Comments on "The Slump, the Recovery and the New Normal" by E.S. Phelps, at a conference on "Challenges of the Global Crisis to Macroeconomic Theory and International Finance" in memory of Pentti J. K. Kouri, in Helsinki on June 11, 2010. By James K. Galbraith

Thank you very much and it's a distinct honor for me to be here to make some comments on Professor Phelps' paper and in honor of Pentti Kouri.

I want to begin by quoting the very succinct summary of the standard narrative that begins the Phelps paper which he writes:

"In the narrative, Chinese saving caused a world "savings glut"; the U.S. Congress cut the cost of capital for residential investment to expand "homeownership"; the U.S. Federal Reserve then cut its "policy rate" to match the decline in the "natural" interest rate; U.S. regulatory changes allowed banks to borrow more in order to do more mortgage lending for residential and commercial structures; finally, changes in social norms permitted CEOs to ask and receive outsize bonuses, permitted speculators to make one-way bets on housing prices, and permitted homebuyers to file fraudulent loan applications, all of which removed the last line of defense against a scramble for more houses."

That paragraph seems to me a very succinct summary standard story of the boom. As for the slump, there we run into a question of theoretical interpretation. According to Phelps, Keynesians claim aggregate demand. I'm not entirely sure that's right; or perhaps for present purposes I'm no longer a Keynesian. Chicago MIT-NYU types have their random disturbances and Professor Phelps writes, "a school that laid the belief in the ground for magic the market cannot prepare us for gross mis-pricing of risk and pathological asset pricing." It's a sentiment I heartily endorse. And he mentions an industrial practice school,which he says also "does not explain the near escape of housing prices from the gravitational pull of fundamentals."

So he proposes for us a fourth approach which he describes as a non-monetary, non-rational expectations hypothesis model stressing that housing finance is not needed to fuel the rise of prices; that expectations alone are sufficient. And I believe that is the core of his argument.

Now the body of the paper made me yearn for an actual copy -- I was reading it in the hotel room in Athens on the computer -- and also for just a few mathematical expressions so that I could see at a glance what he was getting at. It all seemed very ingenious: the effort to explain the housing bubble without reference to the conduct of banks. I think what was going on here was something that Keynes might have called a rise on the own-rate of interest on housing as opposed to the real rate of interest on other assets. The phrase 'positive price Wicksell effect' crops into mind to describe it; I'd have to go back to see whether 'Hicks Lucas Rapping' was a more precise description.

In any event, in the Phelps model the low rate of interest which sets off the housing boom alongside other factors is due perhaps to an Asian, specifically Chinese, savings glut: an obsessive refusal of that population to consume and their search for safety in U.S. bonds. I fear that in the real world there is actually no such thing. Chinese consumption standards are in fact rising very rapidly as anyone with a mother-in-law there knows. The accounting artifact of high savings is due very largely to falling prices of wage goods, unobserved by the surveyors who take PPP measurements but perfectly obvious to ordinary shoppers, and to the correspondingly high private and public investment rate. There is no excess of private savings looking to go anywhere, and thanks to capital control it would be difficult to get it out of the country if there were. The Chinese bond hoard reflects the cost effectiveness of the Chinese export market model plus the compulsory exchange for dollar inflows to the real estate and capital markets. One can perhaps call this savings in accounting terms but it is confusing to do so in ordinary language.

The transformation of Chinese cash into T-bonds is an accounting operation in which the demand equals the supply, and I would argue that the source of decline in long-term interest rates must therefore be sought elsewhere. The true contribution of China to low interest rates is not the supply of savings but effect of the low cost of Chinese wages goods in world markets on the world wide rate of inflation. However, if we have an anterior decline in the world inflation rates then the real rate of interest hasn't declined so much then -- has it? --and the MacGuffin that was required to start the Phelps process is no longer immediately in view.

The next puzzle over which Phelps labors is the rise in U.S. housing prices in the face of stable consumer prices generally. I agree this is the essential puzzle. He finds the explanation in a temporary and irrational, unobservable and irrefutable change in the state of expectations. Animal spirits I think is a term one could use to describe this. I think it is a very substantial step in this paper to bring in the role of speculators, relative to models that ignore them. But it would be useful to do so in the right way. And while one cannot of course disprove Professor Phelps' version I think one can point to a fair amount of actual evidence that takes us in yet a different direction.

Specifically that evidence suggests that housing prices rose because mortgage originators found it profitable to inflate them. Their business model was: the bigger the loan the bigger the fee. So they sought out appraisers willing to inflate their appraisals, created loans with teaser rates to trick the ratings models, and solved the problem of nonpayment by passing the garbage to other investors as quickly as possible. Let me just quote for you a comment in the Washington Post on the 3nd of February, 2007:

“A new survey of the national appraisal industry found that 90% of appraisers reported that manager brokers real estate agents lenders and even consumers have put pressure on them to raise property evaluations and to enable deals to go through.

Market Watch on the 24th of April of the same year quotes the manager of the California Association of Real Estate Appraisers, in a very frank and candid remark, quote, "you show me an honest appraiser and I will show you a poor one." Where by “poor,” what is meant here is “impecunious”. This is “Looting: Bankruptcy for Profit,” as described in Akerlof and Romer’s classic 1993 article. And while the mortgage originators, Countrywide Financial, IndyMac, Washington Mutual, Long Beach and so forth and so on have all failed, their failure does not mean that the scam failed. The perpetrators are mostly walking around rich and free.

In fact I would argue that we have in the system all of the major elements required for the description of a criminal industry. That is to say in the originators we have a counterfeiting scheme: people who issued mortgage documents things that looked like mortgage documents but that were not in fact mortgage documents. The issuers knew very well that there was no prospect that the borrowers would be able to service those loans, and they had entire language to describe this. Liars’ loans. NINJA loans; no income or job or assets. Neutron loans; loans that were set to explode destroying the people but leaving the buildings intact. And the so-called mezzanine tranches of collateralized debt obligations: toxic waste.

We had a way of taking that dirty paper and rendering it clean. A laundering operation. The ratings agencies; that is what they did. They took the paper which was piles of BBB- mortgage obligations and labeled it AAA so that it could be sold to investors on both sides of the Atlantic who were required or who preferred only to take AAA paper and who either chose not to examine what the ratings agencies were doing or to simply trust them entirely unjustifiably.

And we had the third essential element: A fencing operation, taking the stolen goods in effect, the counterfeit paper, and passing it on to the legitimate market. That was carried out by investment and commercial banks.

Professor Phelps says it is not necessary to implicate the financial source in rising housing prices. But I would argue that it is surely sufficient to do so under the circumstances actually observed. I would not dismiss the role of expectation which he emphasizes. But the role of expectation was in coaxing borrowers to take out loans that they could not possibly afford to service, on the assurance and assumption that the rise in price of their house would in two or three years allow them to refinance those loans and not incidentally generating yet another fat fee for the originators.

I want to quote here momentarily a comment on the entities which carried out this operation from the white-caller criminologist William K. Black who, among other things, was the premier analyst of the savings and loans crisis of the United States and a man who was both the architect of the reregulation of that industry in the 1990s and the prosecutions which brought about one thousand people -- insiders in the industry -- to the bar of justice and ultimately to federal prison. He writes:

"the internal controls of large lenders are supposed to include the loan officers, the loan officers' supervisors, loan underwriters, internal appraisers, the credit committee, the senior risk manager, the internal auditor, the audit committee, the chief operations officer, CFO and CEO, the asset/liability committee, and the board of directors. The external controls include the outside auditor, rating agencies and appraisers. A large lender has roughly a dozen overlapping controls that are supposed to stop any practice that leads to a significant number of preventible bad loans. Each of these controls must fail contemporaneously to permit an overall strategy of making tens of thousands of bad loans. The odds against each of those controls failing contemporaneously and independently due to random events are minuscule. The odds that the controls will all fail independently and the failures will continue for five years without being restored are essentially zero. It is impossible [for this to happen] without the active support of senior officers controlling the firm."

Professor Phelps alludes to acts of Congress and to fraud by home buyers. But he misses I believe the salient public and private deeds: de-supervision by regulators and aggressive fraud by lenders, ratings agencies and underwriters, coupled with the extraordinary stupidity of a firm like AIG-FP in writing credit default swaps on all of this bad paper. And later, one might add, the fantastic willingness of the high officials of the United States government -- the Secretary of the Treasury and the Chairman of the Federal Reserve Board, to rescue the banks by guaranteeing their bonds without demanding a change of management or other meaningful reform.

In some ways Professor Phelps' paper, interesting and important though it is, it seems to me to be averting its eyes from this debacle. I have the opposite reaction, watching this cabal effectively engineer a train wreck for the entire capitalist system. It is so fascinating that I simply cannot tear my eyes away.

Let me end, however, on a note of agreement as to where we stand. The problem going forward it s not that we can't stabilize activity. The effect of the automatic stabilizers, the effect of the stimulus package, the effect of the measures that were taken in the heat of the crisis to quell the financial panic; all were clearly felt and we can and we have to a degree stabilized economic activity at a fairly low level and with intolerably high rates of unemployment--certainly in the US and also in Europe.

And to overcome this the economy desperately does need new sources of dynamism and institutions capable of financing this. And I also agree with Professor Phelps -- although I would put the public sector in a stronger role than he would -- that the public sector alone does not have the capacity to handle this problem with the institutional mechanisms that are at hand. So we need something else. And this is why I have advocated -- and frankly I have advocated for decades but now seems to me more urgent than ever -- an infrastructure bank; something for which I helped draft legislation in the U.S. Congress as far back as 1983.

And I now see the need for a return to policy lending institutions of the kind that used to be found in developmental states generally, including the U.S. in the 1940s and 1950s and into the 1960s in France and Japan and elsewhere, precisely to provide the institutional framework and profit incentives to deal with energy, climate change, and other issues, and to create the private sector demand that would generate the jobs that would replace those that we have lost, and effectively to replace the functions which the large private banks are no longer competent to perform.

Thank you.

Transcript by Amy Masarwe.