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OLD IDEAS FOR NEW TIMES

Was Galbraith Right?

The Great Crash, 2008, and Galbraith's Prescience

Stephen Dunn

As the United States and the rest of the developed world lurch toward austerity economics—spending cuts—to deal with the latest financial crises of 2011 and surely 2012, Stephen Dunn says John Kenneth Galbraith offered us one of the most cogent warnings—that these events do repeat—always believing that financial markets were inherently unstable. His lessons went unheeded for the past few decades, but now, the same arguments these nations were given in the 1930s are being repeated. How can this be? We need a good history. Galbraith wrote one.

> Yet, in some respects, the chances of a recurrence of a speculative orgy are rather good. No one can doubt that the American people remain susceptible to the speculative mood—to the conviction that enterprise can be attended by unlimited rewards in which they, individually, were meant to share. A rising market can still bring the reality of riches. This, in turn, can draw more and more people to participate. The government preventatives and controls are ready. In the hands of determined government, their efficacy cannot be doubted. There are, however, a hundred reasons why a government will determine not to use them.
>
> —Galbraith 1955, 206

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The centennial of John Kenneth Galbraith's birth was October 15, 2008. Within two weeks of that milestone, *The Great Crash, 1929* was back on the best-seller lists, as people searched for answers regarding the credit crunch and subprime meltdown of 2008. This paper highlights the similarities of Galbraith's analysis of *The Great Crash, 1929* and the Great Crash of 2008. John Kenneth Galbraith ceaselessly warned of the dangers of financial excess and speculative manias (Dunn 2011). In *The Great Crash, 1929* (1955), *Money* (1975), *A Short History of Financial Euphoria* (1990), and *The Economics of Innocent Fraud* (2004), Galbraith described the common events that precede and accompany particular financial crises, events that are conveniently forgotten by politicians, regulators, and their advisers in the good times, when financial deregulation takes hold.

Galbraith, like Keynes before him, identified the instability of modern capitalism" in terms of the drive to accumulate excessive wealth and the fragile nature of the financial system. As Galbraith remarked in his essay "Financial Genius Is Before the Fall":

> the stock market is inherently unstable, the instability being related to its superbly orchestrated ability to attract people with a promise of effortless riches, give them a taste of such gain, persuade them that it is rewarding their financial acuity (of which they have none) or that of the people who are managing their money (which may be less) and then, usually after overcoming some preliminary setbacks which greatly add to the general state of confidence, destroy these illusions in one mortal thud. (1971, 104)

Galbraith argued that an unfettered, competitive capitalist system, operating on pure free-market principles, was inherently cyclical and unstable, requiring robust regulation and active government.

The Long History of Financial Euphoria

Starting with the tulipmania in the 1630s, bubble after speculative bubble has been erased from the popular memory: the South Sea bubble in the early 1700s; the Mississippi bubble, which caused a stock-market crash in eighteenth-century France; the Florida real-estate bubble in the 1920s; the stock market crash of 1929; the stock market

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crash of 1987; the Nikkei bubble, which began in 1991; the Nasdaq bubble of 2000; and the Great Crash of 2008. These episodes share a theme: a perceived fundamental change in the economy arouses euphoria and heightened expectations of return, leading to excess, fraud, and collapse.[1]

This pattern underpinned the Internet boom and the folly of subprime lending, which characterized housing markets across the global economy in recent years, and which led to financial contagion and the subsequent credit crunch (see Krugman 2008c). An authoritative report by the Bank of England (2008) charts the financial innovation and integration that Galbraith warned would drive financial instability in the Great Crash of 2008. In 2001, UK customer lending was comparable to customer deposits, "but by the first half of 2008 the surplus of lending over deposits—'the customer funding gap'—was £700bn" (Bank of England 2008, 8). This gap was filled by drawing down on international wholesale markets, which consolidated the financial interdependence of the global economic system. This outcome led to an expansion in banks balance sheets and a broader expansion in risk taking. Heightened expectations stimulated a credit boom with a banking system keen to lend money in the desire to cash in on the new situation and secure higher returns. The expansion in business activity has been feeding entrepreneurial and speculative behavior in the banking, financial, and corporate sectors. It has fueled monetary innovation and the new forms of credit and financing structures, such as hedging vehicles, residential mortgage–backed securities, financial derivatives, and credit default swaps. It encouraged Enron, WorldCom, Tyco, Global Crossing—Adelphia-type structures that are contrived to allow executives and firms to take part in the speculative orgy. And it also promoted firm growth and consolidation through merger and acquisition. As Galbraith pointed out in *Economics and the Public Purpose:*

> At all times, however, growth by acquisition is a wholly normal tendency of the planning system. Between 1948 and 1965—years that exclude the frantic mergers of the latter sixties—the 200 largest manufacturing corporations in the United States acquired 2,692 other firms with

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total assets of $21.5 billion. These acquisitions accounted for about one-seventh of all growth in assets by these firms during this period. Excluding the 20 largest manufacturing firms, they accounted for between one-fifth and one-fourth of the growth. During the next three years the 200 largest corporations acquired some 1,200 more firms with additional assets of approximately $30 billion. (1973, 121)

Since then, these trends have only intensified. Global finance and growth through acquisition have exploded exponentially. For example, between 1996 and 2006 the value of global mergers and acquisitions increased from $1trillion to $4 trillion. Similarly, the recent revolution in information technology has driven forward monetary innovation, with the markets in financial futures and interest-rate swaps being more contemporary examples.[2] According to the McKinsey Global Institute, the ratio of global financial assets to annual world output has tripled from 109 percent in 1980 to 316 percent in 2005 (Wolf 2007). By 2005, the global stock of core financial assets had reached $140 trillion.

Galbraith warned of the familiar constants that accompany all crashes—constants that were evident across the collapses of Fannie Mae, Freddie Mac, Bear Stearns, Lehman Brothers, and Merrill Lynch in the United States; constants that also characterize the experience of Northern Rock, the takeover of Bradford and Bingley by Santander, as well as the predicament endured by Halifax–Bank of Scotland (HBOS), Lloyd's, Barclays, and Royal Bank of Scotland (RBS) in the United Kingdom.

Company balance sheets worsen as they take on more borrowing and become weighed down with debt, that is, with high levels of future commitments and payments that they will have to service. With expectations of gain tending to rise with each increase in profits, hedge-financing structures and stock markets tend to become more speculative, as exemplified by rising price-to-earnings ratios. Increasingly, future financial commitments can be met only by new borrowing. The specter of the great crash looms:

Loans which would have been perfectly good were made perfectly foolish by the collapse of the borrower's prices or the markets for his goods or the value of the collateral he had posted. . . . The bankers yielded, as

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> did others, to the blithe, optimistic, and immoral mood of the times but probably not more so. (Galbraith 1955, 196)

As Galbraith, and Keynes before him, warned, such speculation inevitably leads to euphoria or overtrading—"irrational exuberance" in the words of Alan Greenspan—in which rising asset prices encourage speculative excess (see Shiller 2005). As debt accumulates, a situation arises in which debts can only be serviced by the issue of new liabilities. As long as the financial markets are booming, it is possible to sustain low levels of cash inflow by issuing new stocks and securities to finance current liabilities. But when the hangover comes, it hits hard.

Such excess naturally leads to the next phase of when expectations, stock market prices, and financing structures collapse. The conventional measure of whether the stock market is overvalued is the price-to-earnings ratio, which divides stock prices by annual corporate earnings. In 2000, companies in the Standard & Poor's 500 Index were trading at thirty-six times their average earnings over the previous five years. According to Shiller (2005), it was the highest valuation since at least the 1880s. This trend continued until October 2008, when the gap between overly optimistic expectations and the more pedestrian reality was revealed.

Galbraith repeatedly warned of the risks of such financial euphoria.[3] But politicians and players are all too ready to forget that boom and bust is a result of human greed and not something that can be easily designed out of capitalism. When the financial markets slow their expansion, organizations that have covered their future liabilities through issuing more debt are forced to sell assets to meet their liabilities. These "distress" sales cause asset prices to fall, at which point the financial markets, and businesses with exposure to those markets, collapse. The next phase, in which investors try to get their money back out of the markets, naturally gives way to one of panic. This is the essence of the great crash.[4]

At this stage, prices freefall and asset markets break down, unable to cope with the excess of sale orders. Banks collapse, and the fall has a very real knock-on effect on nonfinancial sectors. As Galbraith

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highlighted, both bank failures and the fear of bank failures have the same effect. Both are "forces of compelling power to induce deflation—to contract consumer spending, investment spending, and therewith sales, output, employment, and prices" (Galbraith 1975, 203).

The Fall of the Masters of the Universe

On the eve of Galbraith's hundredth birthday, and following on from the subprime crisis, the Dow and the broader Standard & Poor's 500-stock index both closed down 18 percent for the week, decimating stock options and wealth.[5] The Dow had never had a week that bad in its 133-year history (Bajaj, 2008). The S&P has fallen slightly more on only two occasions before—in 1929 and 1933. Like 1929, 2008 the story was the same—a speculative orgy, crescendo, climax, and crash. Like 1929 the world economy was weakened by "bad distribution of income . . . bad corporate structure . . . bad banking structure . . . dubious state of the foreign balance . . . and poor state of economic intelligence" (Galbraith 1955, 194–202).

Once again the lessons of history were forgotten, and the consequences of deregulation and nonregulation were stark. Wall Street had basically reinvented itself after the repeal of the Glass-Steagall Act in 1999, which had instituted banking controls in the aftermath of the Great Depression.[6] Glass-Steagall banned banks from underwriting securities—mortgage loans were not to be resold. This meant that banks making loans had to do so with the knowledge that they would carry the loan debt over its life. The lender would thus bear the costs, if the borrower defaulted. This provided a strong incentive to avoid bad debtors. Before making loans, lenders would therefore take greater care regarding equity, credit history, and employment prospects. With the repeal of Glass-Steagall, loans could be sold on. Bad debts could be packaged up as good debts and sold on. They could be bundled up into collateral debt obligations (CDOs), structured investment vehicles (SIVs), or other mysterious financial vehicles that circumvented banking regulation.[7] And they could then be sold on

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> to unwary pension funds, local and state revenue funds, individual investors, or other banks domestically or overseas, e.g., Northern Rock in the U.K., who, led on by the high ratings of these complex financial securities by rating agencies, believe these are safe investment vehicles. (Davidson 2008, 2)

This financial mystification underpinned the speculative excess that collapsed when rising defaults on subprime mortgages started to accelerate.[8]

The love of money was once again man's downfall in the Great Crash, 2008. The masters of the universe lost all that they had confidently proclaimed was theirs. As the stock markets continued to fall throughout the summer and fall of 2008, hope of a swift correction receded. The experience of the Great Crash was repeated. As Galbraith remarked:

> The singular feature of the great crash of 1929 was that the worst continued to worsen. What looked one day like the end proved on the next day to have been only the beginning. Nothing could have been more ingeniously designed to maximize the suffering. (1955, 130)

The managers who blew a big hole in Lehman Brothers and Morgan Stanley's balance sheet had earned enormous bonuses in the past. Bankers assume that they get paid for their financial genius, so they believed they got their just deserts, what the market was willing to pay, what the conventional wisdom variously describes as their marginal productivity. The chief executive of Morgan Stanley, John Mack, received a bonus of $40 million in 2006. What is now clear to all, however, is that these bonuses were not tied to increases in productivity or long-term performance. It is also now clear that shareholders failed to exercise control over financial institutions to prevent the enormous expansion in pay in the banking sector (Galbraith 2008). Banking technostructures had run amok with greed, with shareholders and even the bankers themselves believing in their omniscience and omnipotence: "They were impelled to it by the seminal lunacy which has always seized people who are seized in turn with the notion that they can become very rich" (Galbraith 1955, 28).

In 1929, amid the bloodbath, there were buy-backs of stock by investment trusts desperate to prop up their ailing share prices. This

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resulted in a massive loss of liquidity, just when cash was needed most. As Galbraith remarked: "They bought their own worthless stock. Men have been swindled by other men on many occasions. The autumn of 1929 was, perhaps, the first occasion when men succeeded on a large scale in swindling themselves" (1955, 146). Unfortunately, it was not the last time, as business journalist Jeff Randall (2008) documents. In 2006 RBS spent £1 billion ($1.89 billion) buying 54.3 million of its own shares at an average price of £18.37 ($34.72). As late as December that year, it paid £141 million ($266.5 million) for 7.1 million shares (at an average price £19.79 [$37.40]). On October 8, 2008, RBS shares fell by 39 percent to just 90 pence [$1.70]). But the financial genius is before the fall, and RBS was not unique in its wisdom. Even after the credit crunch hit the headlines in September last year, when Northern Rock crumbled, HBOS was busy buying its own shares at inflated prices. In 2006–7, HBOS spent £1.5 billion($2.83 billion, at an average share price of £10.01 [$18.92]). On October 8, 2008, HBOS's shares fell 37 percent to a firesale price of 94 pence ($1.78).

What impelled HBOS to carry on with such a foolish scheme? As Galbraith remarked: "If one has been a financial genius, faith in one's genius does not dissolve at once"(1955, 145). It is thus inevitable that the humiliating journey from hubris to nemesis follows as night follows day: "The cash went out and the stock came in, and prices were not perceptibly affected or not for long. What six months before had been a brilliant financial maneuver was now a form of fiscal self-immolation" (Galbraith 1955, 145).

Similarly the congressional mortification of Dick Fuld, Lehman's former chief executive, on October 6, 2008, and the savaging of Sir Fred Goodwin, the former chief executive of RBS, and Sir Tom McKillop, the former chairman of RBS, by the UK's Treasury Select Committee on February 10, 2009, replayed the experiences that Galbraith chronicled in *The Great Crash.* Lehman's Dick Fuld's humiliation was orchestrated by Henry Waxman (D-CA), whose straightforward question about Fuld's alleged $480 million of earnings—"Is that fair?"—epitomized the great inequalities in wealth that now characterize contemporary, affluent societies. Journalists such as Randall

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(2008) remarked on the sense of déjà vu at the display of outraged inquisitors wiping the floor with Wall Street's masters of the universe. It was all so wonderfully described by Galbraith more than fifty years earlier.

> As the ghosts of numerous tyrants, from Julius Caesar to Benito Mussolini, will testify, people are very hard on those who, having had power, lose it or are destroyed. Then anger at past arrogance is joined with contempt for present weakness. The victim or his corpse is made to suffer all available indignities. Such was the fate of the bankers. They were fair game for Congressional committees, courts, the press, and comedians. (1955, 136)

The Great Crash of 2008 also had its share of larceny. On December 11, 2008, Bernard Madoff, the former chairman of the Nasdaq stock market, was arrested, charged, and ultimately convicted of securities fraud, in one of the biggest fraud cases ever. Madoff's hedge fund ran up $50 billion (£33.5 billion) of fraudulent losses, using money from new investors to pay off existing investors. According to the U.S. attorney's criminal complaint filed in court, it was "basically, a giant Ponzi scheme," a key feature of the analysis of both Minsky and Galbraith. Similarly on February 17, 2009, Sir Allen Stanford was charged with fraudulently selling $8 billion in high-yield certificates of deposit in a scheme that stretched all around the world. This was all reminiscent of the experiences of the interwar period. The experience of Richard Whitney, for example, the former vice president of the New York Stock Exchange (NYSE), in the aftermath of the great crash of 1929, was eerily similar to Madoff's:

> Whitney's dishonesty was a casual, rather juvenile sort. Associates of the day have since explained it as the result of an unfortunate failure to realize that the rules, which were meant for other people, also applied to him. . . . In the twenties the Wall Street firm of Richard Whitney and Company was an unspectacular bond house with a modest business. Whitney apparently felt that it provided insufficient scope for his imagination, and with the passing years he moved on to other enterprises, including the mining of mineral colloids and the market of peat humus in Florida. . . .
>
> Nothing is so voracious as a losing business, and eventually Whitney had three of them. To keep them going, he borrowed from banks,

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> investment bankers, other Stock Exchange members, and heavily from his brother, George Whitney, a partner of J.P. Morgan and Company. The loans so negotiated, from the early twenties on, totaled in the millions, many of them unsecured. As time passed, Whitney was increasingly pressed. When one loan became due he was forced to replace it with another and borrow still more for the interest on those outstanding. Beginning in 1933 his stock exchange firm was insolvent, although this did not become evident for some five years. (Galbraith 1955, 178–79)

Ultimately Whitney's deception and incompetence came to light, just like Madoff's, in a falling market. His company bought between 10,000 and 15,000 shares in a liquor-making company—Distilled Liquors Corporation—at $15 a share in 1933. By the spring of 1934 the stock reached $45, and in January 1935 the firm was listed on the NYSE and then used as further collateral for various loans by Whitney. But Distilled Liquors Corporation was not profitable, and by June 1936 the price had dropped to $11, precipitating a rush of off-loading, which, in order to stem the fall, led to Whitney's seeking to buy and mop up stock to maintain the price:

> All the other investors unloaded on Whitney. At the time of his failure, of the 148,750 shares outstanding, Whitney or his firm owned 137,672. By then the value had dropped to between three and four dollars a share. Mention has been made of the tendency of people in this period to swindle themselves. Whitney, in his effort to support the stock of Distilled Liquors Corporation, unquestionably emerged as the Ponzi of financial self-deception. As the result of his operation, he had all his old debts, many new ones incurred in supporting the stock, all the stock—and the stock was nearly worthless.
>
> As his position become more complex, Richard Whitney resorted increasingly to an expedient which he had been using for several years—that of posting securities belonging to other people which were in his custody as collateral for his loans. By early 1938 he had reached the end of a surprising capacity to borrow money. . . . The rumor spread he was in poor condition. Still, on 8 March, there was a stunned silence on the floor of the Exchange when President Charles R. Gay announced from the rostrum the suspension of Richard Whitney and Company for insolvency. Members were rather more aghast when they learned that Whitney had been in engaged in theft on a large scale for a long period. (Galbraith 1955, 180–81)

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That the arrogant should fall so far is not, however, to be celebrated. It is a reflection of the greed and hubris that financial institutions and those that handle money are steeped in. The reality, however, is mundane—the masters of the universe are far from modern alchemists.[9] As Galbraith coolly observed: "I have never adhered to the view that Wall Street is uniquely evil, just as I have never found it possible to accept with complete confidence the alternative view, rather more palatable in sound financial circles, that it is uniquely wise" (1955, 27). The sooner politicians, regulators, and business journalists realize this, the better.

Are We All Galbraithians Now?

As Galbraith pointed out, anticipating the recent global banking meltdown, banking "runs" precipitate banking collapses. And as has once again been painfully acknowledged, banking collapses matter. This is because "a bank failure is not an ordinary business adventure . . . it has not one but two adverse effects on economic activity: Owners lose their capital and depositors their deposits, and both therewith lose their ability to purchase things. But failure (or for that matter fear of failure) also means a shrinkage in the money supply" (Galbraith 1975, 121). A shrinkage in the money supply means inevitable impacts on demand in the real economy, with the prospect of mass unemployment looming.

In October 2008 the Bank of England (2008) estimated the cost of the global banking collapse to the world's financial firms at $2.8 trillion. The BBC ("World Credit Loss" 2008) estimated that global taxpayers had spent nearly $7 trillion to shore up the world's banks and financial institutions. Such interventions were designed to prevent the financial crisis from overspilling into the real economy; to avoid another Great Depression following another Great Crash; to avoid the reemergence of mass unemployment that plagued the interwar years. Lord Turner, the chair of the Financial Services Authority, which regulates the British banking system, remarked: "There is no chance of a 1929–33 depression. We know the lessons, and we know how to

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stop it happening again" (Graham, 2008, 7). It is not clear, however, that the lessons of history have been fully learned by regulators and politicians.

As already noted above, Galbraith long argued "that the modern economy was subject to severe downward instability, and that this was neither self-limiting nor self-correcting" (1973, 199). This recognition "came in the decade of the thirties. This was the Keynesian Revolution" (ibid.).[10] The way to avoid another Great Depression is for central banks and the International Monetary Fund to act as lender of last resort and for the government to maintain demand by increasing public spending (cf. Davidson 2007; Wray 2007). "As restraint on bank lending during the boom is a basic central-bank function, so serving as a lender of last resort is its main task in the ensuing depression" (Galbraith 1975, 127). Around the world, regulators and central bankers have clearly failed on the first count. But the major fiscal interventions by governments in 2008 and 2009 might just have prevented another Great Depression.

Galbraith argued that there are no automatic mechanisms that ensure that the level of demand will be consistent with high employment: "If business is sufficiently bad, profit prospects sufficiently dim, gloom sufficiently deep, businessmen may not borrow money" (1975, 221). People will not buy all the goods that the economy produces. This is an illustration of the lesson that markets do not always self-correct themselves. In the conventional wisdom, the interest rate brings into balance decisions to save and invest. Free and flexible markets mean that all that is put on sale is bought. And all who want a job get one. But as Galbraith was keen to point out throughout his long life, capitalism and its financial and labor markets have changed. The market does not determine the interest rate. The interaction of the demand and supply of money does not set the various interest rates. Rather it is central bankers, monetary policy committees, and a few large banks that set global financial prices.[11] The level of interest rates reflects the decisions of a few, not the needs of many. And it is the investment decisions of the dominant corporations that largely determine the volume and variability of global spending. Accord-

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ingly, there is no guarantee to ensure that investment spending will be enough to provide enough demand across the global economy to sustain high levels of employment.

Financial markets drive the economy. Banks create money. They create money to make a profit, which oils the wheels and drives demand in the good times. Banks create money by lending to other banks and businesses—businesses that employ people to make and sell things. These jobs create income to spend on other firms' products. But if banks do not lend and consumers do not spend, businesses go to the wall, and demand in the economy dries up. In the fall of 2008, governments across the world started to act by injecting capital into the world's financial institutions, not just to save bankers but to save the real economy. In doing so, they displayed a growing recognition that they must be prepared to spend their way out of trouble (Krugman 2008a, 2008b). They must be prepared for deficits to rise.[12] And they must relearn the lessons of history and forever consign the Washington Consensus—which, in response to the various financial crises, urged raising interest rates, slashing spending, and increasing taxes—to the dustbin of history. Indeed as Galbraith pointed out over fifty years ago, while reflecting on lessons of the Great Depression:

> The conventional wisdom continued to emphasize the balanced budget. Audiences continued to respond to the warning of the disaster which would befall were this rule not respected. The shattering circumstance was the great depression. This led in the United States to a severe reduction in the revenues of the federal government; it also brought pressure for a variety of relief and welfare expenditures. A balanced budget meant increasing tax rates and reducing public expenditure. Viewed in retrospect, it would be hard to imagine a better design for reducing both the private and public demand for goods, aggravating deflation, increasing unemployment, and adding to the general suffering. (1958, 42)

In these global times, such action needs to be coordinated by governments and bankers to make a difference (Galbraith 1973, 338–41). This is an important lesson to learn. This means that a central bank or a monetary policy committee trying to stave off recession by playing with its national interest rate is only really playing with one club—a

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key limitation of the New Consensus view in macroeconomics. This is why in the Great Depression "monetary policy was like a string. You could pull it, though with incalculable results. But you could not shove it at all" (Galbraith 1975, 226). And the string is well and truly broken in a global economy.

To maintain spending, Galbraith recommended that fiscal policy be combined with governments' running deficits. As Galbraith argued:

> The deficit . . . must not be seen as a barrier to effective public action, for by stimulating economic activity it increases earnings and tax receipts. Improvements to the public infrastructure—roads, schools, airports, housing—that are made by those newly employed also add to public wealth and income. Public borrowing can, over time, be a fiscally conservative act. (1996, 40)

This is the way to keep spending high. Galbraith also warned that tax cuts in income, sales, or corporation tax alone will not stimulate the economy, a premise that Gordon Brown should have heeded:

> Tax cuts have little positive business effect. . . . Such tax reduction has little immediate effect on either consumer spending or business investment. If profit prospects are good, a corporate tax cut is not needed to encourage investment. If they are bad, no tax cut will make them good. As practical experience with past tax reduction has shown (and as was duly reported by the Council of Economic Advisors), the initial effect of a cut in personal taxes is overwhelmingly to increase savings. Income so saved does not buy goods, and modern business investment, some special pleading to the contrary, proceeds independently of the supply of savings. Only good economic performance—good employment and demand—will encourage borrowing of these funds. (Galbraith 1979, 29–30)

At the present time, Galbraith would also urge us to reform international monetary institutions to reduce financial market contagion (cf. 1955, 197–99, 203; 1975, 268–75).[13] The conventional wisdom of the Washington Consensus, which has been shown wanting through the repeated mishandling of the Mexican, Thai, Indonesian, and Malaysian financial crises, must be rejected (Krugman 2008c). As Britain's then-prime minister Gordon Brown and France's president Nicolas Sarkozy began to acknowledge in the fall of 2008, it is time we changed the international financial architecture (cf. Stiglitz 2002). The lessons of the postwar period must be relearned:

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> In the years following World War II, the international system worked because American policy was reasonably predictable. . . . Until this arrangement is restored, one thing is certain: the planning systems of several industrial countries will continue, as in the recent past, to stumble from one so-called monetary crisis to the next. (Galbraith, 1973a: 341)[14]

Galbraith (1973a, 270–74) would advise us to reconsider the Keynes plan of Bretton Woods—which was never properly implemented—or Paul Davidson's International Monetary Clearing Union (IMCU) proposal (see Davidson 1994, 252–84).[15] These plans permit each country to pursue full employment without fear of external shocks occurring elsewhere in the global economy.[16]

The Liberal Hour

The centennial of John Kenneth Galbraith's birth came during a week of massive government interventions on both sides of the Atlantic to stem the mounting financial crisis (Dunn 2008b). It came in a year of massive global financial instability. It ensured that Galbraith's analysis of the greed and self-delusion that led to the unraveling of the U.S. stock market and the subsequent Great Depression acquired renewed prominence. Galbraith was once again being read avidly. He was once again a man for our times. Once again, as Paul Krugman observed, the limitations of the conventional wisdom were all too apparent:

> Few economists saw our current crisis coming, but this predictive failure was the least of the field's problems. More important was the profession's blindness to the very possibility of catastrophic failures in a market economy . . . the economics profession went astray because economists, as a group, mistook beauty, clad in impressive-looking mathematics, for truth . . . economists fell back in love with the old, idealized vision of an economy in which rational individuals interact in perfect markets, this time gussied up with fancy equations. . . . Unfortunately, this romanticized and sanitized vision of the economy led most economists to ignore all the things that can go wrong. They turned a blind eye to the limitations of human rationality that often lead to bubbles and busts; to the problems of institutions that run amok; to the imperfections of markets—especially financial markets—that can cause the economy's operating system to undergo sudden,

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unpredictable crashes; and to the dangers created when regulators don't believe in regulation. . . . When it comes to the all-too-human problem of recessions and depressions, economists need to abandon the neat but wrong solution of assuming that everyone is rational and markets work perfectly. (2009)

It should be no surprise that many commentators have sought to return to Galbraith's major works to help explain the major crises of the twenty-first century. Once again the febrile nature of financial markets was reverberating globally. The flurry of action by governments and central banks around the world in the fall of 2008 suggests that the import of Galbraithian analysis is finally recognized by those who inhabit the practical world. With the hundredth anniversary of Galbraith's birth, his economics matter more than ever.

Notes

1. Graham remarks that "since the emergence of modern capitalism some three centuries ago, we have seen more than 30 major financial crises—about one every 10 years. In the U.K., we've had more than 30 years since the last banking rescue (the secondary banks in 1974). One result was a growing belief, now shattered, that banking could be left largely to the private sector" (2008, 28).

2. Soberingly Galbraith warns that what passes as "financial innovation"' is, in reality, "the invention of the wheel over and over again, often in a slightly more unstable version. All financial innovations involve, in one form or another, the creation of debt secured in greater or lesser adequacy by real assets" (1990, 19).

3. Galbraith was no doubt influenced by Keynes, who presciently warned: "Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done" (1936, 159). For an analysis of Keynes's approach to uncertainty and speculation, see Dunn (2008a).

4. From a Galbraithian perspective, as Leathers and Raines point out:

> Shiller's analysis of the "irrational exuberance" of the stock market in the 1990s is incomplete in several critical respects. In regarding institutional investors as influenced by the same factors as non-professional individuals, Shiller . . . ignores Galbraith's observation that those in charge of wealth are assumed to have superior financial intelligence, which they themselves believe. Missing on the psychological side is an explicit recognition of the importance of the speculative mood as being requisite to turning an ordinary bull market in stocks into a speculative bubble. Despite Shiller's attempt to downplay the role of financial euphoria being intensified by the pure instinct of speculation and the vested interest in that euphoria that keeps the bubble

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> inflating, his appropriation of the term "irrational exuberance" is an implicit admission that the psychological factors must lead to euphoric behavior for a bubble to be explained. The Galbraithian factors most prominently missing in Shiller's "structural factors" were the importance of debt in financing the speculation and the role of fraud and manipulation. Failing to adhere to the full Galbraithian analytical framework makes Shiller's analysis of the 1990s stock market bubble rather superficial. (2008, 562)

5. In an ominous portent, Galbraith identified "Thursday, 24 October [as] the day history designates as the beginning of the Crash of 1929" (1971, 115).

6. Davidson (2008) describes the deregulation of U.S. banking activities since the 1970s and the twelve attempts in the past twenty-five years to circumvent Glass-Steagall, which was finally repealed by Congress, with the support of President Bill Clinton, in 1999.

7. As Krugman (2008c, 154–64) highlights, it was the shadow banking system, which evolved a series of all-too-clever investment schemes that bypassed more stringent banking regulations and was de facto unregulated banking, that was a major cause of the financial crash.

8. Davidson highlights how forgetting the lessons of history contributed to the subprime crisis. He also highlights how the study of history can provide lessons in how to address the problem:

> The Roosevelt Administration's handling of the housing insolvency crisis of the 1930s suggests a precedent for dealing with the U.S. housing bubble distress. In 1933, the Home Owners Refinancing Act created the Home Owners' Loan Corporation (HOLC) to refinance homes to prevent foreclosures, and also to bail out mortgage holding banks. The HOLC was a tremendous success, making one million low-interest loans which often extended the pay-off period of the original loan, thereby significantly reducing the monthly payments to amounts that homeowners could afford. In its years of operation, the HOLC not only paid all its bills, but it also made a small profit. Other measures might include setting up a government agency to take non-performing mortgage loans off the books of private balance sheets and therefore remove the threat of insolvency for those who took positions in the mortgage-backed securities after being misled by rating agencies. The result will prevent further sell-offs causing financial distress in all financial markets. (2008, 2–3)

9. As Keynes remarked:

> The vast majority of those who are concerned with the buying and selling of securities know almost nothing whatever about what they are doing. They do not possess even the rudiments of what is required for a valid judgment, and are the prey of hopes and fears easily aroused by transient events and as easily dispelled. This is one of the odd characteristics of the capitalist system under which we live, which, when we are dealing with the real world, is not to be overlooked. . . . [Hence] it may often profit the wisest to anticipate mob psychology rather than the real trend of events, and to ape unreason proleptically. (1930, 323)

10. As noted above, Galbraith was a lifelong Keynesian, but he also updated the analysis to take into account the lessons of circumstance (see Dunn 2011).

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11. As is to be expected, the financial system is not immune to the bimodal view. The dominance of large complex financial institutions (LCFIs) should not be underestimated. The Bank of England identifies the major LCFIs to include "Bank of America, Barclays, BNP Paribas, Citi, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, JPMorgan Chase & Co., Lehman Brothers, Merrill Lynch, Morgan Stanley, RBS, Société Générale and UBS" (2008, 8). Lehman Brothers dropped out of the LCFI group on September 15, 2008, when it filed for bankruptcy.

12. In summarizing the lessons of *The Great Crash, 1929,* Galbraith commented: "A commitment to a balanced budget is always comprehensive. It then meant there could be no increase in government outlays to expand purchasing power and relieve distress. It meant there could be no further tax reduction. But taken literally it meant much more. From 1930 on the budget was far out of balance, and balance, therefore, meant an increase in taxes, a reduction in spending or both" (1955, 200). For a discussion of the continuing importance of deficit financing, see Davidson (2007).

13. Keynes famously warned: "Loose funds may sweep round the world disorganizing all steady business. Nothing is more certain than that the movement of capital funds must be regulated" (1980, 31).

14. As Davidson points out:

> The post-war world has conducted several experiments with the international payments system. For a quarter of a century after the war, there was a fixed, but adjustable, exchange rate system set up under the Bretton Woods Agreement. Since 1973 we have operated under a flexible exchange rate system. The period from 1947 to 1973 was "an era of unprecedented sustained growth in both developed and developing countries. The growth in real gross domestic product per capita in OECD national escalated to 2.6 times that of the interwar period (4.9 per cent annually compared to 1.9 per cent). . . . Free economies experienced unprecedented real economic growth during the Bretton Woods epoch. . . . The dismal post-1973 experience of recurrent unemployment and inflationary crisis, slow growth in OECD countries, and debt-burdened growth and/or stagnation (and even falling real GNP per capita) in developing countries contrasts sharply with the experience during the Bretton Woods period. (1994, 264)

15. Keynes set out a clear outline of what was required, which still resonates:

> We need an instrument of international currency having general acceptability between nations. . . . We need an orderly and agreed upon method of determining the relative exchange values of national currency units. . . . We need a quantum of international currency . . . [which] is governed by the actual current requirements of world commerce, and is capable of deliberate expansion. . . . We need a method by which the surplus credit balances arising from international trade, which the recipient does not wish to employ, can be set to work . . . without detriment to the liquidity of these balances. (1980, 168)

16. Keynes argued for a new international system that shifted the burden of adjustment toward surplus countries: "The object of the new system must be to require the chief initiative from the creditor countries, whilst maintaining enough discipline in the debtor countries to prevent them from exploiting the new ease allowed them in living profligately beyond their means" (1980, 30).

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