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HIGHLIGHTS

THE GREAT CRISIS AND THE AMERICAN RESPONSE

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The "Great Moderation" view of economic life in the last three decades is a story of the credibility of the central banks, of probity and responsibility on the part of the fiscal authorities, of accelerating technological change coupled with changing demands on the labor market. The period was marked by a global subsidence of inflation while financial instability outside the United States promoted the worldwide holding of U.S. dollar reserves, and the United States grew for 30 years with only mild recessions. Out of this, economists created a mental model of self-stabilizing free markets and of hands-off policymakers who behaved so as to permit the forces of the free market to reach their maximum efficiency.

One ostensible contributor to the Great Moderation in the United States was the Federal Reserve reporting procedure instituted in the mid-1970s known as the Humphrey-Hawkins Act—under which the chairman of the Board of Governors reports every six months to both houses of Congress on the goals and objectives of monetary policy. The irony for me is that as a young staff member on the Banking Committee of the House of Representatives I drafted that statutory language. Certainly I did not think at the time that this modest measure was a revolutionary development in the stabilization of the global economy.

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An alternative view has long pointed to the dark side of the Great Moderation. This view focused on the stagnation of real wages in the United States, on the increase in economic inequality, on the growing trade deficit, and on the problem of imperial overstretch. The critique implied that there would be a crisis eventually, but it also suggested that the crisis would come first and foremost from a crash of the dollar—a rejection of American hegemony, ostensibly in favor of the European Union and the euro.

Both views showcase what is essentially a real-economy analysis. Both incorporated a flexible labor market (capable of pushing down wages for unskilled workers) and an efficient capital market (capable of rewarding policy virtue and punishing policy vice). Neither perspective focused intently on the financial sector, on the monetary aspects of the production process, on the relationship of credit to output, or on the relationship between the public and private sectors in the United States. Therefore, these two broadly opposing and symmetric views did not develop an analysis relevant to the crisis that actually occurred.

A third line of argument descended from the ideas of John Maynard Keynes and was articulated by Levy Distinguished Scholars Wynne Godley and Hyman Minsky. Godley was a former senior adviser to the treasury in the UK and a professor of applied economics at the University of Cambridge whose macroeconomic accounting approach was used in a series of papers published by the Levy Institute beginning in the mid-1990s. Godley's analysis pointed, in particular, to the unsustainability of surpluses in the government's budget. Why so? Because the accounting obverse of a surplus in the public sector is a deficit in the private sector. This was manifested in the increasing accumulation of private debt in the technology sector in the late 1990s, leading to a crisis, a decline in economic activity, and a return of government budget deficits.

Similarly, in the 2000s Godley argued that the buildup of private debt against housing would not be sustained. This phenomenon sustained economic growth until 2008 but it had definite limits, because private parties, unlike governments, have to repay their debts.

Hyman Minsky's analysis focused on the intrinsic instability of the financial sector. A period of stable economic growth and low inflation generates increasing confidence on the part of economic players. They shift from 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. Eventually, an increasing number of speculative players transition to Ponzi finance, in which financial commitments can be met only with further borrowings. This is an intrinsically unsustainable situation for a private party, as no one will lend to someone who must borrow in order to pay interest on previous debts.

A great deal of credit has to go to those few people working in the Godley and Minsky traditions, who were clear enough in their thinking to have foreseen, at least in part, the crisis that did in fact occur. Yet I don't think either of these analyses gets quite to the heart of the matter.

A third line descends from my father's work, in *The New Industrial State*, on the role of the great corporation and its relationship to financial authority. The theme also appears in my 2008 book *The Predator State*. The argument I made there, was that it is an error to view the U.S. economy through the free-market prism, created largely under Reagan, of deregulation, privatization, and a detached government operating mainly through monetary stabilization.

When you examine the actual institutions of American economic growth, something quite different emerges. Since the New Deal and Great Society, the public sector has been in full partnership with private institutions. This is true of Social Security, of Medicare and Medicaid; it is true in higher education and in the housing sector. Quasi-public financial institutions gave us 30-year fixed-rate mortgages, secondary mortgage markets, and federal mortgage guarantees. They gave us the savings-and-loan institutions, dedicated to housing finance, which operated for decades under special interest-rate regulations that permitted them certain advantages in the financial marketplace.

These public-private collaborations, while inefficient and defective in important respects, have been substantial successes; they are very robust politically and they achieve their stated objective by facilitating wide access to the services that they foster. In relation to these massive economic institutions, truly free markets barely exist; they are a fringe phenomenon despite holding a particular pride of place in American political rhetoric.

Conservatives in particular have understood very well that the true sources of American power lie with those who manage and control the public-private sectors, and especially the public institutions in those sectors. The objective of modern conservativism has not been, for many years, to roll back the state. Instead, it has been to place these institutions in sympathetic hands, and thus to permit a share of the vast cash flows they oversee to be directed to politically favored groups. This is what I call the predator state. It is a state that is intent on using, and if necessary reconfiguring, existing institutions as a device for political patronage on a grand scale.

Closely related to this has been a vast misapprehension of what regulation is for. In an advanced society, regulation is not a "burden" on businesses in general. It is, rather, the means whereby we attempt to guarantee that markets are viable and that it's reasonably safe to participate in them. Without efficient regulation, most modern institutions, from airlines to banks, would not exist. Nobody would fly without the Federal Aviation Authority running traffic control, and few would put money in the banks without the Federal Deposit Insurance Corporation. It is efficient regulation—and not technical knowledge per se, that largely distinguishes "advanced" from "developing" societies in the modern world.

In the last decade or so, the predator state largely took over the financial sector. Beginning under Clinton and accelerating under Bush, there were very clear signals that laws would be repealed or go unenforced, that regulations and supervisory standards would be relaxed. The result was that the housing finance sector was overrun by the most aggressive practitioners of the art of originating mortgages—*mortgages that were plainly fraudulent in millions of cases*.

To take up just one aspect of this: there is no nonfraudulent reason for a lender knowingly to accept an inflated appraisal on a house. But they did so repeatedly and massively. Why? Because the business model was no longer one of originating mortgages, holding them, and earning income as home owners paid off their debts. It became one of originating the mortgage, of taking a fee, of selling the mortgage to another entity, and taking another fee. To do that, the mortgages had to be packaged into bonds and rated, 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 bestowed by the ratings agency. Alchemy was the result, as BBB- paper was transformed into AAA.

There was even a language associated with this: *liars' loans*, *NINJA loans* (no income, no job or assets), *neutron loans* (loans that would explode, killing the people but leaving the buildings intact), and *toxic waste* (that part of the securitized collateral debt obligation that would take the first loss). It is a criminal language, a language of perpetrators, of people who know exactly what they are doing, and do it anyway. It is a language of counterfeiters, of money launderers, and of fencers. The mark, incidentally, as Michael Lewis tells us in his account, *The Big Short*, was known in the industry as "Duesseldorf."

The banking sector realized that the game was up in August 2007. Each bank realized that many of their own assets were worth nothing. 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 former Treasury Secretary Henry Paulson; it was an effort to keep the game going a little bit longer and defer realization of the losses past the November 2008 elections.[1] It did not succeed. That game came to an end in September 2008, with the failure of Lehman Brothers. The result of that was the Troubled Asset Relief Program of early October 2008, which effectively forced the congressional leadership to validate the bailouts already underway for more than a year. Meanwhile the Federal Reserve nationalized the commercial paper market, extended over $600 billion in currency swaps to foreign central banks, and took other extraordinary and unprecedented steps.

The rescue effort successfully quelled the panic, but this success was achieved at the price of a larger failure: by forestalling a restructuring and reform that would get at the root of the financial crisis. With the arrival of the Obama administration came an opportunity to get banking reform right, but that opportunity was missed. And the result of that was a political disaster.

The banks were saved—by a relaxation of the accounting standards, by the public relations device of "stress tests," and by a monetary policy that permits them to operate profitably without making business loans, as they borrow from the central bank for practically nothing and then lend back to the government and other risk-free borrowers at 3 or 4 percent.

At the same time, fiscal policy moved automatically toward large deficits: revenues collapsed and expenditures rose—both of which helped to stabilize the private sector, in exact Godley fashion. Private savings went ahead of investment, so that the savings rate has gone up just as the government deficit has—an accounting necessity. That was the principal reason why we didn't move into another Great Depression. In addition, there was a very useful stimulus bill, the American

Recovery and Reinvestment Act, which is helping to prevent the complete meltdown of state and local governments, and providing construction jobs in the public sector.

The successes to date are marked by extreme limitations in four areas: first, the problems of the housing sector will only be resolved over a very long time horizon, so that construction and borrowing against home equity can contribute very little to recovery in the near future. Second, the crisis of states and localities continues, leading to a functional dismantling of many major institutions of the American welfare state. Third, the financial sector remains in untrusted and untrustworthy hands, something that can only be dealt with by thoroughgoing investigations and prosecutions, which have not yet occurred. And fourth, the American crisis has generated a second crisis in Europe, which threatens economic stability on that continent.

Spreads on Greek government bonds began to diverge from those on German government bonds in September–October 2008. The timing shows that the "Greek crisis" is closely related to the crisis in the United States and to the generalized flight to safety that crisis provoked. Since European banks are highly leveraged, the German and French governments have had a strong interest in protecting them from insolvency based on the fall in value of the sovereign debts that they hold, and so the European Central Bank has been obliged to become a lender of last resort.

This leaves Europe with a situation that is similar to that in the United States: the banks have been effectively rescued but the economies have not. And the price is paid by relentless rounds of fiscal austerity, leading to declining activity, higher unemployment, and lost tax revenues, so that the "problem" of budget deficits and public debt never goes away. This may lead to an 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.

All of this suggests that it may be past time to begin to consider the larger institutional requirements for recovery from a systematic collapse of global financial markets. As this, we should by now have realized, is actually what has occurred.

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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