HIGHLIGHTS

The Levy Economics Institute of Bard College

Public Policy Brief

Highlights, No. 103A, 2009

FINANCIAL AND MONETARY ISSUES AS THE CRISIS UNFOLDS

JAMES K. GALBRAITH

Introduction

The working group on financial and monetary issues of Economists for Peace and Security (EPS) and the Initiative for Rethinking the Economy (IRE) met recently in Paris to discuss the ongoing crisis and resulting reform proposals, including the new initiatives of the G-20 and the Obama administration.[1] This brief provides a structured summary of the major points of those meetings.

The authority of this particular group was established in June 2008, when it met and thereafter issued one of the first comprehensive warnings about the impending (global) financial collapse. That warning helped to place several members of the group in position to influence the legislative discussion of the Troubled Asset Relief Program (TARP) and the fiscal expansion package in the United States, as well as the development of the G-20 position in early 2009.

State of Play

As the group met, prominent voices, including Chancellor Merkel of Germany and other leaders of the European Union (EU), were preparing to issue statements declaring the world economic crisis substantially resolved and urging a shift in focus to "exit strategies" aimed mainly at fiscal deficit reduction. The Paris group took a very different view.

Participants recognized that emergency action and automatic stabilization—the large budget deficits, especially in the United States, the UK, France, and Germany—had worked to avert a

The full text of this paper is published as Levy Institute Public Policy Brief No. 103, available at www.levy.org.

ISSN 1063-5297
ISBN 978-1-931493-98-7

catastrophic collapse of liquidity in the world system, and to place a floor under the decline of output in the more advanced countries. They recognized the favorable impact of fiscal expansion policies and the likely positive effects of an end to inventory liquidation in the months ahead. Yet all of this falls far short of creating conditions for sustained economic recovery and a return to high employment.

Members of the Paris group were strikingly pessimistic—a pessimism shared despite a wide range of theoretical perspectives. One speaker summarized the general position as a "Minskyan supercycle"—a crisis of underconsumption and overproduction, including a vast overhang of private debts and the reluctance of governments to allow major corporations and (especially) banks to disappear—a step that would adjust supply, and therefore profitability, to demand. Not incidental to this is an undoing of globalization, the collapse of the banking system, and the bankruptcy of states, cities, and even some national governments. Moreover, there is no assurance that the response by capable actors at the national or transnational level will be either timely or sufficient, either in the United States or in Europe.

A still larger issue concerns the backdrop of the Kondratieff cycle: the long waves of technical change that generally underlie major economic depressions. In the slump, governments come under pressure to save fading or dying industries and fail to put adequate resources behind the sectors whose growth is most promising—notably, sustainable energy, greenhouse gas reduction, and public health. In these matters, organized politics and rational foresight stand at cross-purposes, and the cause of economic recovery is not served.

Is it possible to return to the structures of economic growth in the decade before the crash, a time of worldwide expansion that included a decline in global pay inequalities between nations? The consensus was no. A global expansion produced a global crisis, as private equity promoted outsourcing and the United States provided deficit financing that sustained worldwide demand. Meanwhile, commodity prices rose and there was a massive flow of foreign direct investment that led to a buildup of foreign exchange reserves (mostly in dollars), while the normal exchange rate adjustment mechanisms were blocked.

The influence of private equity on global investment patterns will not return. Nor will the growth of rich-country consumer debt be restored. And getting adequate demand into the world system remains a critical problem. Either the United States must provide an ever-larger current account deficit in relation to U.S. GDP or else some other major player must assume the role of consumer of last resort. In particular, Europe has sidestepped this role, despite the fact that parts of Eastern Europe are approaching collapse. Failing either of these options, there is no offset to the global desire for savings, and the world economy cannot grow its way out of depression and unemployment without major and sustained public initiative.

In the U.S. economic sphere, the problem lies essentially with the transfer of resources and power to the top of the system and the dismantling of effective taxing power over those at the top. The effect of this is to create a following that is devoted to preserving the existing (unstable) system. Further, there were massive frauds leading up to the current crisis (e.g, in the origination of mortgages), but in the policy approach so far, there is a consistent failure to address, remedy, and prosecute these frauds. Fundamental reform and "bottom-up" recovery strategies based on social insurance and public investment are therefore blocked from the outset. Meanwhile, major legislation from health care to bank reform continues to be written in consultation with the lobbies.

One of the gravest dangers to economic recovery, finally, lies precisely in the political classes' inflexible commitment to the preceding economic order. This feeds denial of the problem, so that the U.S. discussion of "green shoots" and talk among European leaders of "exit strategies" amount to little more than politically inspired wishful thinking.

A General Framework: Liberal and Neoliberal Reform

All agree that the financial system needs "reform." And the program of the Obama administration emphasizes what is plainly true: the crisis arose from failures of regulation, and the remedies will require fundamental change.

In historical context, neoliberalism, in political terms, appropriated the symbols of the liberal revolution (notably, Adam Smith), in a new alliance of the rich against the middle class and the poor. In neoclassical economics (the metatheory of neoliberalism), the market comes to substitute for the functions of the state and serves only private interests, rather than the broader public interest. The slippage from liberal to neoliberal thinking occurs in every domain of economic discourse, and it is especially clear in banking. Banks are institutions, chartered by public authority, to serve public purpose. The state has power over the conduct of banks, including taking them over and running them when they are troubled enough to threaten the public guarantee that lies behind bank deposits.

"Financial markets," and especially the "shadow banking system," are neoliberal creations that escape both regulation and insurance. The result has been to vitiate the concept of public purpose, creating in banks privileged and powerful market-oriented institutions that use and largely control the state, rather than respond to it.

The Geithner-Summers plan recognizes the deficiencies of this system and strongly acknowledges the need for comprehensive reform. Certain of the specific proposals in the plan, especially that for a "Consumer Financial Safety Commission" with broad powers to oversee the financial products offered to consumers, are promising. Equally promising is the push to bring over-the-counter derivatives under control and to institute clearinghouses, implying obligatory standardization of contracts. Nevertheless, the U.S. administration's approach (and that of the European regulatory authorities) remains anchored in a neoliberal vision of financial markets and not in the liberal vision of banking institutions.

The attempt in the neoliberal era to escape from deposit insurance proved completely unworkable as the crisis spread (e.g., the run on Northern Rock and the enactment of TARP). Deposit insurance is the one proven antidote to panic, and it entails a need for in-depth prudential regulation, not just of the markets but of the institutions themselves. Moreover, the result of combining too-big-to-fail with neoliberalism is perverse, facilitating and even encouraging dysfunctional risk taking and excessive compensation—incentives for fraud.

The Paris group held differing opinions on the proper resolution of this dilemma but members were in broad agreement that a mixed system, with liberal (public-private) institutional underpinnings and a market context, requires regulation of both institutional conduct and governance, as well as market instruments. And in this respect, the reform packages in the United States and Europe fall short. There are already some 7,000 public-private financial partnerships (called "banks"), with a capital requirement of 10 percent and insurance on the rest of their liabilities.

There is no particular need for the U.S. Treasury to attempt to establish separate entities as receptacles for toxic assets. There is also no excuse for the government to fail to set the standards it deems appropriate for the conduct of the existing banks (including rules for compensation, the origination of loans, underwriting loan-backed securities, and insurance against risk).

The Larger Context for Reform: To What End?

The purposes of economic policy are tied up with the accounting frameworks in predominant use, and these have specific historical origins and contexts (e.g., national income accounts emphasize economic growth, while unemployment statistics emphasize the performance of the job market). The reporting framework for central banks, developed in the 1970s, was strongly influenced by the monetarist goal of tying central bank conduct to the drive for price stability. Environmental, health, and inequality indicators tend to play secondary roles in the design of economic policy.

The crisis exposes the need for profound reform, not only in the way we conduct economic policy but also in the way we measure the outcomes. We have an economic counting scheme that celebrates all resource-using activity as growth while remaining suspicious of the full use of human resources, counting "full employment" as a potential threat to profitability and as a source of inflation. This is exactly the reverse of the system of relative values that we know to be needed.

Pierre Calame presented a series of principles for an accounting framework that could lead toward a sustainable system. These involved distinguishing between four basic classes of goods: global public goods, nonrenewable resources, human resource use, and the production and sharing of knowledge goods. His framework clearly suggests that the world community should press toward a redefinition of economic accounting standards aimed at placing planetary sustainability on the highest accounting level. For example, an activity should be accounted positively if it reduces greenhouse gas emissions, which would induce tax and regulatory revisions that could cause movement toward sustainable technologies and away from destructive ones. Similarly, an international framework should penalize the waste of nonrenewable resources, especially by richer countries, while rewarding a shift toward conservation and renewable energy.

At the same time, it is essential to recognize that there is no operational limit on either the spread of knowledge or the use of human talent. A critical function of government is to ensure that education, research, and scientific development reach their full potential, and also that the resulting human potential is fully employed. Clearly, events that move all four classes in a favorable (unfavorable) direction are unambiguously to be preferred (avoided). The task of policy design is to fire correctly on as many of the four cylinders as possible.

An immediate implication of this approach is that one cannot hope to direct sensible economic reform *through* the banking sector, because banks' distorted accounting structures distort their behavior. This has led to unstable overinvestment (in technology, housing, and oil), increasing economic inequality, and a complete lack of environmental progress. Meanwhile, periodic gains in employment are wiped out in the subsequent crash. The task of reform is to find a way to set the direction of growth along lines that meet a range of important physical and social objectives.

As a general proposition, the group also strongly agreed that efforts to revive the economy by first reviving the financial sector cannot work. The correct approach should consist of measures run through the public, household, and business sectors, such as a program of general fiscal assistance (i.e., revenue sharing). These measures would stabilize government finances in the United States and in Europe; provide relief from payroll taxes and stabilize household finances (and, indirectly, help the financial sector); expand Social Security benefits as well as unemployment insurance and other direct payments to individuals; and provide foreclosure relief to help keep people in their homes.

A program that provides a public job at a fixed wage for all takers functions like a buffer stock, stabilizing both total employment and the bottom tier of the wage structure. People can move in and out of the buffer as private demand for their services varies. Meanwhile, private employers like hiring those who already work, and will prefer hiring from the federal jobs program rather than from among those who remain unemployed.

The problem of unemployment is easily cured, without threat of inflation. It is merely sufficient to provide jobs, at a fixed wage, to whoever wants them, and to organize work that needs to be done. Such work should be socially useful and have an environmentally low impact: from child care to teaching and research, elder care, conservation, arts, and culture. Where possible, it should contribute to global public and knowledge goods, and it should not compete with work normally done in the private sector. The point is not to socialize the economy but to expand the range of useful activity. The barrier to all this is simply a matter of politics and organization, not of money.

The effect, nevertheless, would be to raise all private sector wages to the buffer-stock minimum, while eliminating the reserve of unemployed workers used to depress wages in low-skilled private sector industries. There will be no pressure to raise wages *above* the buffer threshold, since private employers providing higher wages can draw on an indefinitely large workforce. Hence, the program is not inflationary.

Moving on to the problem of global public goods, it is clear that the neoliberal concept of reform—the creation of market mechanisms—is the dominant approach to the problem of climate change at the present time. The weakness of the cap-and-trade approach to marketable carbon permits is highly apparent (e.g., the market is compromised by exemptions).

The solution to this problem *can only be* to plan and to invest in the creation of appropriate solutions to the greenhouse gas problem, and to do so in a way that is independent of the short-term profit motive. Such planning and investment are necessarily public functions that will not be provided optimally by any market mechanism. They will require the inception of new-knowledge goods—planning frameworks for energy sustainability at the local and regional level—that will in turn require educational and research resources. They will require the creation of a long-term financing network—such as the National Infrastructure Fund long proposed for the United States—capable of sustaining capital investment activity. And they will require a national and transnational planning framework, embedded in institutions at the highest levels of government, including ministries in Europe and cabinet departments in the United States.

Toward a Functional System of Banking and Finance

Banks and other powerful financial players want the world returned to the condition that existed before the crash. The problem is partly that the system *cannot* be put back to as it was and partly that it *should not* be.

A central dilemma of globalization is that finance escapes from national systems of regulation far more easily than any other activity. Thus, the problem of effective financial regulation starts with the problem of borders. Banking institutions are effectively broken into subsidiaries, each operating under local rules and taking advantage of every form of tax and regulatory arbitrage.

Hopes for an effective international safety-and-soundness regime are frustrated by national political considerations (e.g., countries that provide tax and regulatory havens). The multinational banks form lobbies that can dominate national political systems and play one government off against another. International institutions are weak and excessively market oriented, placing automatic cushions—specifically, capital requirements—at the heart of the regulatory framework.

Compared to Basel I, the Basel II framework for banking reduced capital requirements and increased the incentive to rely on ratings agencies, which delivered (biased) AAA ratings to private securities on a fee-for-service basis. This was a formula for ratings fraud, on a global scale, along with increased leverage, which increased the fragility of the institutions in ways that could not be traced or anticipated by the authorities (e.g., the purchase of credit default swaps). And, with the collapse of Lehman Brothers and AIG, the catastrophe arrived—and came close to destroying the institutional basis of the global financial system.

The response of the system to the panic was to nationalize the provision of liquidity and to absorb the shadow banking system into the state. Meanwhile, the solvency problems of the banks proper were being overlooked, while the government infused them with cash. In practice, it appears that the Federal Reserve, through its program of nonrecourse lending against risky collateral, is providing a kind of on-balance-sheet version of the AIG credit default swaps.

The problem of liquidity can be solved only at the level of the currency unit, which (except in Europe) is a national issue. So long as the underlying conditions persist, the position of government in financial matters cannot be dispensed with.

The Paris group was in general agreement that the past cannot be re-created because apparently stable and trustworthy institutions have been destroyed. The functions and activities of the precrisis period cannot be reproduced in the postcrisis atmosphere. The group therefore sees no alternative to the permanent restoration of national or equivalent public power over all financial institutions. Banks are public-private partnerships, funded partly at public risk (via deposit insurance and implicit guarantees). They cannot logically operate independent of the power that guarantees their funding, and the attempt to allow them to do so is intrinsically destabilizing.

Once having extended deposit insurance, government cannot remove it. Placing government guarantees behind the money market mutual funds effectively turned them into narrow banks. The fact that the central bank now supports the commercial paper market, collateralized debt obligations, and mortgage-backed securities permanently affect the market's credibility.

The idea that bank risk taking can be effectively limited by capital requirements is a neoliberal illusion, stemming directly from the concepts of perfect information and market discipline. In reality, capital requirements are neither a barrier to risk taking nor a cushion against losses. They are a tax on the operation of institutions and a source of conflict as declining valuations wipe out the cushion for individual institutions and increase the pressure on the system as a whole. Yet the problem is 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 to establish and enforce effective rules for institutions, citizens, banks, taxation, and mortgages that are the only serious antidote to reckless finance.

Enforcement is essential, as fraud and misrepresentation are pervasive (e.g., the failure of market-based solutions to the toxic asset problem). So long as the financial system is not thoroughly purged of those responsible for financial crimes, the system itself will not regain credibility, nor the trust of domestic or international clients.

It follows that the group favors a major strengthening of independent audit and enforcement capabilities (e.g., criminologists) in the regulatory agencies. Applying this perspective to the redesign of financial systems would largely reconcentrate financial activity in banks (and shrink the shadow banking system) and align the reach of particular banks with the regulatory frontiers applicable to that bank. These steps would promote a more conservative, less predatory, and less reckless approach to financial services, and shrink the largest and most broadly transnational banking institutions in order to achieve a structure that is aligned to public purpose and no longer poses a distinct risk to the system. "Critical system infrastructure" presently administered by large banks could be managed in the public sector, as a public utility.

The ongoing process of regional monetary management is most advanced in Europe, but it is emerging in Asia and Latin America as well. The Paris group regards this development as a positive step.

International Monetary Reform Still to Come

The first lesson of international monetary systems in the 20th century is that they do not last forever. In spite of differences on the current medium-term outlook, the group agreed that a better system should be designed.

The principal vulnerability of the dollar-based system lies in the fact that the main justifications for it no longer exist (e.g., the United States' dominant economic and military position in the postwar world). Although the development in the 1990s of an asymmetric system rooted in dollar reserves remains a compelling reason for the system to continue, it amounts to saying that the dollar reserve system depends basically on the United States being the country most willing to run large trade deficits. This cannot be a secure foundation for a permanent system.

There are three logical alternatives to the dollar-based system: (1) the dollar might be replaced by another key currency such as the euro (but the eurozone would have to run substantial current account deficits); (2) the EU would need to develop a reserve asset enjoying the full faith and credit of the union itself, not merely national bonds denominated in euros; and (3) the United States would have to embark on a policy of much greater austerity, essentially renouncing recovery from the great crisis.

The second possibility means the revival and expansion of the special drawing right, which was a G-20 commitment to help deal with the crisis in Central and Eastern Europe. This initiative raises a serious question as to the role of the International Monetary Fund (IMF), which, according to the group, is beyond repair. The IMF and the World Bank routinely set themselves apart as preferred creditors, imposing conditionality and austerity measures on the most vulnerable member countries with the objective of undermining the most basic human economic rights, under conditions that preclude effective economic recovery.

Clearing away the present dysfunctional international monetary institutions would open a path toward a reformed system, in which the function of an international reserve currency would provide resources to support the development of the nontraded and, especially, the nonprofit sectors in countries that cannot sustainably finance their own current account deficits. The goal of the international system would be to free developing countries from a compulsive need to serve the export sector on any terms. The final alternative to a single-reserve-asset world is to pursue the development of regional monetary authorities, which make dollar reserve assets earned by countries that are successful net exporters available to neighbors who are not. Such regional authorities have distinct advantages over a global system.

The problem of asymmetry is the problem of assuring sufficient aggregate effective demand in the world economy to permit the full utilization of human resources—while conserving, as much as possible, nonrenewable and environmental resources. The way forward is to put resources at the disposal of countries, regions, and households that have been starved for such resources over the neoliberal era. The United States can (and will) continue to supply the main global reserve asset, running a trade deficit to match. But it would be highly desirable to supply additional reserves, and hence to fund additional activity demand, through an alternative asset, channeled mainly through regional institutions and deployed mainly in the not-for-profit and nontraded-goods sectors.

In brief conclusion, the group of experts convened in Paris warns that the crisis is not over, that policies so far set in motion are not sufficient, and that the goals set by the authorities to this point, which amount to a restoration of previous conditions, are neither desirable nor possible. 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.

Note

1. Participants in the conference included Marshall Auerback, RAB Capital, PLC; William K. Black, University of Missouri–Kansas City; Jack A. Blum, attorney, Washington, D.C.; Jean-Joseph Boillot, Euro-India Group; Luiz Carlos Bresser-Pereira, Fundação Getulio Vargas, São Paulo; Pierre Calame, Fondation Charles Léopold Mayer; Christian Chavagneux, *Alternatives Economiques* and *L'Economie Politique*; Ping Chen, China Center for Economic Research and Virtual Center for Complexity Science, Peking University; Stephen S. Cohen, University of California, Berkeley; Jane D'Arista, University of Massachusetts Amherst and Financial Markets Center; Paul Davidson, The University of Tennessee, College of Business Administration; Paul H. Dembinski, Observatoire de la Finance; James K. Galbraith, The University of Texas at Austin and EPS; Robert Guttmann, Hofstra University and Université de

Paris-Nord; Thea Harvey, EPS; Patrick Hébert, Calyon; Michael D. Intriligator, University of California, Los Angeles; Wojtek Kalinowski, IRE; Jan Kregel, The Levy Economics Institute of Bard College; Aurore Lalucq, IRE; Bernard Lietaer, Access Foundation and University of California, Berkeley; Michael Lind, New America Foundation; Perry Mehrling, Barnard College, Columbia University; Warren Mosler, Valance Co.; Alain Parguez, Université de Franche-Comté, Besançon; Jean-Paul Pollin, Université d'Orléans; Kunibert Raffer, Universität Wien and New Economics Foundation; J. Barkley Rosser, James Madison University; Nicolas Véron, Bruegel; and Lucy Law Webster, EPS and Center for War/Peace Studies.

About the Author

Senior Scholar JAMES K. GALBRAITH is Lloyd M. Bentsen Jr. Chair in Government/Business Relations at the Lyndon B. Johnson School of Public Affairs, The University of Texas at Austin. He also chairs the board of Economists for Peace and Security and is director of the University of Texas Inequality Project.

Galbraith is the author, most recently, of *Unbearable Cost: Bush, Greenspan, and the Economics of Empire* (Palgrave Macmillan, 2006) and *The Predator State: How Conservatives Abandoned the Free Market and Why Liberals Should Too* (Free Press, 2008). He is a former executive director of the Joint Economic Committee and was an architect of the modern procedures of congressional monetary policy oversight. From 1993 to 1997 he served as chief technical adviser to China's State Planning Commission as part of a UNDP project on macroeconomic reform. Galbraith studied economics as a Marshall Scholar at King's College, Cambridge, and holds economics degrees from Harvard University (B.A.) and Yale University (Ph.D.).

Recent Public Policy Briefs

Financial and Monetary Issues as the Crisis Unfolds
JAMES K. GALBRAITH
No. 103, 2009 (Highlights, No. 103A)

The Global Crisis and the Implications for Developing Countries and the BRICs
Is the B *Really Justified?*
JAN KREGEL
No. 102, 2009 (Highlights, No. 102A)

Promoting Gender Equality through Stimulus Packages and Public Job Creation
Lessons Learned from South Africa's Expanded Public Works Programme
RANIA ANTONOPOULOS
No. 101, 2009 (Highlights, No. 101A)

It's That "Vision" Thing
Why the Bailouts Aren't Working, and Why a New Financial System Is Needed
JAN KREGEL
No. 100, 2009 (Highlights, No. 100A)

The Return of Big Government
Policy Advice for President Obama
L. RANDALL WRAY
No. 99, 2009 (Highlights, No. 99A)

The Case Against Intergenerational Accounting
The Accounting Campaign Against Social Security and Medicare
JAMES K. GALBRAITH, L. RANDALL WRAY, and WARREN MOSLER
No. 98, 2009 (Highlights, No. 98A)

After the Bust
The Outlook for Macroeconomics and Macroeconomic Policy
THOMAS I. PALLEY
No. 97, 2009 (Highlights, No. 97A)