sector, a deficit manifested in the increasing accumulation of debts held by, in the late 1990s, mainly private corporations, and mainly in the technology sector. That is to say, there was an obligation to make good by generating cash flows on financial commitments via increasingly improbable business plans—an obligation that, in fact, could not be honored and was not honored, and that was largely repudiated in the slump that followed the crash in the tech sector in the middle of 2000. And, of course, government budgets went promptly back into deficit at that time.

A second proposition of the Godley analysis related to the events that then developed in the housing sector over the course of the decade of the 2000s. Now a different part of the private sector went increasingly into debt. Households increasingly took on mortgage obligations, draining the equity from their homes in order to support their consumption patterns, generating construction and other forms of economic activity. In so doing, they generated tax revenues, which again narrowed (though they did not eliminate) the government budget deficit over this period, while sustaining economic growth until around 2008.The essential point was that this phenomenon, like the previous one, had definite limits, because private parties, unlike governments, do have to repay their debts.

Hyman Minsky's analysis, although thoroughly compatible with Godley's, focused on the intrinsic instability of the financial sector, an instability from which the Great Moderation economists assiduously avert their eyes because it violates their notions of human economic rationality, but an instability that is nevertheless, in Minsky's view, entirely the product of rational processes. Minsky's argument was that stability itself creates instability. A period of stable economic growth and low inflation generates increasing confidence on the part of economic players. They can come to believe that they are part of a new era—that things really have changed. They come to be discontented with the low rates of return that are available on ordinary investments and therefore naturally seek the frontiers of greater risk. As they do that, they are seeking more and more to be on the tails of the distribution—to move the mean of the distribution (something that is quite difficult to achieve)—and they shift from a position in which their financial obligations are what Minsky called hedge positions—completely fundable on the basis of historic cash flows—to speculative positions, which must be refinanced in uncertain conditions at some future time. These conditions may well be favorable to refinancing; they may well be sustainable for at least some time. But they are not guaranteed to be such, depending as they do upon basically unforeseeable macroeconomic circumstances at the time the debts come due.

The problem is that as more and more players move into speculative territory, they reach a second-phase boundary, another transition, moving from what Minsky called speculative finance to what he called Ponzi finance, or a situation in which financial commitments can be met only with further borrowings—a situation that is intrinsically unsustainable for a private party because no one will lend to someone who must borrow in order to pay interest on previous debts.

There were some who did see unsustainable processes at work. Dean Baker, head of the Center for Economic Policy Research in Washington, D.C., was a remarkable example. Beginning in the early part of the last decade he called attention to, among other things, the sign of extraordinarily high price-rental ratios in the public housing sector—high and rising, and clearly more likely to fall at some time than to continue to rise forever. A great deal of credit has to go to those few people working in the Godley and Minsky traditions who were brave enough to foresee the developments that had in fact occurred and whose framework was such that it put them quite close to the actual character of the disaster that unfolded from 2007 forward.

Yet I don't think either of these analyses gets quite to the heart of the issues. So I would like to put before you a third line, one that is broadly in descent from my father's work, in *The New Industrial State*, on the role of the great corporation and its relationship to financial authority. This is a theme that I took up in general terms in application to the situation that we now face, in my 2008 book *The Predator State*. The argument I made was that it is fundamentally an illusion—an error—to view the U.S. economy through the free-market prism, created in the Reagan period, of deregulation, privatization, and a detached, benevolent government operating mainly through monetary stabilization. I would argue instead that when you examine the institutions of American economic growth you find a dominant role in many important areas of the public sector—of the government—usually in a kind of partnership with private institutions. This is found, for example, in the Social Security system, which provides a bulwark against poverty for the elderly but is supplemented by many of them through private pensions and investments accumulated over the years in tax-sheltered private accounts. It's true of the health care system, which is a public system for very substantial parts of the population: everyone age 65 and over is covered by Medicare, a great many poor people are covered by Medicaid, veterans are assisted by the Veterans Benefits Administration, and public employees are, of course, covered.

But the public sector in health care operates in a kind of antagonistic partnership, and a very difficult and inefficient partnership, with a private sector that continues to provide private health insurance largely through employers with, again, tax-favored programs. This is also true of higher education, in which public and private institutions hold approximately equal weight. A system of land-grant universities has produced some of the greatest achievements of U.S. higher education over the years, but there are also fine private institutions that depend very heavily on tax-favored philanthropic contributions. And it's true in the housing sector: in the financing of privately owned homes, in the institutions, created in the New Deal and reinforced in the Great Society, that gave us 30-year fixed-rate mortgages; that gave us Fannie Mae and Freddie Mac (public entities that were later privatized), which refinanced those mortgages; that created a structure in the 1930s through the '70s and '80s of savings-and-loan institutions that were dedicated to housing finance and that operated under special interest-rate regulations that permitted them certain advantages in the financial marketplace.

By and large, these public-private collaborations, while inefficient and defective in important respects—again, that's certainly true of our health care—have been substantial successes.

They are very robust politically and they achieve their stated objective, by and large, by facilitating wide access to the services that they foster. In comparison with this system, particularly when one also considers the regulation of many other aspects of the economy, truly free markets are very small change. They barely exist; they are a fringe phenomenon. And while they hold a particular pride of place in American political rhetoric, practical people in political life understand their limited nature. That is to say, conservatives, particularly in recent administrations, have understood very well that the true sources of American power lie with those who manage and control the public-private sectors, especially the public institutions in those sectors.

The conservative objective in modern times has not been to privatize these institutions completely or to eliminate them but to place them in sympathetic hands, and thus to permit small amounts of vast cash flows to be directed to politically favored groups. This is what I call the predator state: a state that is not intent upon restructuring the rules in any idealistic way but upon using the existing institutions as a device for political patronage on a grand scale. Closely related to the predator state has been the general reinterpretation (something that has troubled me ever since I first encountered it in graduate school in the 1970s) of the role of regulation in an economy, a reinterpretation of regulation not as a function of necessity but as a burden, as something that should be minimized to the extent possible, and where the benefits should always be weighed against the costs. That view is sufficiently familiar as to go unquestioned by a great many, but I would suggest that it is a view that profoundly misconstrues what regulation is and what it does in an advanced society.

In an advanced society, in sectors where there is the slightest complexity (and there are many of them), where there are production processes involving lengthy supply chains, regulation serves not as a burden on businesses but as a guarantee that the markets are viable, a guarantee that it's reasonably safe to participate in the commerce at hand—safe to eat the lettuce or to buy the electric appliance or to commit your savings to a financial institution. Without the regulatory apparatus that pervades our lives, most of the institutions in an advanced economic society, from airlines to banks, would not exist. Nobody would get on an airplane if they did not believe that the Federal Aviation Administration was running traffic control—that planes were not going to run into each other in the sky. And nobody would put their money into banks if they did not believe that the regulatory agencies would have some authority over management of their deposits and provide insurance to protect them in the case of a run.

What happened in the last decade or so, it seems to me, is that the predator state took root in an especially dramatic way in the financial sector. Very clear signals were sent that previous laws, regulations, and supervisory standards would be relaxed. This was not a subtle business. In the first term of the second Bush presidency, the chief of the Office of Thrift Supervision came to a press conference with a stack of federal regulations pertaining to underwriting standards and a chainsaw—*a chainsaw*. This, as I say, was not subtle. His more subtle colleagues brought pruning shears. The message was unambiguous: the cop was off the beat.

The result was that the financial industry was largely overrun by the most aggressive practitioners of the art of originating questionable mortgages. I'll go further than that: the art of originating mortgages *that were plainly fraudulent*. It was an environment in which the lenders certainly knew that the borrowers would not be in a position to continue to service those mortgages past, at most, three or four years—mortgages that were in fact designed to have that result. These were mortgages made to people who could not document their incomes, who had bad or nonexistent credit histories, against houses appraised by appraisers chosen by their willingness to inflate the value of those houses and drafted in such a way that the initial rate was low enough to be serviced for a short period of time —so-called "teaser" rates—but with provisions that would cause the payments to double or triple in two or three years, when the rates were reset to what was widely and accurately expected to be the prevailing higher interest rates imposed by the Federal Reserve.

To take up just one aspect of this: there is no nonfraudulent reason for a lender to knowingly accept an inflated appraisal on a house. No known explanation of that can be construed as innocent. Why did they do it? The business model was no longer one of originating mortgages, holding them, and earning income as home owners paid off their debts; it was one of originating the mortgage, taking a fee, selling the mortgage to another entity, and taking another fee. To do that, the mortgages had to be packaged. They had to be sprinkled with the holy water of quantitative risk-management models. They had to be presented to ratings agencies and blessed and sanctified, at least in part, as triple-A, so that they could legally be acquired by pension funds and other fiduciaries, which have no obligation to do any due diligence beyond looking at the rating.

Alchemy was the result: a great deal of lead was marketed as gold. I think it's fair to say that if this sounds to you like a criminal enterprise, that's because that's exactly what it was. There was even a criminal language associated with it: *liars' loans*, *NINJA loans* (no income, no job or assets)—it sounds funny, but in fact this is why the world financial system has melted down—*neutron loans* (loans that would explode, killing the people but leaving the buildings intact), *toxic waste* (that part of the securitized collateral debt obligation that would take the first loss). These are terms that are put together by people who know what they are doing, and anybody close to the industry was familiar with those terms.

Again, there's no innocent explanation. I would argue that what happened here was an initial act of theft by the originators of the mortgages; an act exactly equivalent to money laundering by the ratings agencies, which passed the bad securities through their process and relabeled them as good securities, literally leaving the documentation in the hands of the originators (the computer files and underlying documents were examined by the ratings agencies only very, very sporadically); and a fencing operation, or the passing of stolen goods, by the large banks and investment banks, which marketed them to the likes of IKB Deutsche Industriebank, the Royal Bank of Scotland, and, of course, pension funds and other investors across the world. The reward for being part of this was the extraordinary compensation of the banking sector, which permitted them extraordinary results, to the point that 40 percent of reported profits in the United States were earned in the banking sector by enterprises that paid out about half of their gross revenues in compensation—very, very good work if you can get it.

This is not an isolated occurrence. It is something that is part of a well-established historical pattern. That pattern has its identifiable characteristics, and those characteristics are known in the economics literature. They were laid out very carefully in 1993 by George Akerlof and Paul Romer in an article titled "Looting: The Economic Underworld of Bankruptcy for Profit." That article was based upon the experiences of a decade previously in the savings-and-loan industry and the work of a criminologist by the name of William K. Black, who identified the patterns and whose work led not only to the early recognition that the S&L industry was being taken over by criminal enterprises but also to later prosecutions that put about one thousand S&L insiders into federal prison in the early-to-mid 1990s, along with roughly three thousand others, including many commercial bankers.

The banking sector realized that the game was up in August 2007. Everybody realized that many of their own assets were worth nothing, and therefore they could not lend to each other without incurring the risk that they were lending to an insolvent party. And so the interbank loan market collapsed. The government's response to that has been called the Paulson Put, after Henry Paulson, who was secretary of the Treasury at the time; this was an effort to defer realization of the losses, if possible, past the November 2008 elections. Thomas Ferguson and Robert Johnson, in the *International Journal of Political Economy*, lay this out in two very long articles.[1] They show that Paulson looked for ways to refinance the toxic assets and he found them, in the federal housing agency, and he found them particularly by persuading the great secondary mortgage market makers Fannie Mae and Freddie Mac to increase their holdings of toxic securities—subprime loans—attempting, as I said, to keep the game going a little bit longer. He did not succeed in keeping it going past the election, of course: it came to a great crash in September 2008, with the failure of Lehman Brothers. The result of that was an extraordinary effort to persuade Congress to pass the Troubled Asset Relief Program (TARP) in early October 2008, effectively forcing the Democratic leadership to validate a massive rescue effort of the financial institutions that had been under way for a year in the Republican administration.

The overall rescue effort was effective and largely successful—at least in some ways. It quelled a panic that might well have produced truly catastrophic results, but it achieved this success at the price of a larger failure: by forestalling a restructuring and reform that would get at the root of the financial crisis. It's also fair to say that the machinations at that particular moment—in particular, the extraordinary willingness of the Republican caucus in the House of Representatives to take some advice that came out of right field and vote against TARP in the first round—had a decisive effect on the outcome of the presidential election.

With the arrival of the Obama administration came a second opportunity to get banking reform right. I'm afraid to say, that opportunity also was not taken. The Obama administration was compelled by the same logic that the Bush administration had been following—that is, to prevent panic and to save institutions at the expense of pursuing the effective restructuring that would enable them to contribute to the processes of economic recovery anytime soon. The result of that, of course, was a political disaster, in that the banks very quickly realized that they were saved. They were saved by a relaxation of the accounting standards that permits them to this day to continue to fail to realize their losses—losses that will not be repaired. It permits them to operate profitably without making loans, by borrowing from the central bank for practically nothing and then lending back to the government for 3 or 4 percent—again, very good work if you can get it; I advise everyone to take out a bank charter without delay—and to pay themselves bonuses, too.

At the same time, the great institutions that I spoke of earlier—the great public-private institutions that create obligations for the federal government along with the progressive income tax, among other things—cooperated through a process economists know as *fiscal stabilization*, putting the government into deficit far beyond any prior predictions of what was sustainable or stable, and creating, in exact Godley fashion, a corresponding financial surplus in the private sector. Savings went ahead of investment, so that the savings rate has gone up just as the government deficit has. This is an accounting necessity, as the two are exactly the same phenomenon simply recorded on opposite sides of the balance sheet. That was the principal reason why we didn't move into the Great Depression, Mark II. We have a very large government sector that moved very rapidly to stabilize activity, as a result of processes that were baked in the cake and did not require new legislation. There was in addition to that a very useful stimulus bill, the American Recovery and Reinvestment Act, which, while not as large as I would have liked it to have been, certainly is contributing now to preventing the complete meltdown of state and local governments, and to providing construction jobs in the public sector.

That's roughly where we are at the present time. There are some successes—as I say, things could have been worse—but the successes are marked by four extreme limitations. The first is in the housing sector. Remember that housing is a source of financial wealth of what was once the American middle class. That middle class is largely lost. The equity that it built up in its homes over many decades is severely impaired. A very large part of that group owes more on its mortgages than it could receive were its houses on the market, if it could sell its housing at all. Those with very few other liquid assets are effectively financially insolvent. This is a problem that will only be resolved over a very long time horizon, as people give up their homes and move into rentals—reversing, in effect, one of the greatest social projects of the 20th century. It's a process that is under way, but it will be a long one, and very painful.

A second broad area where we are not succeeding is in the institutions that provide services at the state and local levels: higher education, public schools, libraries, parks, police and fire departments, all of which are under intense pressure as a result of the federal government's failure to completely fill the enormous budget gaps that have opened up, particularly in states where the housing crisis is most intense, like California and Florida. The result is the functional dismantling of the major institutions of the American welfare state going on as we speak. The University of California has long been the greatest public university ever created. What's going on there now—massive budget cuts that have led to higher fees and fewer classes—is very sad. It's shameful. And it's hard to imagine how it will be reversed.

The third area is the financial sector: how does it regain trust and build confidence? The problem with trust is that it cannot simply be regained; it has to be earned. It has to be merited. And once reality sets in, once information is available, once people realize the extent of the corruption and criminalization at the root of this problem, trust cannot be regained until the wheels of justice turn. I gave testimony to this effect to the Senate Judiciary Subcommittee on Crime and Drugs on May 4. The issue has been raised in other Senate subcommittees as well. It's being raised by the Financial Crisis Inquiry Commission chaired by Phil Angelides. It's being raised by the Securities and Exchange Commission. It's being raised at the Justice Department. It's being raised by a congresswoman named Marcy Kaptur (D-OH), who has sponsored a bill to provide an extra thousand agents to the FBI to investigate white-collar crime. That process, once started, must be completed, or trust cannot be restored. If it is circumscribed, then the consequences will be roughly the same as the consequence to the airlines if we give up air traffic control: no one will use the institutions because the information about their lack of safety will be out there but the corrected actions will not have been taken. That's the challenge we'll have to face going forward.

The fourth area where we have not succeeded is international. Not enough has been made of the link between the American crisis, which peaked in 2008, and the European crisis peaking now. It has been customary to treat the events in Europe as a Greek crisis, as a situation related to the particular profligacy of the Greek government over the years—a profligacy that was only revealed by, certainly not caused by, the present socialist government. I think this is s a profoundly misleading narrative, one very similar to that blaming the crisis of U.S. states on localities, and it fundamentally misses the essential story. Let's ask at what time the spreads on Greek government bonds began to diverge from those on German government bonds. The answer is September–October 2008 or just after, and those spreads have been diverging ever since.

Why is that? I think the answer is obviously not related to Greece but absolutely related to New York and Washington, to the crisis in the United States and a generalized flight to safety, away from anything that might be considered problematic—movement that ultimately leads to a political game between the bond markets and the most powerful political entities available, the European Union and the European Central Bank, over whether those entities will relieve the large financial institutions of the losses associated with the failure of borrowers to refinance their debts. This game is in the process of being resolved, and I think the only way it *can* be resolved is with the capitulation of the authorities and the Europeanization of Mediterranean debts.

This leaves Europe with something very similar to what we have in the States, a situation in which the banks have been effectively rescued but the economies have not, and the price is paid by relentless rounds of fiscal austerity. We may get more of this at the federal level in the United States in the months to come, leading to an essential inability of economies on both continents to move back to a pattern of constructive growth, with the public and private sectors in balance, because there is nothing on the private side that will take up the losses being incurred on the public side. That raises a very deep question in my view: Going forward, is it possible to construct a world in which we have extraordinarily powerful private financial markets, equipped with what Warren Buffett called "financial weapons of mass destruction"—credit default swaps—greatly outbalancing the value of the assets against which they are written and therefore dominating the markets? Markets in which these instruments determine the price of every bond issued by every public authority except, perhaps, the Government of the United States itself? In that environment, how is it possible to reestablish either long-term corporate borrowing for entrepreneurial purposes or long-term government borrowing for capital improvements and improving the quality of life? And if that is not possible, what alternative institutions do we propose?

Last summer I attended a very interesting conference in Umbria sponsored by the Russian Academy of Sciences and presided over by former President Mikhail Gorbachev. It was small—13 to 15 people. I was the only American, and I gave my remarks at the opening session. I said, "Mr. President, when Homer returns to write the history of this epoch, he will no doubt say that the Russian mathematicians streamed forth from Muscovy in 1991 and presented themselves before the gates of Wall Street bearing the gift of quantitative risk management, and they were received with joy. In 20 years they had done their work and succeeded in destroying the whole place. It was the greatest Trojan horse operation since Troy. So he will no doubt say, Mr. President, that you were responsible not only for the demise of Soviet Communism but also for the demise of financial capitalism." To which Gorbachev responded, "I've been accused of worse."

We do have to ask whether Marx, Lenin, and Luxemburg may have the last laugh in this matter. If we do not wish them to have the last laugh—and I do not; I would much rather it be John Maynard Keynes, Wynne Godley, and Hyman Minsky who have the last laugh—then we really must get to work and change not only our thinking but also our actions at this stage. Because I think that the moment when the issue will be decided is not very far away.

*Transcribed by Amy Masarwe.*

## Note

1. See Thomas Ferguson and Robert Johnson, "Too Big to Bail: The 'Paulson Put,' Presidential Politics, and the Global Financial Meltdown. Part I: From Shadow Financial System to Shadow Bailout," *International Journal of Political Economy* 38, no. 1 (Spring 2009): 3–34; and "Too Big to Bail: The 'Paulson Put,' Presidential Politics, and the Global Financial Meltdown. Part II: Fatal Reversal—Single Payer and Back," *International Journal of Political Economy* 38, no. 2 (Summer 2009): 5–45.

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