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GOVERNMENT RESPONSE TO FINANCIAL CRISIS PREVENTED SECOND GREAT DEPRESSION, BUT RECOVERY FACES EXTREME LIMITATIONS, NEW STUDY FROM LEVY ECONOMICS INSTITUTE SAYS

ANNANDALE-ON-HUDSON, N.Y.— While acknowledging that the U.S. government's response to the financial crisis—through the Troubled Asset Relief Program and American Recovery and Reinvestment Act—helped avert a second Great Depression by rescuing banks, preventing the meltdown of state and local governments, and providing construction jobs to the public sector, a new policy paper from the Levy Economics Institute of Bard College contends that those successes came at the price of forestalling restructuring and reform. In his new Public Policy Brief, *The Great Crisis and the American Response*, Levy Senior Scholar James K. Galbraith addresses the nature of the financial crisis in the United States and argues that the economy faces extreme limitations: a decimated housing sector and a reeling middle class; the functional dismantling of the major institutions of the American welfare state; and 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.

"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," writes Galbraith, who traces the crisis to the ascendancy of a predator state in control of the public-private institutions at the heart of the nation's economy. Those in control of these institutions view the function of regulation not as a necessity but as a burden—a fundamental misunderstanding, according to Galbraith. "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," he writes. "Without the regulatory apparatus that pervades our lives, most of the institutions in

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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."

Furthermore, Galbraith labels the mortgage fraud at the heart of the crisis a criminal enterprise, and sees the failure to prosecute those responsible, and the missed opportunity to reform and restructure the financial system, as a key limitation on the global economy going forward: "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."

Another area where the failure to reform financial markets can be seen is in the crisis in Europe, which is customarily treated as a Greek crisis. Galbraith calls this assertion misleading, stressing that Greek government bonds began to diverge from German government bonds at the same time, in September–October 2008, that the financial crisis in the United States was sparking a massive flight to safety, away from anything that might be considered problematic. He suggests that the only way the crisis in Europe can be resolved is with the Europanization of Mediterranean debts. "This leaves Europe with a situation very similar to what we have in the 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," Galbraith says. "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."

Galbraith concludes by asking, "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?"

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